Institute of Chartered Secretaries and Administrators

Canadian Division
Financial Reporting and Analysis

Sample Paper – Suggested Answers

Important notice

When reading these answers, please note that they are not intended to be viewed as a definitive ‘model’ answer, as in many instances there are several possible answers/approaches to a question. These answers indicate a range of appropriate content that could have been provided in answer to the questions. They may be a different length or format to the answers expected from candidates in the examination.

QUESTIONS

Section A

*Compulsory – **you must answer** this question.*

1. The following information has been extracted from the draft financial statements of Tidworth Ltd. ('Tidworth'), which is a manufacturing company. IFRS balance sheet format is used below. The company transitioned to IFRS as of its 31 March 2011 year-end.

Income Statement for the year ended 31 March	**2012**	**2011**
	$000	**$000**
Revenue	135,000	90,000
Operating profit	8,440	4,500
Finance costs	2,230	-
Profit before tax	6,210	4,500
Taxation expense	2,070	1,540
Profit after tax	4,140	2,960

Statement of Financial Position at 31 March	**2012**	**2011**
	$000	**$000**
Assets		
Property, plant and equipment at cost	60,000	40,000
Accumulated depreciation	22,000	16,000
	38,000	24,000
Current assets		
Inventories	8,800	6,000
Trade receivables	23,260	12,000
Cash and cash equivalents	-	700
	32,060	18,700
Total assets	70,060	42,700
Equity and liabilities		
Share capital	20,000	20,000
Retained earnings	19,590	16,760
Total equity	39,590	36,760
Non-current liabilities		
Long-term borrowings	16,000	-
Current liabilities		
Trade payables	6,540	4,400
Bank overdraft	5,860	-
Taxes payable	2,070	1,540
Total current liabilities	14,470	5,940
Total liabilities	30,470	5,940
Total equity and liabilities	70,060	42,700

The following further information is provided relating to the year to 31 March 2012:

- Plant was purchased on 1 April 2011 at a cost of $20,000,000. The new plant immediately became fully operational.

- Sales increased by 50% from 1 April 2011 as the result of a major advertising campaign undertaken in the spring of 2011.

- The loan was raised at 9% interest on 1 April 2011 and is repayable in four equal annual instalments commencing 1 April 2012.

- A dividend of $1,310,000 was paid on 30 June 2011.

The company's bankers have advised the directors of Tidworth that the bank overdraft needs to be repaid by 31 March 2013. The following forecasts have been made:

- Operating profit in the year to 31 March 2013 will remain at the same level as in the year to 31 March 2012 and the amount of depreciation charged will also be the same.

- The levels of inventories, trade receivables and trade payables at 31 March 2013 will be the same as at 31 March 2012.

- The company will need to replace fully depreciated plant at a cost of $2,400,000 in June 2012.

Required

(a) Prepare a cash flow statement for the year to 31 March 2012.

(7 marks)

(b) As company secretary, write a succinct report for the board of Tidworth which:

- Examines the financial progress and position of the company based on the cash flow statement prepared under (a), above, and not more than five relevant ratios focusing on asset utilization and short-term liquidity.

- Assesses whether the company is likely to be able to repay the overdraft by 31 March 2013. You should support your assessment with an estimated cash flow statement for the year to 31 March 2013.

(18 marks)

Note: You may make any reasonable assumptions when preparing the estimated cash flow statement under (b), above.

(Total: 25 marks)

Solution 1

(a)	**Cash flow statement for Tidworth Ltd. for 2011-12**	$000	$000
	Cash flows from operating activities		
	Operating profit	8,440	
	Adjustment for depreciation	6,000	
	Cash flow before working capital adjustments	14,440	
	Increase/decrease in inventories	-2,800	
	Increase/decrease in trade receivables	-11,260	
	Increase/decrease in trade payables	2,140	

Cash generated from operations	2,520	
Interest paid	-2,230	
Dividends paid	-1,310	
Tax paid	-1,540	
Net cash generated from operating activities		-2,560
Cash flows from investing activities		
Purchase of plant		-20,000
Cash flows from financing activities		
Proceeds from loan		16,000
Net decrease in cash and cash equivalents		-6,560
Cash and cash equivalents at beginning of period		700
Cash and cash equivalents at end of period		-5,860

(b)

Subject: **Report for the board on the financial progress and position of Tidworth Ltd.**

To: **The Board of Directors of Tidworth Ltd.**

From: **Rachel Jones, Company Secretary**

Date: **June 2012**

Examination of the financial progress and position of the company

This examination is based on the cash flow statement set out above and relevant accounting ratios (appearing in the Appendix to this report) that focus on asset utilization and short-term liquidity.

Cash flow statement

The company has generated a healthy cash flow from operating activities before working capital adjustments of $14,440,000. Most of this has been absorbed by the additional investment in trade accounts receivables, resulting in a modest overall cash flow from operations of $2,520,000. Payments to providers of long-term finance and to the government have resulted in a negative cash flow from operating activities of $2,560,000.

Major financial developments during the year involved a significant expansion of our business based on heavy additional investment in plant. Eighty per cent of the finance for the new plant was provided by a long-term loan, while the remainder was met from short-term borrowings. The implications of this are further explored below when focusing on salient accounting ratios.

Asset utilization

Each of the asset utilization ratios shows decline. The fall in the non-current asset turnover ratio should probably not be a matter of major concern. The investment in property, plant and equipment appears to have increased capacity by 50% and there is an equivalent rise in sales revenue. The decline in the ratio based on net investment in non-current assets may be attributed to the fact that some of the assets are approaching the end of their useful economic life.

Of more concern is the substantial slow down in the rate of collection of accounts receivables. This matter needs careful investigation to discover why this has happened. Possibilities include: longer credit periods being allowed in order to make the company’s products more attractive to customers; a weakening in the company’s credit control arrangements.

Short-term liquidity

Here again, the relevant ratios show have declined. However, for a manufacturing company, the figures at 31 March 2012 are by no means unreasonable. To an extent, the company appears to have been justified in funding some of the long-term investment from short term sources of finance. However, the apparent robustness of these ratios is attributable to the high figures for trade accounts receivables, which, as explained above, may be a cause for concern.

The implications of the expansion programme for developments over the next twelve months is now considered.

Assessment of whether the company is likely to be able to repay the overdraft by 31 March 2013

This assessment is based on the estimated cash flow statement for the year to 31 March 2013, set out in the Appendix below. In preparing this cash flow statement, an estimated figure has been included for interest on the bank overdraft.

The cash flow statement reveals a healthy cash flow for the year to 31 March 2013. There is to be no additional investment in working capital which contrasts significantly with the position in the previous year when credit allowed to customers spiralled. Indeed, if more stringent credit control procedures can be applied, cash generated from operations might be even higher.

There will be the need to fund plant replacement, but at a fairly modest level. However, the first instalment of the loan must be repaid. The net cash generated from operating activities is sufficient to cover these outflows and enable repayment of part of the bank overdraft.

There is therefore some improvement in the financial position of the company, but it needs to be borne in mind that the second instalment of the loan repayment falls due on 1 April 2013. It will be necessary to return to the bank to meet the $4,000,000 cost involved. Assuming we are able to demonstrate our ability to continue to repay the overdraft over the next twelve months, we will be able to return to the bank for further funding with a reasonable degree of confidence.

Appendix

Accounting ratios	**Calculation**	**Ratio**	
		2011-12	**2010-11**
Asset utilization			
Asset turnover ratio	135,000/70,060	1.9:1	
	90,000/42,700		2.1:1
Non-current asset turnover ratio	135,000/38,000	3.6:1	
	90,000/24,000		3.8:1
Accounts receivables turnover	23,260/135,000x365	62.9 days	
	12,000/90,000x365		48.7 days
Short-term liquidity			
Current ratio	32,060:14,470	2.2:1	
	18,700:5,940		3.1:1
Liquidity (acid test) ratio	23,260:14,470	1.6:1	
	12,700:5,940		2.1:1

Estimated cash flow statement for Tidworth Ltd. for 2012-13

Cash flows from operating activities	**$000**	**$000**
Operating profit	8,440	
Adjustment for depreciation	6,000	
Cash generated from operations	14,440	
Interest paid – loan	-1,080	
Interest paid – bank overdraft, say	-600	
Dividends paid	-1,310	
Tax paid	-2,070	
Net cash generated from operating activities		9,380
Cash flows from investing activities		
Purchase of plant		-2,400
Cash flow from financing activities		
Repayment of loan – first instalment		-4,000
Net increase in cash and cash equivalents		2,980
Cash and cash equivalents at beginning of period		-5,860
Cash and cash equivalents at end of period		-2,880

Section B

*Answer **three** questions from this section.*

2. The following trial balance relates to the financial affairs of Onchan Ltd. ('Onchan'), a trading company, as at 31 March 2012. It is a Canadian public company. The company transitioned to IFRS during its year ended 31 March 2011. It is now one year later after the IFRS transition.

	$000	$000
Sales revenue		51,500
Administration, selling and distribution expenses	17,500	
Cost of sales	30,270	
Real estate properties	13,500	
Rented office building	13,200	
Investments	5,980	
2,000,000 shares in an associated company at cost	3,600	
Inventories	7,200	
Trade accounts receivables	5,100	
Cash at bank	2,110	
Trade accounts payables		5,380
Ordinary share capital (shares of $1 each)		18,000
Retained profit at 1 April 2011.		23,580
	98,460	98,460

The following additional information is provided:

(i) The real estate properties were revalued at $50,000,000 on 31 March 2012 and the directors have decided to use this figure for the purpose of financial reporting as of 31 March 2012.

(ii) The rented office building is a separate cash generating unit and an impairment review was undertaken on 31 March 2012. This revealed that the office building had a value in use of $11,310,000 while its net selling price was $9,840,000.

(iii) The transactions on the Investment account during the year to 31 March 2012 were as follows:

	$000
Purchase of a 6% debenture issued by a major supplier, Erin Ltd. on 1 April 2011. The directors intend to hold the debenture until maturity. The effective rate of interest receivable over the life of the debenture is 8%.	5,000
Interest received from Erin Ltd. on 31 March 2012.	300
100,000 shares in a listed company, Ramsey Ltd., purchased with cash, which is temporarily surplus to requirements. The shares had a market price of $18.20 per share on 31 March 2012.	1,400
Dividend received from Ramsey Ltd.	120

(iv) Alderney Ltd is an associated company with an issued share capital of 5,000,000 ordinary shares of $1 each. The shares in Alderney Ltd. were purchased on 1 April 2011 for the figure appearing in the trial balance. Alderney Ltd. reported a profit of $1,300,000 for the year to 31 March 2012.

(v) Onchan trades in three different products for which the following information is provided at 31 March 2012:

Product	Cost	Net realisable value
	$000	**$000**
Exe	2,400	3,500
Wye	3,100	1,620
Zed	1,700	2,350

Required

Prepare the Income Statement of Onchan for the year to 31 March 2012 and the Statement of Financial Position at that date, in accordance with the provisions of IAS 1 'Presentation of Financial Statements' as adopted for Canadian financial reporting purposes.

(25 marks)

Notes: All items are material.
Calculations to the nearest $000.
Ignore taxation.

Solution 2

Income Statement of Onchan Ltd. for the year ended 31 March 2012	**$000**	
Revenue	51,500	
Cost of sales	31,750	W1
Gross profit	19,750	
Administrative, selling and distribution expenses	17,500	
Impairment review	1,890	W2
Operating profit	360	
Interest income	400	W3
Dividends received	120	
Increase in fair value of investment	420	W3
Share of profit of associated company	520	W4
Profit	1,820	

Statement of Financial Position of Onchan Ltd. at 31 March 2012 using IFRS format but traditional Canadian format could also be used (order of liquidity)	**$000**	
Assets		
Non-current assets		
Real estate property at fair value	50,000	W5
Rented office building	11,310	W2
Investment in associated company	4,120	W4
Loan held to maturity	5,100	W3
Available-for-sale investment	1,820	W3
	72,350	
Current assets		
Inventories	5,720	W1
Trade accounts receivables	5,100	
Cash	2,110	
	12,930	
Total assets	85,280	

Equity and liabilities		
Ordinary share capital	18,000	
Revaluation surplus	36,500	W5
Retained earnings	25,400	W6
Total equity	79,900	
Current liabilities		
Trade accounts payables	5,380	
Total equity and liabilities	85,280	

Workings

		$000	$000
1	Inventories at lower of cost and net realisable value		
	Exe		2,400
	Wye		1,620
	Zed		1,700
			5,720
	Cost of sales		30,270
	Amount written off Wye	3,100- 1,620	1,480
			31,750
2	Rented office building		
	Value in use (VIU)		11,310
	Net selling price (NSP)		9,840
	Recoverable amount – higher of VIU and NSP		11,310
	Carrying value		13,200
	Impairment loss		1,890
3	Investment account		
	Debenture issued by Erin Ltd. (HTM)		
	Income recognised	$5,000 x 8%	400
	Carrying value		
	Purchase price		5,000
	Add: income recognized		400
	Less: income received		-300
			5,100
	Shares in Ramsey Ltd. (AFS)		
	Stated at fair value	100,000 x $18.20	1,820
	Less: carrying value		1,400
	Increase in value recognized		420
4	Investment in associated company (equity method)		
	Cost		3,600
	Share of profit	$1,300 x 40%	520
	Carrying value		4,120
5	Real estate property		
	Re-valued amount (fair value)		50,000
	Carrying value		13,500
	Credited to revaluation surplus		36,500
6	Retained earnings		
	Balance brought forward		23,580
	Profit for period		1,820
			25,400

3. The Statements of Financial Position of Castletown Ltd. ('Castletown') and Douglas Ltd. ('Douglas') as at 31 December 2011 contained the following information:

	Castletown	Douglas
Assets	**$ million**	**$ million**
Non-current assets	126	38
Net current assets	79	12
Total assets	205	50
Equity		
Ordinary shares of $1 each	100	20
Retained profit at 1 January 2011	83	25
Profit for 2011	22	5
Total equity	205	50

The following additional information is provided:

(i) Castletown purchased 16 million shares in Douglas on 1 January 2011. The purchase consideration consisted of 12 million shares in Castletown, which were valued at $6.50 each at the acquisition date. This transaction has not yet been entered in the books of Castletown and is not reflected in the above Statement of Financial Position.

(ii) The fair value of Douglas's non-current assets at 1 January 2011 was $48 million. Douglas neither purchased nor sold any non-current assets during 2011. There were no material differences between the carrying value and fair value of Douglas's net current assets at the date of acquisition.

(iii) The directors of Castletown estimated, at the date of acquisition, that costs of $7 million will need to be incurred in 2012 to reorganise the activities of Douglas so as to maximise the benefits arising from the amalgamation of the two companies' activities. The directors are of the opinion that these reorganization costs should be treated as part of the purchase price.

(iv) During 2011, Castletown transferred to Douglas goods which cost $5 million, at their market selling price of $8 million. These goods remained unsold at the year end and are included among inventories in Douglas's Statement of Financial Position.

Required

(a) Define 'fair value' in accordance with IFRS 3 'Business Combinations' as adopted for Canadian financial reporting purposes.

(3 marks)

(b) Advise the management of Castletown concerning the appropriate accounting treatment of (i) non-current asset values at the acquisition date and (ii) the planned future reorganization costs in order to comply with IFRS 3 and any other relevant accounting standard.

(8 marks)

(c) Prepare the consolidated Statement of Financial Position of Castletown and its subsidiary, Douglas, at 31 December 2011 in accordance with standard accounting practice.

(14 marks)

Note: Ignore depreciation and impairment of non-current assets.

(Total: 25 marks)

Solution 3

(a) IFRS 3 defines fair value as: 'The amount for which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arms' length transaction.

(b) Non-current assets: All assets and liabilities should be recorded in the consolidated accounts at the fair value at the date of acquisition, that is the amount at which the asset or liability could be exchanged in an arms' length transaction. This basic rule must be applied to non-current assets. The objective is to ensure that all profits, both realized and unrealized, are reflected in the net assets recognized at the acquisition date. It also helps ensure the calculation of a more accurate figure for goodwill, which is a residual balance arrived at after deducting the fair value of tangible and identifiable non-tangible assets from purchase price.

Reorganization costs: Liabilities should not be recognised at the date of acquisition if plans merely reflect the acquirer's intentions. Liabilities associated with reorganizing the activities of Douglas should only be recognised where the acquiree has, at the acquisition date, an existing liability for restructuring recognised in accordance with IAS 37 entitled Provisions, Liabilities and Contingent assets. There is no evidence of a legal obligation to reconstruct, so the question is whether the Board has taken sufficient actions to create a constructive obligation. For example, does a detailed plan for reconstruction exist which has been discussed with relevant personnel.

(c)

Consolidated Statement of Financial Position of Castletown Ltd. and its subsidiary

Assets	**$million**	
Goodwill	34	W1
Non-current assets	174	W2
Net current assets	88	W3
Total assets	296	
Equity		
Ordinary shares of $1 each	112	W4
Share premium account	66	W5
Retained profit at 1 January 2011	83	
Profit for 2011	23	W6
	284	
Non-controlling interest	12	W1
Total equity	296	

Workings:

		Total equity	*At acquisition*	*Since acquisition*	*Non-controlling interest*
1		$m	$m	$m	$m
	Share capital	20	16		4
	Revaluation surplus	10	8		2
	Profit: at acquisition	25	20		5
	since acquisition	5		4	1
		60	44	4	12
	Price paid $6.50 x 12 mill.		78		
	Goodwill		34		

		Castletown	*Douglas*	*Group*
2		$m	$m	$m
	Non-current assets	126	48	174
3	Net current assets	79	12	91
	Less: unrealised profit ($8m - $5m)			3
				88
4	Castletown, opening Statement of Financial Position			100
	Share issue, 1 January 2011			12
				112
5	Share issue proceeds.			78
	Less: Nominal value of shares			12
	Share premium account			66
6	Castletown			22
	Douglas (W1)			4
	Unrealized profit			-3
				23

4. Harborough Ltd. ('Harborough') is a Canadian listed public company on the TSX Exchange, which makes up its accounts on the calendar year basis. The following information is provided relating to its business operations:

(i)

	2011	2010
	$ million	**$ million**
Sales revenue	2,420	2,300
Cost of sales	1,640	1,500
Operating expenses	500	428

(ii) Harborough operates through two divisions: the Newton division trades in the product Newton, and the Lowestoft division trades in the product Lowestoft. The following information is provided in respect of the Newton division for 2011:

	$ million
Sales revenue	600
Cost of sales	520
Operating expenses	142

(iii) Raydon Ltd. ('Raydon') is a competitor of Harborough, trading solely in the product Lowestoft. The following information is provided for Raydon for 2011:

	$ million
Sales revenue	1,680
Operating profit	300
Gross assets	2,040

(iv) You discover that the gross assets attributable to the products traded in by Harborough at 31 December are as follows (there are no common assets unallocated to divisions):

	2011	2010
	$ million	**$ million**
Newton	360	400
Lowestoft	1,920	1,800

Required

(a) Outline the objective of IFRS 8 'Operating Segments' as adopted for Canadian financial reporting purposes.

(3 marks)

(b) Prepare the Income Statement of Harborough for 2011 in accordance with the requirements of IFRS 8, so far as the information permits, so as to reveal the separate results of each business segment.

(6 marks)

(c) Write a succinct report for the board which reviews:

(i) The overall performance of Harborough in 2011 compared with the previous year.

(ii) The performance of the Lowestoft business segment of Harborough compared to that of Raydon.

Your report should include:

- Calculations of the following ratios: total asset turnover, operating profit percentage and return on gross assets.
- An explanation of the relationship between the three ratios.
- A consideration of the action the directors of Harborough might wish to take on the basis of your findings.

(16 marks)

(Total: 25 marks)

Solution 4

(a) The objective of segment reporting is to assist users of accounts to evaluate the different business segments and geographical regions of a group and how they affect the overall results of the group as a whole. This type of performance assessment is enhanced by comparisons with previous periods and comparable businesses.

(b) **Income Statement of Harborough Ltd. for 2011**

	Lowestoft	*Newton*	*Total*
	$m	*$m*	*$m*
Sales	1,820	600	2,420
Cost of sales	1,120	520	1,640
Gross profit	700	80	780
Operating expenses	358	142	500
Operating profit/-loss	342	-62	280

(c)

Subject: **Financial analysis of the performance of Harborough Ltd.**

To: **The Board of Directors of Harborough Ltd.**

From: **Rachel Jones, Company Secretary**

Date: **June 2012**

In accordance with the board's instructions, set out below is a succinct report on:

(i) The overall performance of Harborough in 2011 compared with the previous year.

(ii) The performance of the Lowestoft business segment of Harborough compared to that of Raydon.

Relevant accounting ratios are set out in an Appendix.

Overall performance of Harborough

Results in 2011 have clearly deteriorated compared with those for the previous year. This may be due to the poor performance of the Newton division which has suffered a loss of $62 million during 2011.

A comparison of the three ratios shows that the 2011 results are, overall, significantly inferior to those for 2010. Total asset turnover has marginally improved but the operating profit percentage is in steep decline, possibly due to the loss suffered by the Newton division.

The return on gross assets is the product of the total asset turnover ratio and the operating profit percentage. Companies can improve profitability by either increasing their operating margins or by achieving fuller utilization of available assets. Conversely, a decline in either of these reduces overall profitability.

With asset utilization fairly flat and margins well down, the rate of return on gross assets of Harborough declined by an equivalent amount.

Comparison with Raydon

The performance of the Lowestoft division compared with Raydon Ltd is impressive.

For Harborough's Lowestoft division, each of the total asset turnover and operating profit percentage are at least a point above the corresponding measures for Raydon.

The combined effect is to produce a return on gross assets for Harborough's Lowestoft division of 17.8% compared with 14.7% by Raydon.

The implications of these figures are that the directors of Harborough should consider the closure of the Newton division.

However, an assessment would need to be carried out to ensure that, if this course was followed, operating costs currently allocated to the Newton division are avoidable.

Appendix		*2011*	*2010*
Total asset turnover	2,300 ÷ 2,200 (W1)		1.05
	2,420 ÷ 2,280 (W2)	1.06	
Operating profit percentage	372 (W3) ÷ 2,300 x100		16.2%
	280 ÷ 2,420 x 100	11.6%	
Return on gross assets	372 ÷ 2,200 x 100		16.9%
	280 ÷ 2,280 x 100	12.3%	
		Raydon	*Harborough/ Lowestoft*
Total asset turnover	1,820 ÷ 1,920		0.95
	1,680 ÷ 2,040	0.82	
Operating profit percentage	342 ÷ 1,820 x 100		18.8%
	300 ÷ 1,680 x 100	17.9%	
Return on gross assets	342 ÷ 1,920 x 100		17.8%
	300 ÷ 2,040 x 100	14.7%	

Workings

1 400 (Newton) + 1,800 (Lowestoft)
2 360 (Newton) + 1,920 (Lowestoft)
3 2,300 (sales revenue) – 1,500 (cost of sales) + 428 (operating expenses)

5. Identify and discuss any four reasons for differences in financial reporting systems between countries.

(25 marks)

Solution 5

The following are four reasons for differences in financial reporting systems between different countries.

(i) *The character of the national legal system*

Either common law or Roman law forms the basis for legal systems in operation in many countries in the world.

Canada is an example of a country where the legal system is substantially based on common law and, as a result, it traditionally relies on the application of equity and fairness to specific cases rather than compliance with a set of detailed rules.

The result has been limited regulation of financial reporting except that the Canadian Institute of Chartered Accountants handbook of accounting standards (now IFRS) are required to be used under the Canada Business Corporations Act. .

The Canadian common law tradition has been accommodated within the changing character of legislation being applied to member states by allowing a degree of flexibility where strict compliance with detailed rules causes accounts not to exhibit a true and fair view.

France and Germany are examples of countries where the legal system is based on Roman law and this results in less flexibility in the preparation of published financial reports.

(ii) *The way in which industry is financed*

The information requirements of different providers of company finance themselves differ.

Canadian, British and US companies rely more heavily on shareholder finance than do many European and Japanese companies where loan finance is more prominent.

Where the capital market dominates, there is greater evidence of attention to concepts such as accruals and substance over form as a means of improving the quality of information available for performance assessment purposes.

Where the loan creditor is more prominent, there can tend to be a greater emphasis on prudence and conservatism.

(iii) *The relationship of tax and reporting systems*

In Canada, separate rules exist for the computation of taxable business profits compared with the profits reported in published financial statements.

This frees financial reporting to publish the information which best suits the requirements of providers of finance.

In other countries, such as Germany for example, expenditures are only allowed for tax purposes if treated in the same manner when preparing published financial reports.

The result also is that, where accounting and taxable profit must be the same, actions taken to achieve public policy objectives, e.g. accelerated write offs to encourage investment, will distort reported profits and asset values.

(iv) *Influence and status of the accounting profession*

A respected and influential accounting profession developed much earlier in some countries than in others for many reasons which, in Canada, included the early emergence of the limited company and, therefore, an active capital market.

In such countries public accountants, with increasing support from the professional bodies they created, developed their own ideas about how accounts might fairly present an entity's financial progress and position.

In many other countries, accountants were regarded as no more than bookkeepers whose job it was to keep the records but exert little or no influence over their content.

The lack of a role for the accountant was for many years exacerbated in Eastern European countries due to the implementation of systems of central planning and the absence of a market mechanism using accounting information as the basis for resource allocation decisions.

6. Discuss the following issues in the context of corporate governance and the external auditor:

(a) The advantages to an audit client of its auditors providing consultancy services it requires, rather than engaging a different firm to do the work.

(12 marks)

(b) The potential problems associated with accounting firms providing consultancy services to their audit clients.

(13 marks)

(Total: 25 marks)

Solution 6

(a) *Advantages to an audit client of its auditors providing consultancy services.*

The company's auditors will have a thorough knowledge of its affairs as the result of performing the audit and this will:

- reduce the learning time required when carrying out consultancy work, thus
- potentially result in cheaper consultancy services.

The client knows the auditors well and is in a good position to judge whether they can effectively perform the services required.

Audit firms have developed financial and related business services and are expert in a wide range of consultancy business.

For example, audit firms have specialized skills in information and computer systems, and e-commerce and Internet applications.

Overall, it is likely that auditors can often provide high quality services to audit clients at a lower cost than could be provided by other consultants.

(b) *The provision of consultancy services creates independence problems for the audit firm for the following reasons.*

i. Auditor may be reporting on their own work, such as on the effectiveness of an accounting system which they have installed.

- Another common example of lack of independence occurs where the auditor both prepares and audits the financial statements, there is a risk that quality of the audit will be less than what it would be if these two functions were separately undertaken.
- The main problem is that it is difficult for anyone to be sufficiently objective and critical when checking one's own work. For example, an independent person is much better at detecting errors in another person's work.
- If the auditors discover errors in financial statements they have prepared, they may be reluctant to highlight mistakes which would reflect poorly on their prior work.
- Thus, the audit firm may give an unqualified audit report when the audit report should have been qualified (modified) because of material errors in the financial statements.

ii. Because of the level of fees derived from consultancy work, the auditor may be reluctant to qualify the audit report.

- Significant here is the fact that the profitability of the non-audit work can influence overall independence.

iii. The ethical rules of most of the accounting bodies, the IFAC, Canadian ASB and the US SEC, say the auditor should avoid making management decisions when performing consultancy work.

- However, there are problems in defining the situations when the auditor would be making management decisions, and it is difficult for third parties and regulators to detect whether audit firms are carrying out management decisions for the client company.

The easiest solution to this problem might be to prohibit auditors from carrying out consultancy work for audit clients. In practice, companies often adopt a policy for non-audit work which defines the work auditors cannot undertake and identifies the authority required to authorise the auditors to undertake other types of non-audit work.