ICAEW

ADVANCED LEVEL

1 NOVEMBER 2021

3.5 HOURS

CORPORATE REPORTING

This exam consists of **three** questions (100 marks).

Marks breakdown

Question 1	40 marks
Question 2	30 marks
Question 3	30 marks

The questions in this paper have been prepared on the assumption that candidates do not have a detailed knowledge of the types of organisations to which they relate. No additional credit will be given to candidates displaying such knowledge.

For question 1, which requires Data Analytics software, the link can be found above the word processing area.

The link to the ICAEW bookshelf can be found in each question above the word processing area.

Important Information:

1. Please read the instructions carefully before you begin your exam.

Starting and ending the exam

2. Click on the **right arrow** in the header to begin the exam. The exam timer will begin to count down.

3. A warning is given five minutes before the exam ends. When the exam timer reaches zero, the exam will end. To end the exam earlier, navigate to the last question and click the right arrow button. Click the **Submit** button to close the exam.

Encountering issues during the exam

4. If you encounter any issues during the delivery of the exam you should alert the invigilator (or online chat support if you are sitting remotely). Neither the invigilator nor the online chat support can advise you on how to use the software.

Preparing your answers

5. Respond directly to the exam question requirements. Do not include any content of a personal nature, this includes your name or any other identifying content.

6. You may use a pen and paper for draft workings. Any information you write on paper will not be read or marked.

7. The examiner will take account of the way in which your answers are structured. You must make sure your answers and workings are clearly visible in the word processing area when you submit your exam. Only your answer in the word processing area will be marked. **You must copy over any data from the spreadsheet area to the word processing area for marking**. The examiner will **not** be able to expand rows or columns where content is not visible.

After the exam

8. If you are sitting in an exam centre and believe that your performance has been affected by any issues which occurred during the exam, you must inform your invigilator at

the time of the occurrence and follow up with ICAEW directly after your exam. You will then need to submit a special consideration application to ICAEW if you wish us to consider such issues, as per our published policy. If you are sitting remotely please submit your special consideration application referring to anything of note which occurred and will have been recorded, for use as evidence to support your case.

9. A student survey is provided post-exam for feedback purposes.

QUESTION 1
Assume the date is 1 November 2021

The final audit visit for Llama started recently and you have just joined the audit.

The engagement manager for the Llama audit, Fran Farmer, gives you the following briefing:

"You, as audit senior, will have reviewed the background information prepared by the previous audit manager and the audit planning notes prepared by the audit assistant, Ben Boreham. You will also be familiar with the data for Llama for the 11 months ended 31 May 2021.

"Data for June 2021 has been imported into the data analytics software from Llama's nominal ledger, so the data for the full year ended 30 June 2021 is now available.

"Ben has performed audit procedures on additions to property, plant and equipment (PPE) and the depreciation charge (**Exhibit 1**). Ben has also carried out audit procedures on the transactions and outstanding balances with CCC (**Exhibit 2**).

"Llama has provided information about the lease agreements for the properties occupied by Llama's three restaurants, Llama One, Llama Two and Llama Three (**Exhibit 3**).

"I have set out my instructions for you in a separate document (**Exhibit 4**)."

Requirement

Respond to the audit engagement manager's instructions (Exhibit 4).

Total: 40 marks

Exhibit 1: Audit procedures for additions to PPE and the depreciation charge for the year – prepared by Ben Boreham

Audit procedures on additions to PPE

My lead schedule for PPE shows the following balances at 30 June 2021 for the three PPE asset cost accounts.

Account Code	Account Description	Prior Year 2020 £	Current Year 2021 £	Change £	% change
0010	Leasehold improvements	1,899,145	2,755,180	856,035	45%
0040	Furniture and fixtures	918,684	1,535,414	616,730	67%
0055	Computer equipment	51,434	121,396	69,962	136%
Total of cost accounts		2,869,263	4,411,990	1,542,727	54%

I have carried out the following audit procedures on additions to PPE:

- Asset additions in Account code 0010 – Leasehold improvements

I think the additions to this account should be assigned a low audit risk because I compared the total of the purchase invoice additions to the capital expenditure budget during my planning visit.

I have analysed the purchase invoice additions to this account as follows:

Purchase invoices posted by:

	£
Pierre	675,452
Dianna	161,719
Ahmed	2,658
Susan	1,402
Total	841,231

I have calculated that 80% of the invoices, by value, included in this Account code have been posted by Pierre Delvenne, the finance director.

I have used the data analytics software to identify four large transactions posted by Pierre. These are four 'Interim application' invoices which represent progress payments for the refit of the Llama Three restaurant.

I agreed each of these four amounts to an interim valuation from Llama's surveyor. The four invoices represent expenditure of £571,400, 84.6% of the invoices processed by Pierre to this account.

I was provided with a copy of the contract with the construction company for the entire refit project and I noted that the contract was not signed by the contractor.

- Asset additions in Account code 0040 – Furniture and fixtures

I identified the largest transaction for £101,116 posted to this account in my audit planning notes.

I have investigated a further large transaction, which should be recorded as a leasehold improvement and not as an addition to furniture and fixtures.

Transaction ID	£	Effective date	User	Description
49545	43,000	1/11/2020	Susan Chu	Interim application No 1

I have asked Susan to adjust this transaction and to record £43,000 as an addition in account 0010.

Most of the other transactions included in Account code 0040 are small in value and therefore I have not carried out any further procedures.

- Asset additions in Account code 0055 – Computer equipment

I reviewed this account and there are no material transactions, so I have not completed any audit procedures for additions to this account code.

I therefore conclude that additions to leasehold improvements, furniture and fixtures and computer equipment are fairly stated.

<u>Audit procedures for the Account code – 008000 Depreciation</u>

My lead schedule for PPE shows the following balances at 30 June 2021 for the three PPE accumulated depreciation accounts.

Account Code	Account Description	Prior Year 2020 £	Current Year 2021 £	Change £	% Change
0011	Leasehold improvements depreciation	(183,511)	(284,009)	(100,498)	55%
0041	Furniture and fixtures depreciation	(201,208)	(348,629)	(147,421)	73%
0056	Computer equipment depreciation	(13,151)	(33,395)	(20,244)	154%
Total of accumulated depreciation accounts		(397,870)	(666,033)	(268,163)	67%

I compared the depreciation charge of £268,824, recorded in Account code – 008000 Depreciation, with the £268,163 change in the total of all the accumulated depreciation account codes noted above. The difference is not material.

I obtained a schedule of the asset useful lives used to calculate depreciation for the year ended 30 June 2021. All assets are assumed to have a nil residual value and depreciation is calculated using the straight-line method.

Leasehold improvements	25 years
Furniture and fixtures	10 years
Computer equipment	4 years

I recalculated the depreciation charge using the asset lives and found no material differences.

I discussed the asset useful lives with Pierre, who told me that there was a change in accounting estimates from 1 July 2020. Until that date, the useful lives for leasehold improvements and furniture and fixtures were 15 years and 8 years respectively.

Pierre's justification of this change was that Llama has the right to extend the term of its leases for all three restaurant properties (Exhibit 3).

In my opinion the depreciation charge is fairly stated.

Exhibit 2: Audit procedures on the transactions and outstanding balances with CCC – prepared by Ben Boreham

I have performed audit procedures for intercompany balances. These balances are the amounts owed by Llama to its parent company, CCC.

My lead schedule shows the following amounts owed to CCC at 30 June:

		Prior year	Current year
		2020	**2021**
Account code	**Account description**	**£**	**£**
2103	CCC – Intercompany loans	1,067,332	2,166,548
2118	CCC – Intercompany trade creditor	765,351	926,151
		1,832,683	3,092,699

I reviewed the loan agreement between Llama and CCC and established that:

- there is no fixed repayment date for amounts outstanding; and
- interest is chargeable at 8% per annum.

In my view, this is a low-risk account as amounts are owed to the parent company and there is no fixed repayment date. Pierre told me that it is highly unlikely that repayment of the loan will be demanded by CCC.

In my opinion intercompany balances are fairly stated.

Exhibit 3: Information for the property lease agreements

Each restaurant operates from leasehold premises. The leases for Llama One and Llama Two were extended with effect from 1 July 2020. A single lease for both properties was signed on 1 July 2020.

The lease for the new property, Llama Three, was entered into on 1 July 2020.

Llama has exclusive use of the three properties for the duration of the lease terms.

At the end of the lease terms, Llama does not have a legal option to purchase the properties. However, Llama has the right to extend the term of its leases for all three restaurant properties.

The annual lease payments have been recorded in Account code 007100 – Rent as follows:

	£	**Lease term**	**Implicit annual interest rate**
<u>Llama One</u> 4 quarterly payments of £13,512	54,048		
<u>Llama Two</u> 4 quarterly payments of £16,125	64,500		
Total annual payments under extended lease	118,548	15 years	8%
<u>Llama Three</u> 12 monthly payments of £20,833	249,996	10 years	8%

Other costs included in Account code 007100 are:

	£
Legal fees for Llama One and Llama Two lease	6,443
Legal fees for Llama Three lease	2,738
Annual maintenance charge for Llama Three	8,836

Exhibit 4: Audit engagement manager's instructions – audit of Llama for the year ended 30 June 2021

1. In respect of the audit of each of: (a) additions to PPE; and (b) the depreciation charge:

    - identify and explain any weaknesses in the audit procedures performed by Ben Boreham (Exhibit 1); and
    - set out and explain the key audit risks and any additional audit procedures we should perform to address each risk. Use the data analytics software to identify specific key transactions which require further investigation.

2. Set out and explain the key audit risks, including inherent risks, arising from transactions and outstanding balances with CCC (Exhibit 2).

3. Using the information about property lease agreements (Exhibit 3):

    - set out and explain the appropriate financial reporting treatment for the property leases in Llama's financial statements for the year ended 30 June 2021;
    - prepare correcting adjusting journal entries; and
    - summarise the impact of your adjustments on Llama's profit or loss for the year ended 30 June 2021 as shown in the data analytics software.

Ignore any further adjustments for current tax and deferred tax.

Question 2

Eastoak plc is an AIM-listed company that manufactures building products for the construction industry.

Eastoak has a 30 September year end. It does not have any subsidiary companies. Its functional currency is the £.

Eastoak has three divisions which each produce a separate product line:

- Ventilation division (based in UK)
- Lighting division (based in UK)
- Insulation division (based in France).

Shareholders have been concerned for some time about the results of Eastoak. After extended discussion, the Eastoak board decided to close the Insulation division. The division was closed on 1 July 2021.

Despite the closure, shareholders remained concerned and, following a board meeting in September 2021, the finance director and CEO resigned.

On 1 October 2021, Buzz Jones was appointed as the new Eastoak CEO. Eastoak advertised for a new finance director, but the position is as yet unfilled.

You work for a firm of ICAEW Chartered Accountants. You have been seconded to assist Buzz with the preparation of the Eastoak financial statements for the year ended 30 September 2021. Eastoak is not an audit client of your firm.

Buzz called to give you the following briefing.

"A junior member of the Eastoak finance team, Georg May, has been helping me to put together the Eastoak financial statements for publication, but we need your technical expertise. Georg has prepared draft financial information for the year ended 30 September 2021. He has identified three financial reporting issues which may require adjustment (**Exhibit 1**).

"The year ended 30 September 2021 was a challenging year for the business. As part of its management commentary in the financial statements, the board wants to include a review of the impact of the decision to close the Insulation division and of the performance of the two remaining divisions. Therefore, I asked Georg to prepare a draft analysis of the overall performance of Eastoak and its divisions which can be used as the basis of the management commentary (**Exhibit 2**). However, I believe this analysis needs further consideration because I do not think his interpretation is appropriate or that his analysis is complete.

"I would like you to prepare a working paper for me in which you:

1. Set out and explain, for each of the three issues in Exhibit 1, your recommended financial reporting treatment in Eastoak's financial statements for the year ended 30 September 2021. Include correcting journal entries.

2. Prepare a revised statement of comprehensive income for Eastoak for the year ended 30 September 2021 (Exhibit 1), suitable for publication, which includes your adjustments from 1. above. Show your workings.

3. Evaluate Georg May’s draft analysis of Eastoak’s overall performance and its divisions (Exhibit 2). Include any relevant additional analysis. Use your revised statement of comprehensive income.”

Requirement

Prepare the working paper requested by Buzz Jones.

Total: 30 marks

Ignore any adjustments for current tax and deferred tax.

Exhibit 1 Draft financial information for Eastoak, prepared by Georg May

Eastoak: Draft statement of comprehensive income for the year ended 30 September

	2021	2020
	£000	£000
Revenue	385,000	376,000
Cost of sales	(283,388)	(263,200)
Gross profit	101,612	112,800
Administrative expenses	(92,120)	(82,720)
Closure costs	(2,000)	-
Operating profit	7,492	30,080
Finance costs	(500)	(1,100)
Profit before tax	6,992	28,980
Income tax expense	(1,328)	(5,506)
Profit for the year	5,664	23,474
Other comprehensive income	-	-
Total comprehensive income	5,664	23,474

The above statement of comprehensive income includes the following amounts in respect of the Insulation division, which was closed on 1 July 2021:

	2021	2020
	£000	£000
Revenue	76,600	99,416
Cost of sales	(52,088)	(69,591)
Gross profit	24,512	29,825
Administrative expenses*	(24,357)	(21,872)
Closure costs**	(2,000)	-
Operating (loss)/ profit	(1,845)	7,953
Income tax credit/(expense)	351	(1,511)
(Loss)/Profit after tax	(1,494)	6,442

*****A share of the total administrative expenses for the year ended 30 September 2021 has been allocated to the Insulation division in the same proportion as for the year ended 30 September 2020 (ie £92,120 x (£21,872/£82,720) = £24,357).

****** The closure costs comprise redundancy costs of £1,200,000 and a provision for £800,000 in respect of estimated costs to retrain staff who have relocated from the Insulation division to the Ventilation and Lighting divisions.

Financial reporting issues

1. Closure of Insulation division

The Insulation division operated from a factory in France and 90% of its sales were invoiced in €. On 1 July 2021, operating activities ceased. On the same date, the Eastoak board instructed an agent to advertise the division's assets for sale as soon as possible at a realistic price.

The carrying amounts of the Insulation division assets held for sale, as they are currently recognised in Eastoak's statement of financial position at 30 September 2021, are:

	Land	**Buildings**	**Plant and equipment**
	£000	**£000**	**£000**
Carrying amount at 30 September 2020	5,000	5,880	8,600
Depreciation charged for the year ended 30 September 2021	-	(140)	(1,290)
Carrying amount at 30 September 2021	5,000	5,740	7,310

The Insulation division did not buy or dispose of any assets in the year ended 30 September 2021.

Eastoak uses a revaluation policy for land and buildings but recognises plant and equipment at cost.

Shortly after the assets were advertised, a property developer in France offered to buy the land and buildings for €14 million. A competitor of Eastoak offered €9.7 million for the plant and equipment. Selling costs are expected to be €500,000 for the land and buildings and €100,000 for the plant and equipment. Both disposals are likely to complete by 31 December 2021.

The exchange rate at 1 July 2021 and 30 September 2021 was £1 = €1.1.

2. Refinancing arrangement

On 1 October 2015, Eastoak borrowed £20 million from its bank. The fees and transaction costs were minimal. The loan is repayable on 1 October 2025.

Until 1 October 2020, interest of 5% per annum was paid annually in arrears.

Immediately after the interest had been paid on 1 October 2020, Eastoak renegotiated the terms of the loan agreement with its bank as follows:

- No further annual interest payments will be made.
- The loan will be settled by Eastoak paying £30 million to the bank on 1 October 2025.

The new loan has an effective interest rate of 6% per annum which was the market rate for this type of loan at 1 October 2020. The fair value of the loan at this date was £22.418 million (excluding fees).

The fees paid to the bank for the refinancing arrangement were £500,000 and have been included in finance costs in Eastoak's statement of profit or loss.

3. Share-based payment scheme

On 1 October 2020, in order to improve employee performance, Eastoak decided to introduce a share-based payment scheme for the employees of the Ventilation and Lighting divisions.

No adjustments have been made in the Eastoak financial statements for this scheme.

On 30 September 2024, the vesting date, each employee can choose to receive either:

a) 2,000 shares in Eastoak, which cannot be sold until 12 months after the vesting date; or
b) a cash amount equal to the value of 1,700 shares in Eastoak.

The market price of an Eastoak share was £4.00 on 1 October 2020. On 30 September 2021, the market price was £4.50. The fair value at 1 October 2020 of the right to receive one share under the scheme (after taking into account the selling restriction) was £3.50.

Vesting is conditional on being continuously employed by Eastoak over the period 1 October 2020 to 30 September 2024. On 1 October 2020, Eastoak expected that 700 employees would meet the vesting condition. At 30 September 2021, Eastoak revised its estimate of the number of employees expected to meet the vesting condition to 600.

Exhibit 2: Draft analysis of the overall performance of Eastoak and its divisions – prepared by Georg May

Overall company revenue has increased by 2.4% however this includes a 23% fall in revenue from the Insulation division and an increase of 11.5% in the revenue for the Ventilation and Lighting divisions.

The revenue for the Ventilation and Lighting divisions has increased as a result of a 15% increase in sales volumes for these products compared with the year ended 30 September 2020.

Although sales volumes of the Insulation division's products remained constant, exchange rate fluctuations caused a 20% reduction in its revenue in £ compared with the year ended 30 September 2020.

The impact of currency movements on revenue for the Insulation division has contributed to a fall in the gross profit for the company from 30% to 26.4%. The Insulation division has made a loss for the year ended 30 September 2021 of £1,494,000 compared with a profit of £6,442,000 for the year ended 30 September 2020.

Question 3

You are Alex Baura, an audit senior at Helio Zena (HZ), a firm of ICAEW Chartered Accountants.

You are planning the audit of Circeon plc and the Circeon Group for the year ending 31 December 2021.The engagement manager provides you with the following briefing note.

Briefing note

Circeon plc is the parent company for a group which develops and sells innovative medical products.

It has a number of wholly-owned subsidiaries, including Thetaron Ltd. Thetaron was incorporated in January 2019 to research and develop BSM49, a device for managing diabetes.

Thetaron's results were immaterial to the Circeon Group in both 2019 and 2020. Its financial statements for those years were not audited by HZ. However, HZ has been appointed as Thetaron's auditor for the year ending 31 December 2021, replacing the current auditor. The Circeon finance director, Max Omicon, is pleased that we are now the auditor for Thetaron.

Although the Circeon Board has confidence that BSM49 is commercially viable, it has other strategic priorities and is therefore considering whether to sell its shares in Thetaron.

Yesterday, Max informed me that Circeon has received two alternative offers for either 100% or 40% of the shares it owns in Thetaron. If the Circeon board decides to accept either offer, the completion date will be 31 December 2021.

Max provided information about Circeon's investment in Thetaron shares and the two alternative offers received (**Exhibit 1**). I have forwarded this to you, together with Thetaron's most recent summary forecast for the year ending 31 December 2021 (**Exhibit 2**). The forecast was prepared by Sam Heran, the Thetaron CEO, an ICAEW Chartered Accountant. It includes significant research and development expenditure.

One of my friends plays squash with Sam. My friend sent me an email including some information about Thetaron (**Exhibit 3**), which we will need to consider carefully.

Instructions

What I need you to do is:

(1) Explain the financial reporting treatment for the year ending 31 December 2021 of the disposal of shares in Thetaron (Exhibit 1) for each of:

(a) Offer 1; and
(b) Offer 2,

for each of

- the separate company financial statements of Circeon plc; and
- the consolidated financial statements of the Circeon Group.

For each offer (a) and (b), include relevant calculations and assume that the disposal of the shares takes place on 31 December 2021 and that Thetaron's results are in line with the forecast provided (Exhibit 2).

(2) In respect of HZ's audit of Thetaron's financial statements for the year ending 31 December 2021:

- explain the key audit risks to be addressed; and
- set out the audit procedures for research and development costs.

Assume the completion date is 31 December 2021.

(3) Explain the ethical issues for both HZ and Sam that arise from the information in the email I have received (Exhibit 3). Set out any actions that HZ should take.

Requirement

Respond to the engagement manager's instructions.

(**30 marks**)

Exhibit 1: Information about Circeon's investment in Thetaron and the two alternative offers received – provided by Max Omicon, Circeon finance director

Circeon plc's investment in Thetaron

Thetaron was incorporated on 1 January 2019. On incorporation, it had a share capital of 1 million £1 ordinary shares, all of which were issued at par to Circeon plc.

Circeon plc measures investments in subsidiaries at cost and has not recorded any impairment in respect of its investment in Thetaron.

On 1 January 2020, Circeon plc made a loan of £3 million to Thetaron to fund Thetaron's development work on BSM49. The interest on the loan is at the market rate of 5.5% per annum and the principal is repayable on 31 December 2025. Thetaron has the right to repay all or part of this loan early, without penalty.

Two alternative offers

Circeon plc has received two alternative offers for its shares in Thetaron, both of which assume a completion date of 31 December 2021.

<u>Offer 1</u>

An offer to Circeon plc from a management buyout (MBO) team for the entire issued share capital of Thetaron comprising:

- Initial cash consideration of £1.7 million payable immediately on completion. This offer assumes that Thetaron's net assets (excluding the loan from Circeon plc) will have a carrying amount of £1.2 million. The initial consideration will be adjusted £1 for £1 if the statement of financial position at the completion date shows a higher or lower carrying amount for net assets. For example, if the statement of financial position shows net assets (excluding the loan) of £1.1 million, the initial consideration will be reduced by £100,000 to £1.6 million.

- Additional consideration equal to 1% of revenues earned by Thetaron from sales of BSM49 in the three years from 1 January 2022. The first sales of BSM49 are expected in 2022. The additional consideration is payable on 31 March 2025 and its fair value at 31 December 2021 has been calculated as £400,000.

The MBO team comprises the Thetaron CEO, Sam, and three other Thetaron board members. Venture Capital funding has been arranged.

If Circeon plc accepts the MBO offer, its existing loan of £3 million will be repaid in full by Thetaron on the completion date. Thetaron will finance this loan repayment by borrowing from a consortium of UK banks.

Offer 2

An offer to Circeon plc from Sam (acting alone rather than as part of an MBO) for 40% of the issued share capital of Thetaron, comprising cash consideration of £700,000.

The consideration will be adjusted if the net assets in the statement of financial position at the completion date (excluding the loan from Circeon plc) are more or less than £1.2 million, the adjustment in this case being 40% of the difference. For example, if the statement of financial position shows net assets (excluding the loan) of £1.1 million, the consideration will be reduced by £40,000 to £660,000.

If this offer is accepted, Thetaron will not make early repayment of the £3 million loan from Circeon plc.

The board's request

The Circeon board would like to understand the impact of each offer on the separate financial statements of Circeon plc and the consolidated financial statements of the Circeon Group. Circeon measures non-controlling interests using the proportion of net assets method.

Exhibit 2: Thetaron summary forecast for the year ending 31 December 2021, provided by Sam Heran, Thetaron CEO

Summary forecast statement of profit or loss for the year ending 31 December 2021

	Note	£000
Revenue		–
Costs of research and development	1	(1,950)
Other operating costs		(260)
Loan interest		(165)
Loss before taxation		(2,375)
Tax credit	2	475
Net loss for the year		(1,900)

Summary forecast statement of financial position as at 31 December 2021

	Note	£000
Property, plant and equipment	3	100
Cash		840
Other current assets	4	480
Current liabilities		(220)
Net current assets		1,100
Non-current liabilities (Circeon plc loan)		(3,000)
Net liabilities		(1,800)
Share capital		1,000
Retained earnings		(2,800)
		(1,800)

<u>Notes</u>

1. Research and development costs relate wholly to the development of BSM49. They comprise staff costs, consumables and an allocation of utility and other costs.
2. The tax credit has been prudently estimated and represents group relief receivable for the surrender of some of Thetaron's tax losses to other group companies.
3. Property, plant and equipment comprises IT equipment, fixtures and fittings.

4. Other current assets comprise the estimated receivable for group relief and sundry prepayments.

Exhibit 3: Extract from email received by audit manager from a friend

When I saw Sam last night, he could not wait to tell me that he and his MBO team have made offers to Circeon plc for its shares in Thetaron. He is clearly excited about becoming a Thetaron shareholder and he mentioned some very encouraging results from initial marketing of BSM49. These results have generated significant attention from potential customers.

Sam asked me to keep quiet about these encouraging results, because only he and his MBO team know about them, but I thought you would like to know. He said he is close to doing a deal with at least one potential customer, but that he had suggested waiting until after any share transaction is complete, so the customer could deal with the new owners.