Answers

1 (a) Consolidated Balance Sheet of Holding as at 31 March 2002

	$000	$000
Assets		
Non-current assets		
Property, plant and equipment (w (i))		32,300
Consolidated goodwill (1,800 – 300) (w (iv))		1,500
		33,800
Current assets		
Inventories (w (ii))	11,000	
Trade receivables (3,600 + 2,300 – 700)	5,200	
Cash and bank	150	16,350
Total assets		50,150
Equity and Liabilities		
Capital and reserves		
Equity shares of 25 cents each		5,000
Reserves		
Accumulated profits (w (iii))		25,850
		30,850
Minority interest (w (vi))		2,400
Non-current liabilities		
12% Loan note (w (v))		6,400
Current liabilities		
Trade payables (6,250 + 3,700 – 700)	9,250	
Operating overdraft	1,250	10,500
Total equity and Liabilities		50,150

Workings (Note: all figures in $000)

There are several methods of preparing consolidated working schedules, no one method is considered superior to another. For illustration alternative methods are shown for the accumulated profits, consolidated goodwill and minority interest.

(i) Property, plant and equipment

Balance from question – Holding	12,000
– Sandham	12,200
Investment property (see below)	5,400
Deduct depreciation of property (5,400/18 years)	(300)
Increase in fair value of plant	4,000
Deduct additional depreciation (25% x 4,000 for one year)	(1,000)
	32,300

Although under IAS 40 the investment property can continue to be shown as such in Holding's entity financial statements, when it is let to a member of the group it must be classed as an owner occupied property. It would be transferred at its carrying value at the date of the change of use ($5·4 million) and then depreciated over its remaining life (18 years). This reclassification would also require the current year's increase in the value of the property $0·06 million ($6 million – $5·4 million) to be removed from the accumulated profits of Holding. Note: surpluses under the fair value model in IAS 40 are included income.

(ii) Inventories

Amount per question (7,800 + 3,450)	11,250
Unrealised profit in inventory (3,000 x 20%/120% x 1/2)	(250)
	11,000

(iii) Accumulated profits

	Holding	Sandham		Holding	Sandham
Depreciation investment property (w (i))	300		b/f	27,150	5,000
Transfer re property, plant and equipment	600				
Depreciation of plant (4,000/4 years)		1,000	Interest adjustment		200
Unrealised profit in inventory (w (ii))	250		Post acq profits	150	
Minority interest (25% x 4,200)		1,050			
Pre-acq profit (75% x 4,000)		3,000			
Post-acq profit (75% x (4,200 – 4,000))		150			
Goodwill amortisation (w (iv))	300				
Balance c/f	25,850				
	27,300	5,200		27,300	5,200

Alternative presentation:

Holding per question			27,150
Transfer re property, plant and equipment			(600)
Depreciation investment property (w (i))			(300)
Unrealised profit in inventory (w (ii))			(250)
Goodwill amortisation (w (iv))			(300)
Post acquisition reserves of Sandham:			
Per question	5,000		
Interest adjustment	200		
Additional depreciation of plant	(1,000)		
Reserves at acquisition	(4,000)		
	200	x 75%	150
Accumulated consolidated reserves			25,850

(iv) Cost of control

Investments at cost	8,850	Equity shares (75% x 2,000)	1,500
		Pre-acq profit (w (iii))	3,000
		Fair value of plant (75% x 4,000)	3,000
		Fair value of loan (75% x 600) (w (v))	(450)
		Goodwill	1,800
	8,850		8,850

Alternative presentation:

Investment at cost – equity			8,850
Less equity shares	2,000		
pre-acq profits	4,000		
fair value adjustments – plant	4,000		
– loan	(600)		
	9,400	x 75%	(7,050)
Consolidated goodwill			1,800

Goodwill of $1,800 is depreciated over 6 years; for one year = $300

(v) The value of the loan note at the date of acquisition of $6 million would be increased by the fair value adjustment of $600,000. In the year to 31 March 2002 the interest adjustment of $200,000 would be deducted from this value to give a carrying value of $6·4 million.

(vi) Minority interest

Balance c/f	2,400	Equity shares (25% x 2,000)	500
		Fair value of plant (25% x 4,000)	1,000
		Fair value of loan (25% x 600) (w (v))	(150)
		Accumulated profit (w (iii))	1,050
	2,400		2,400

Alternative presentation:

Equity shares	2,000		
Accumulated profits			
Per question	5,000		
Interest adjustment	200		
Additional depreciation of plant	(1,000)		
Fair value – plant	4,000		
– loan	(600)		
	9,600	x 25%	2,400

(b) (i) The recognition of brands (in entity financial statements) is governed by IAS 38 'Intangible Assets'. Intangible assets can only be recognised where they embody probable future economic benefits that will flow to the enterprise, and the cost of the assets can be measured reliably. Note this only applies to the cost and not to a valuation of such an asset. Furthermore IAS 38 specifies that internally generated brands (and similar items) should not be recognised as assets. Applying this would mean that Sandham could not have recognised its brand despite its value being supported by an independent source.

(ii) Recognition of intangible assets as part of an acquisition is more complex. IAS 22 'Business Combinations' requires all of a subsidiary's identifiable assets and liabilities to be recognised (at fair value) on the consolidated balance sheet at the date of acquisition. Guidelines for the recognition of intangible assets states that their fair values may be determined by an active market or 'on a basis that reflects an amount that the enterprise would have paid for the asset in an arm's length transaction'. IAS 38 specifically says that certain enterprises have developed techniques for valuing brands and similar items and these techniques can form the basis of a fair valuation of a brand on acquisition.

The problem in this question is that it appears the management of Holding were not aware of the brand (or at least its valuation) at the date of acquisition and thus did not include it in its consolidated balance sheet. However, IAS 22 does allow assets and liabilities that were not recognised at the time of acquisition to be subsequently recognised where additional evidence becomes available. This may occur up to the end of the first full accounting period commencing after the acquisition. Applying this means that it may be possible for Holding to recognise the brand in the consolidated financial statements to 31 March 2002.

However, a further issue must be considered. IAS 22 limits the amount that may be recognised for an intangible asset, whose value is determined other than by reference to an active market, to a value that does not create negative goodwill. In this case it means that although there is a valuation of \$3 million for the brand, Holding can only recognise \$1·8 million of this (i.e. an amount equal to the goodwill on acquisition). Any greater amount than \$1·8 million would create negative goodwill and this is not permitted.

The effect of recognising the brand is that it would replace the goodwill figure. The consequences of this are that the brand would be depreciated over 30 years, whereas the goodwill was depreciated over six years. IAS 38 further requires that where the estimated life of an intangible asset is greater than 20 years, the enterprise must conduct an annual impairment review of the asset's value.

2 (a) Finbush Income Statement – Year to 31 March 2002

	\$000
Sales revenue (137,500 – 3,200 (w (i)))	134,300
Cost of sales (w (ii))	(93,400)
Gross profit	40,900
Operating expenses	(12,400)
Loan interest (600 + 600 accrued)	(1,200)
Imputed investment income (w (i))	960
Profit from ordinary activities	28,260
Tax on ordinary activities (3,000 + 600 re extraordinary item – 190 + 890 deferred tax (w (iv)))	(4,300)
Net profit from ordinary activities	23,960
Extraordinary item – cost of natural disaster (\$3 million less tax at 20%)	(2,400)
Net profit for the period	21,560

(b) Finbush – Balance Sheet as at 31 March 2002

	$000	$000
Assets		
Non-current assets		
Property, plant and equipment (w (v))		86,400
Investment (8,000 – 2,240 (w (i)))		5,760
		92,160
Current Assets		
Inventories	12,400	
Trade receivables	8,300	20,700
Total Assets		112,860
Equity and Liabilities		
Capital and reserves		
Equity shares of $1 each		50,000
Reserves		
Accumulated profits		21,560
		71,560
Non-current liabilities		
6% Loan note	20,000	
Deferred tax (w (iv))	4,000	
Environmental provision (w (iii))	5,000	29,000
Current Liabilities		
Trade payables	6,700	
Accrued finance costs	600	
Bank overdraft	2,000	
Income taxes payable (w (iv))	3,000	12,300
		112,860

(c) Finbush – Statement of Changes in Equity – Year to 31 March 2002

	$000 Share capital	$000 Accumulated profits	$000 Total
B/f 1 April 2001	50,000	8,400	58,400
Prior period adjustments – depreciation of leasehold (w (iii))		(8,000)	(8,000)
– inventory (w (ii))		800	800
Net profit for the period		21,560	21,560
Equity dividends – paid		(1,200)	(1,200)
C/f 31 March 2002	50,000	21,560	71,560

Workings

(i) Sales revenue

IAS 18 'Revenue' requires the substance of transactions to be recorded. The interest free loan has been granted on the basis of the high amount of business from the major customer. The substance of this is that it is a financing arrangement or deferred income. The standard requires that an imputed rate of interest is applied to the loan and the sales are reduced by the deferred consideration. As the loan is for three years and normal interest rates on this type of loan would be 12%, compound interest of $3·2 million ($8 million x 0·4 – per question) must be accounted for as follows.

	Dr $000	Cr $000
Sales revenues	3,200	
Income statement – imputed interest ($8 million x 12%)		960
Investment (balance)		2,240
	3,200	3,200

(ii) Cost of sales

	$000
Per question	85,000
Earthquake cost treated as extraordinary	(3,000)
Depreciation (w (iii))	10,600
Prior period adjustment – inventory (9,000 – 8,200 see below)	800
	93,400

Under IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies', a change in the method of valuing inventory constitutes a change of accounting policy. The current year's results must be reported on the basis that the new policy has always been in force. This means the cost of sales must be based on opening inventory value of $9 million instead of the current figure of $8·2 million. This also creates a prior period adjustment of $800,000.

(iii) Depreciation/amortisation:

			$000
Leasehold (60,000/30 years – see below)			2,000
Mine ((10,000 + 5,000) x 1·6/20 – see below)			1,200
Plant	– newly acquired (6,000 x 20% x 6/12)	600	
	– remaining ((45,000 – 6,000 above – 5,000 fully depreciated) x 20%	6,800	7,400
			10,600

IAS 16 'Property, Plant and Equipment' requires assets to be depreciated/amortised over their useful lives by an appropriate manner. The fact that an asset may have gone up in value does not negate this requirement. Therefore the leasehold must be depreciated over 30 years not the last 10 years. This would create a depreciation charge of $2 million in the current year and a prior adjustment of $8 million, being four years accumulated depreciation.

IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' requires environmental provisions that meet the definition of a liability to be provided for in full at the date they become a liability. In this case a liability is created when mining commences, therefore the whole of the site restoration costs of $5 million must be provided for on 1 April 2001. However the whole of the provision is not written off to the income statement immediately, instead it is added to the cost of the relevant asset (the mine) and the asset is then depreciated as appropriate. In the case of a mine it would be reasonable to base the depreciation on the amount of material extracted compared to the total estimated yield (1·6 out of 20 billion tonnes), rather than on a straight-line basis over its 10 year life.

(iv) Tax/deferred tax
The amount of $190,000 credited to deferred tax is an overprovision of income tax in the previous year. This should be credited to the income statement in the current period. The adjusted opening balance on deferred tax would then be $3,110,000 ($3·3 million per question – $190,000 overprovision). As the closing deferred tax balance has to be $4 million, a charge of $890,000 to the income statement is required.

(v) Property, plant and equipment

	$000
Leasehold (60,000 – 2,000 – 8,000 prior period adjustment)	50,000
Mine (10,000 + 5,000 – 1,200)	13,800
Plant (45,000 – 7,400 – 15,000)	22,600
	86,400

(d) The situation in the question raises several problem areas. The principal problem is that where local statutes or regulations conflict with those of an International Accounting Standard, it is difficult if not impossible to comply with both. Where this has occurred in the past regulatory bodies have either changed local accounting standards or lobbied for changes in statutes. IAS 1 'Presentation of Financial Statements' says that financial statements that comply with IASs should state that fact, but financial statements should not be described as complying with IASs unless they comply with all IASs. Non-compliance cannot be rectified by disclosure or explanatory material. Thus the directors' suggestion of disclosing the effect that applying IASs would have made is not a solution.

A possible solution is to prepare two sets of financial statements. The first complying with local statutes and regulations to be used for domestic filing regulations. A second set could comply with IASs and be used for the purpose of the cross-border listing.

Another interesting issue is that the directors of Finbush believe that the local regulations give a fairer presentation of the financial statements. There are extremely rare circumstances where management may decide that compliance with a requirement of an IAS would be misleading. There is a remote possibility that this is the case here. Thus if the directors depart from IAS 32 on the basis that it gives a fair presentation to do so, then it can be argued that they are complying with IASs. If this is the course of action the directors take, the following disclosures are required:

- that management has concluded that the financial statements (as presented) fairly present the company's financial position, financial performance and cash flows;
- that the company has departed from an International Accounting Standard in order to achieve a fair presentation;
- the name of the Standard from which it has departed and the treatment the Standard would require;
- why it has departed from the Standard;
- the reasons why compliance with the Standard would be misleading; and
- the financial impact of the departure.

3 (a) Defined contribution plans:

These are relatively straightforward plans that do not present any real problems. Normally under such plans employers and employees contribute specified amounts (often based on a percentage of salaries) to a fund. The fund is often managed by a third party. The amount of benefits an employee will eventually receive will depend upon the investment performance of the fund's assets. Thus in such plans the actuarial and investment risks rest with the employee. The accounting treatment of such plans is also straightforward. The cost of the plan to the employer is charged to the income statement on a annual basis and (normally) there is no further on-going liability. This treatment applies the matching concept in that the cost of the post-retirement benefits is charged to the period in which the employer received the benefits from its employee. Post-retirement benefits are effectively a form of deferred remuneration.

Defined benefit plans:

These are sometimes referred to as final salary schemes because the benefits that an employee will receive from such plans are related to his/her salary at the date they retire. For example, employees may receive a pension of 1/60th of their final year's salary for each year they have worked for the company. The majority of defined benefit plans are funded i.e. the employer makes cash contributions to a separate fund. The principles of defined benefits plans are simple, the employer has an obligation to pay contracted retirement benefits when an employee eventually retires. This represents a liability. In order to meet this liability the employer makes contributions to a fund to build up assets that will be sufficient to meet the contracted liability. The problems lie in the uncertainty of the future, no one knows what the eventual liability will be, nor how well the fund's investments will perform. To help with these estimates employers make use of actuaries who advise the employers on the cash contribution required to the fund. Ideally the intention is that the fund and the value of the retirement liabilities should be matched, however, the estimates required are complex and based on many variable estimates e.g. the future level of salaries and investment gains and losses of the fund. Because of these problems regular actuarial estimates are required and these may reveal fund deficits (where the value of the assets is less than the post-retirement liability) or surpluses. Experience surpluses or deficits will give rise to a revision of the planned future funding. This may be in the form of requiring additional contributions or a reduction or suspension (contribution holiday) of contributions. Under such plans the actuarial risk (that benefits will cost more than expected) and the investment risk (that the assets invested will be insufficient to meet the expected benefits) fall on the company. Also the liability may be negative, in effect an asset.

Accounting treatment:

The objective of the new standard is that the financial statements should reflect and adequately disclose the fair value of the assets and liabilities arising from a company's post-retirement plan and that the cost of providing retirement benefits is charged to the accounting periods in which the benefits are earned by the employees.

In the balance sheet:

An amount should be recognised as a defined benefit liability where the present value of the defined benefit obligation is in excess of the fair value of the plan's assets (in an unfunded scheme there would be no plan assets). This liability will be increased by any unrecognised net actuarial gains (see below).

Where an actuarial gain or loss arises (caused by actual events differing from forecast events), IAS 19 requires a '10% corridor test' to be made. If the gain or loss is within 10% of the greater of the plan's gross assets or gross liabilities then the gain or loss may be recognised (in the income statement) but it is not required to be. Where the gain or loss exceeds the 10% corridor then the excess has to be recognised in the income statement over the average expected remaining service lives of the employees. The intention of this requirement is to prevent large fluctuations in reported profits due to volatile movements in the actuarial assumptions.

The following items should be recognised in the income statement:

- current service cost (the increase in the plan's liability due to the current year's service from employees)
- interest cost (this is an imputed cost caused by the 'unwinding' of the discounting process i.e. the liabilities are one year closer to settlement)
- the expected return on plan assets (the increase in the market value of the plan's assets)
- actuarial gains and losses recognised under the 10% corridor rule
- costs of settlements or curtailments.

(b) Income statement

	$000
Current service cost	160
Interest cost (10% x 1,500)	150
Expected return on plan's assets (12% x 1,500)	(180)
Recognised actuarial gain in year	(5)
Post-retirement cost in income statement	125

Balance sheet

	$000
Present value of obligation	1,750
Fair value of plan's assets	(1,650)
	100
Unrecognised actuarial gains (see below)	140
Liability recognised in balance sheet	240

Movement in unrecognised actuarial gain	
Unrecognised actuarial gain at 1 April 2001	200
Actuarial gain on plan assets (w (i))	10
Actuarial loss on plan liability (w (i))	(65)
Loss recognised (w (ii))	(5)
Unrecognised actuarial gain 31 March 2002	140

Workings:

(i)

	Plan assets $000	Plan liabilities $000
Balance 1 April 2001	1,500	1,500
Current service cost		160
Interest		150
Expected return	180	
Contributions paid	85	
Benefits paid to employees	(125)	(125)
Actuarial gain (balance)	10	
Actuarial loss (balance)		65
Balance 31 March 2002	1,650	1,750

(ii)

Net cumulative unrecognised actuarial gains at 1 April 2001	200	
10% corridor (10% x 1,500)	150	
Excess	50	/ 10 years = $5,000 actuarial gain to be recognised.

4 (a) (i) The objectives of IAS 14 (revised) 'Segment Reporting' is for users of financial statements to obtain a better understanding of the past performance of an entity by being able to better assess the entity's risks and returns as they relate to the individual segments of the business. The provision of segment information enables a more informed judgement about the enterprise as a whole. The aggregated information contained in consolidated financial statements 'hides' information about the individual segments. For example the loss making activities of one segment may be hidden by the profits of another segment. A similar point could be made in relation to liquidity positions, levels of gearing, segment cash flows and future growth prospects. Diversified operations represent distinct products or markets with distinct risks and returns and it would be impossible to assess the effect these individual segments have had on the past performance and their likely effect on the future performance without the disclosure of segment information.

(ii) A business segment is a distinguishable component of an enterprise which provides an individual product or service (or group thereof) that is subject to different risks and returns from the other business segments. In deciding on individual segments consideration should be given to the nature of the product and production processes, the type of customer, the product distribution methods and if appropriate the nature of the regulatory environment.

A geographical segment is a distinguishable component of an enterprise that provides products or services within a particular economic environment that is subject to risks and returns that are different from the other geographical segments. Deciding factors include similarity of economic or political conditions, physical proximity, special risks associated with a particular area such as exchange control regulations or currency risks. Geographical segments may be based on the location of their operations (by source) or on the location of their markets (by destination).

A reportable segment is a business or geographical segment that contributes 10% or more of the enterprise's total figures for:

- sales revenues
- results in terms of profits or losses (profit making segments are aggregated and individual profit making segments are compared to this aggregated figure. A similar exercise is performed for loss making segments)
- total assets.

If the aggregate of segments satisfying the 10% thresholds is less than 75% of the enterprise's total figures, then smaller segments become reportable segments until the 75% level is reached or exceeded.

(iii) Problem areas with segment reporting:

The definition of a reportable segment can cause problems. Although there is a good deal of guidance in the standard, ultimately it is the directors who decide what the reportable segments will be and the basis on which they are reported (i.e. which will be the primary reporting format and what secondary information is then disclosed as a consequence). Inevitably this discretion can make inter-firm segment comparisons difficult or invalid.

The process of preparing segment information involves the question of cost apportionment and allocation. Such apportionment should only be done if there is a 'reasonable basis' on which to base it. Where management feels that it would be difficult to arrive at a reasonable basis such costs should not be apportioned and instead treated as unallocated reconciling items. Again this is an area that may lead to inconsistencies.

Interest costs also represent a problem. Most companies' interest costs are based on an overall financial strategy that is not related to individual segments. Thus the standard says that segment results should normally exclude interest charges. A similar argument is levelled at interest earned. Where interest is a fundamental part of a segment's results e.g. in the financial sector, it should be included in the segment's results.

Taxation and extraordinary items are not considered to be a segment expense.

There is also a problem with the definition of net assets. This problem is linked to the allocation of interest. Where a company's segment results do not include interest, then for the sake of 'symmetry', interest bearing assets and liabilities should not be included in segment net assets.

Special consideration of the above point should be given to activities in the financial sector i.e. interest is usually included in segment results and the corresponding assets and liabilities are also included in segment net assets.

Segments may trade with other segments (on commercial or non-commercial terms), IAS 14 (revised) requires segment reports to include details of inter-segment trading and the disclosure of transfer pricing policies. It is hoped this will allow analysts to assess properly the effect on a segment's results of inter-segment trading.

(b) The engineering, textiles and chemicals activities are well in excess of the 10% size threshold and are therefore reportable segments. The cumulative total of these three segments is only 65% of Portico's overall figures and the Standard says that segment information must constitute no less than 75% of the total consolidated (or enterprise) revenues. Thus both the travel agency and house building activities would have to be treated as separate segments. The remaining four smaller activities should not be aggregated or combined with another segment as the question says that they are not similar to any other segment, therefore they would be treated as unallocated reconciling items.

The utility costs in item (i) should be allocated to the individual segments as there is sufficient evidence (the invoices) on which to make an accurate allocation of costs.

The research and development expenditure in (ii) is a central overhead expense that is allocated to segments on the basis of proportional segment revenues for internal accounting purposes. Although there is a presumption that internal methods of allocation are reasonable IAS 14 (revised) says that this is not necessarily the case. Prima facia there is no obvious reason why proportional segment revenue is a measure of the proportional benefit each segment receives from the research and development activity. Thus, in this case, there is a strong argument for the research and development expenses to be treated as an unallocated reconciling item.

The leased assets and related items are an interesting area. The assets and related depreciation would certainly qualify for inclusion in the appropriate classification of segment information (i.e. in the segment assets and as part of segment results), however the leasing obligation and related interest costs are a different matter. For the purpose of consistency, the leasing obligations should be seen as part of the overall financing strategy of Portico and not related to individual segments. The logic of this is that the company's other assets may be financed by other forms of borrowing, but those liabilities and finance costs are not (normally) allocated to segments. Therefore both the leasing obligations and the related interest costs should be treated as unallocated reconciling items.

5 Omsk auditor's report

(a) ... financial statements are the responsibility of the Company's management.

(i) International Accounting Standards determine the form, content and disclosures in the financial statements. Not all of the documents included in the company's annual report are necessarily fully audited, this is why there is a reference in the opening paragraph to the financial statements that have been audited, to distinguish them from parts of the report that have not.

(ii) The report states that the financial statements are prepared in accordance with International Accounting Standards. International Accounting Standards are laid down by an international body made up of accountants, academics and users of financial statements – the International Accounting Standards Board. Financial statements generally comprise income statements, balance sheets, statements of changes in equity and associated notes.

(iii) The auditor's report is addressed to shareholders. Directors (or management), on behalf of shareholders, generally appoint auditors to report to the shareholders on the financial statements prepared by them for the benefit of shareholders. It is an important principle of auditing that auditors are independent of directors (or management); only in this way can they lend credibility to the financial statements.

(iv) Auditors are not generally permitted to prepare the financial statements of companies which they audit (otherwise they would be reporting on their own work), but they sometimes assist companies, particularly smaller companies who do not necessarily have the technical know-how in-house, for the preparation of the final financial statements.

(v) In many countries, legislation dictates that the responsibility for financial statements rests with the directors regardless of who actually prepares them.

(b) International Standards on Auditing

(i) International Standards on Auditing (ISAs) are promulgated by the International Federation of Accountants which is representative of the accounting profession worldwide. The International Auditing Practices Committee prepares these standards.

(ii) ISAs set out how an audit should be performed in terms of basic principles and essential procedures together with related guidance and explanatory material.

(iii) These standards (like International Accounting Standards) are sometimes adopted in their entirety by countries that do not have the resources to develop their own standards, and all major auditing standard setters follow ISAs in developing their own guidance and seek to influence the development of ISAs.

(iv) ISAs ensure that a consistent, reputable audit approach is adopted by those who issue audit reports such as these and the wording of the report itself is taken from ISA 700 'The Auditor's Report on Financial Statements'.

(v) Most large firms of auditors, and many small firms, use ISAs in addition to or instead of national standards, depending on circumstances. The use of ISAs helps to ensure the transparency and comparability of audit, and thus improves the credibility of financial statements which is important for the proper functioning of the capital markets.

(c) ... reasonable assurance

(i) Reasonable assurance is a difficult term to define. It does not, and is not intended, to convey a degree of precision, but rather to indicate that the auditor has used his or her judgement to assess whether the financial statements give a true and fair view.

(ii) Reasonable assurance relates to both the quantitative and qualitative elements in the financial statements and indicates that the auditor, has, in his judgement, obtained 'sufficient appropriate' audit evidence to support the audit opinion. The requirement to obtain sufficient, appropriate evidence is a requirement of ISA 500 'Audit Evidence'.

(iii) Professional opinions differ, and what constitutes reasonable assurance to one auditor may not do so to another. Equally, the nature and extent of audit evidence obtained by one auditor might be quite different to that obtained by another, but they might both agree that the evidence obtained by the other auditor provided reasonable assurance.

(iv) Auditing is not without cost and auditors cannot be expected to audit above and beyond what is required to give reasonable assurance, the cost would be too great. Absolute assurance would not only be prohibitively expensive, it would also be virtually impossible to obtain. Auditors do not certify that the company is a going concern, for example.

(v) Reasonable assurance provided by auditors can be compared to opinions given by other professional experts; such experts give opinions, not guarantees' and it is therefore for interested parties (such as shareholders) to form their own conclusions on the subject matter in the context of all the circumstances, not just the audit report.

(d) ...free of material misstatement

(i) Materiality is a concept that is fundamental to both auditors and preparers of financial statements. It is quite impossible for the financial statements to be '100% accurate', for two reasons. Firstly, many of the figures in the financial statements depend on the judgement and estimates of directors. It is necessary to estimate the useful life of an asset, for example, in order to spread the cost over the period during which the asset generates revenue (the valuation of properties is similarly subject to change). Estimates have to be revised in the light of experience. Secondly, it is simply not cost-effective to try and trace every 'missing penny' in a large organisation and certain items simply have to be written off. The cost of dealing with them would greatly outweigh the benefits.

(ii) A material matter is one that would reasonably influence the economic judgements of a user of financial statements.

(iii) Materiality has both quantitative and qualitative aspect. This is why the term 'misstatement' is used. So the absence of a particularly important disclosure would be just as material as an 'incorrect' figure. The definition of materiality, which is derived from accounting and auditing standards, has to be translated by auditors into workable form.

(iv) Materiality is usually calculated as a percentage of profits, assets or gross margins. This figure is then used in selecting samples for testing, and for interpreting the results of testing. Material errors in the financial statements must be adjusted, if a qualified audit report is not to be given. Immaterial errors are collated, and if, collectively, they are material to the financial statements, some adjustment must be made.

(e) ... true and fair view

(i) This is also a difficult term to define. It is used in the UK and in Europe, the US 'equivalent' in common use is 'present fairly in all material respects'. The two terms can both be used under ISAs.

(ii) Truth implies accuracy and correctness. Fairness implies a broader more balanced view. Financial statements should be free from bias and should not be prepared in an overly good light, nor in an overly poor light. Much academic work has been performed on the meaning of truth and fairness, but no precise definition is available in accounting or auditing standards.

(iii) Truth and fairness is taken to apply to the financial statements as a whole. It is possible (although unusual) for a set of financial statements to be prepared in accordance with accounting standards (and national legislation), but for them to fail to give a true and fair view. A much more common situation is where the financial statements are not prepared in accordance with accounting standards, in which case, unless there is a very good reason for it (the 'true and fair override'), the financial statements cannot give a true and fair view. This means that true and fair means something more than mere compliance with standards or regulations.

(iv) Where auditors are unable to form an opinion on the truth and fairness of financial statements, either because of a lack of audit evidence, or because there is something 'wrong' with the financial statements, they are required to state this in their audit report and to give an explanation. In most cases, auditors state that 'except for' the relevant matter, the financial statements give a true and fair view. In rare cases, auditors state that either they are unable to form an opinion (because of lack of evidence), or that the financial statements do not give a true and fair view.

6 Tomsk

(a) Internal control objectives

(i) Controls should be in place to ensure that all leases entered into are trapped by the accounting system, that only authorised leases are entered into and that the leases are properly classified as operating or finance leases.

(ii) Controls should ensure that lease commitments are promptly recorded at the correct amount in the correct accounting period, by means of general ledger codes which distinguish between operating and finance leases.

(iii) The controls noted in (i) and (ii) above will often be automated computer controls, but there must be some level of periodic human review of computer output in order to ensure that the computer programming is achieving the desired control objectives. This type of review may be performed by internal auditors.

(iv) Controls should also ensure, periodically, that leased assets are in existence, by means of physical verification. Many systems involve some form of bar coding in conjunction with an asset register in which those with responsibility for assets are asked to confirm that assets are still in existence and being used.

(v) Controls should ensure that leased assets included on the balance sheet (finance leases) are accurately depreciated at an appropriate rate.

(vi) There should also be controls over the production of the final financial statements to ensure that the appropriate figures are correctly extracted from schedules and ledgers and that there is proper disclosure of the figures in the financial statements. This is usually achieved by means of a hierarchy of approvals.

(b) Leases – audit of figures and disclosures

(i) In order to audit the income statement charge for leases, it will be necessary to obtain an understanding of the internal controls exercised by Tomsk over leases, and to perform tests on their operation. If those tests show that controls are being exercised properly over the period under review, it will be possible to reduce the level of substantive testing on the income statement entries.

(ii) Substantive tests on the entries in the income statement might include:

(1) Selection of a representative sample of authorisations for new leases which should be traced through the system from the lease documentation, through to the recording of the receipt of the asset, and from there to the entries in the daybooks, ledgers, schedules supporting the financial statements and the financial statements themselves (to ensure completeness of the recording of finance lease interest and operating lease charges).

(2) The test above can also be performed in the opposite direction in order to ensure that recorded leases exist.

(3) Inspection of, for example, vehicle taxation documentation (or similar) to provide evidence that the asset exists and is under the control of Tomsk at the balance sheet date. An alternative might be to request sight of a sample of vehicles themselves.

(4) Inspection of a sample of lease documents to ensure that they all fulfil the requirements for operating or finance leases.

(5) Inspection of a sample of documentation relating to the disposal of the asset once the lease term has ended in order to establish whether the assets are being returned to the lease company or whether the assets are being sold to employees or their families, which would be evidence that the leases should be accounted for as finance leases.

(6) Inspection of a sample of leases entered into around the period-end to ensure that they have been accounted for in the correct accounting period and in the correct manner.

(7) The performance of analytical procedures on the operating lease charges, and finance lease interest payments, on, for example, a month by month basis, by comparison with prior periods, budgets and the number of salesmen.

(8) Obtaining management representations to the effect that management consider the leases to be operating or finance leases respectively.

(9) Obtain a schedule of balance sheet entries and check its arithmetical accuracy and correct extraction. Ensure, by manual calculations, that the outstanding capital and interest at the end of the period have been correctly calculated.

(10) Ensure that the required IAS 17 disclosures have been made. Commitments for minimum lease payments under non-cancellable operating leases with a term of more than one year should be disclosed in summary form giving the amounts and periods in which the payment will become due (within 1 year, 2 – 5 years and over 5 years). For finance leases, the total minimum lease payments at their balance sheet and their present value should be disclosed as for operating leases (within 1 year, 2 – 5 years etc.).

(11) If the firm considers that the operating leases should be accounted for as finance leases, it should insist on appropriate adjustments being made. If adjustments are not made, the firm should issue a qualified audit report.

(c) Accounting treatment for leases – problems for auditors

(i) Leases are important because the incorrect accounting treatment can lead to a loss (a charge in the income statement) being turned into an asset, where operating leases are treated as finance leases. This problem is mitigated by the fact that depreciation is charged on capitalised leases but the problem remains. This can affect the gearing of a company, the return on capital employed, earnings per share and a number of other key accounting ratios. Where finance leases are incorrectly accounted for as operating leases, similar problems arise. It is recognised that many leasing contracts are engineered, in practice, to suit the accounting requirements of the company concerned, and in many cases, assets are kept off the balance sheet where they should be shown on the balance sheet, as may be the case here.

(ii) There have been a number of papers issued by accounting standard-setters on this subject over the years, including the IASB. One suggestion as to how to deal with the problems is to require all leases for over, say, one year to be accounted for as finance leases.

(iii) As auditor of Tomsk, the firm appears likely to be pressurised into giving an unqualified audit report where a qualified audit report may be necessary. Whilst accounting standards and other documents require that the substance of transactions be reported, rather than merely their legal form (the 'Framework for the Preparation and Presentation of Financial Statements' and IAS 17), it is very difficult for auditors to argue that the substance of a lease is a finance lease, when all of the legal technicalities show it to be an operating lease.

(iv) Tomsk is suffering from poor performance. If the firm were to insist that the leases be accounted for as finance leases, there would be several obstacles. The firm would effectively be calling into question the judgement of the previous auditors, would risk losing the audit, and would have to justify the change in accounting policy which would then have to be disclosed in the financial statements. This might call into question the integrity of directors, as well as the previous auditors. It is also possible that it would result in a greater (or lesser) charge to the income statement in the form of depreciation of the assets, were they to be accounted for as finance leases – this would depend on the age profile of the asset concerned.

(v) The firm has to consider what would happen should Tomsk be taken over by another company that might question the current accounting treatment. Situations such as these are very difficult to deal with in practice and agreeing to the current accounting policy may be just as risky to the firm as opposing the directors' treatment of the assets.

7 Sampling techniques and analytical procedures

(a) Substantive testing

Sampling procedures

(i) Both statistical and non-statistical sampling procedures are designed to enable the auditor to draw conclusions about the characteristics of a population by examining a sample drawn from it. It is neither more practical nor (necessarily) more effective to examine a full population made up of many thousands of transactions.

(ii) Samples can be drawn from, say, a population of sales invoices and traced through daybooks and ledgers through to source documentation to show that invoices have, for example, been properly authorised, have been properly recorded at the correct amount in the correct period, and posted to the correct accounts.

(iii) Computer assisted audit techniques can help select the sample, test the sample, and draw conclusions from it. Such methods can help examine a much greater volume of, say, purchase invoices (on which calculations can be checked) more accurately than manual procedures.

(iv) All sampling procedures extrapolate the level of error found in the sample to the population as a whole.

(v) Statistical procedures can be used to give precise estimates as to the level of error within a population, within certain limits. For example, a sample of entries in an asset register can be tested and statistical procedures can show that, given the results, there is a 99% chance of the population being within, say, 90% or 95% of the stated amount. These are known as confidence levels and precision limits.

Analytical procedures

(vi) Analytical procedures look at a class of transactions or balances as a whole. They involve making predictions as to likely financial and non-financial relationships, analysing those relationships and seeking explanations and corroboration for unexpected variations, and expected variations that do not occur.

(vii) Analytical procedures are often applied to immaterial areas (such as accruals or petty cash) and in conjunction with detailed sampling to material areas.

(viii) For example, analytical procedures are often applied to gross margins, on a month by month, period by period and line by line basis, by comparison with prior periods and budgets.

(ix) Analytical procedures can also be applied to payroll calculations, where the relationship between production or sales and pay can be easily predicted, and where the relationship between gross pay and deductions for tax and social insurance can be expected to be reasonably constant.

(b) Relative merits of sampling and analytical procedures

(i) Trends in auditing in recent years have moved away from the detailed testing of transactions and balances to a greater reliance on analytical procedures. This is partly because it is believed that detailed testing procedures are appropriate in a non-computerised environment, but that they are no longer necessary because of the increased accuracy of computers and better controls over them.

(ii) A greater reliance on analytical procedures also has the advantage of using the judgement of auditors, rather than using their training for mundane transaction testing work. It is argued by some that the use of analytical procedures is less expensive, overall.

(iii) It is sometimes said that analytical procedures are a good method of testing for completeness, although this is only true if there is a pre-determined expectation as to the quantum of the population as a whole, which may not be possible. Analytical procedures are of limited value where the population under review is volatile, growing rapidly, or where there is no track record of changes in the population (such as for a new business). There are therefore certain situations in which analytical procedures must be applied with extreme caution, or where they should be backed up by detailed testing of transactions and balances.

(iv) Detailed testing of transactions and balances using statistical sampling techniques do not eliminate the need for auditor judgement, they depend on the auditor's assessment of matters such as materiality, risk and tolerable error. Indeed, statistical sampling can be said to give spurious accuracy.

(v) Non-statistical procedures rely on auditor judgement to a greater degree and are therefore subject to a greater degree of bias. But they do not have the disadvantages of statistical sampling to the extent that statistical procedures can require a great deal of effort in selecting the sample to be tested and can encourage a mechanistic approach to auditing.

(vi) Sampling and analytical procedures both have their place in the auditor's toolbox, but both require the exercise of considerable judgement and should not be applied as a matter of course.

			Marks
1	**(a)**	Consolidated balance sheet:	
		– property, plant and equipment	3
		– investment property reclassified as owner occupied	2
		– goodwill (calculation 3; depreciation 1)	4
		– inventory	2
		– trade receivables/payable	1
		– elimination of inter group balance	1
		– bank/overdraft (separate)	1
		– accumulated profit	4
		– minority interest	3
		– 6% loan note	2
		Available	23
		Maximum	20
	(b)	(i) and (ii) one mark per relevant point to maximum of	5
		Maximum for question	**25**
2	**(a)**	Income statement:	
		– sales	1
		– cost of sales	3
		– loan interest	1
		– imputed investment income	2
		– income tax	2
		– extraordinary item	1
		Available	10
		Maximum	8
	(b)	Balance sheet:	
		– property, plant and equipment	5
		– investment	1
		– current assets	1
		– deferred tax	1
		– environment provision	1
		– current liabilities	2
		Available	11
		Maximum	9
	(c)	Changes in equity:	
		– prior period adjustments	2
		– net profit fro period	1
		– equity dividend	1
		Available	4
		Maximum	3
	(d)	One mark per relevant point to a maximum of	5
		Maximum for question	**25**

			Marks
3	**(a)**	One mark per relevant point to a maximum of	7
	(b)	Income statement – One mark per item	4
		Balance sheet:	
		– plan's obligation/assets	1
		– unrecognised gain	1
		– gain on plan's assets at 31 March 2002	2
		– loss on plan's liabilities at 31 March 2002	2
		Available	10
		Maximum	8
		Maximum for question	**15**
4	**(a)**	(i), (ii) and (iii) – one mark per relevant point to a maximum of	9
	(b)	Identifying reportable segments	2
		Treatment of items (i) and (ii) – one mark each	2
		Item (iii) – asset and related depreciation	1
		– lease obligation and related interest	1
		Available	6
		Maximum	6
		Maximum for question	**15**
5	**Omsk auditor's report**		
	(a)	… financial statements are the responsibility of the Company's management Up to one mark per point to a maximum of	4
	(b)	International Standards on Auditing Up to one mark per point to a maximum of	4
	(c)	… reasonable assurance Up to one mark per point to a maximum of	4
	(d)	… free of material misstatement Up to one mark per point to a maximum of	4
	(e)	… true and fair view Up to two marks per point to a maximum of	4
			20
6	**Tomsk**		
	(a)	**Internal control objectives** Up to one mark per point to a maximum of	4
	(b)	**Leases – audit of figures and disclosures** Up to one mark per point to a maximum of	8
	(c)	**Accounting treatment for leases – problems for auditors** Up to one mark per point to a maximum of	3
			15
7	**Sampling techniques and analytical procedures**		
	(a)	**Substantive procedures** Up to one mark per point to a maximum of	9
	(b)	**Relative merits of sampling and analytical procedures** Up to one mark per point to a maximum of	6
			15