ADVANCED LEVEL EXAMINATION

MONDAY 24 AUGUST 2020

(3½ 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

1. Please read the instructions on this page carefully before you begin your exam. If you have any questions, raise your hand and speak with the invigilator before you begin.

2. Please alert the invigilator immediately if you encounter any issues during the delivery of the exam. The invigilator cannot advise you on how to use the software. If you believe that your performance has been affected by any issues which occurred, you must request and complete a candidate incident report form at the end of the exam; this form must be submitted as part of any subsequent special consideration application.

3. Click on the **Start Exam** button to begin the exam. The exam timer will begin to count down. A warning is given five minutes before the exam ends. When the exam timer reaches zero, the exam will end. To end the exam early, press the **Finish** button.

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

5. The examiner will take account of the way in which answers are structured. Respond directly to the exam question requirements. Do not include any content or opinion of a personal nature. A student survey is provided post-exam for feedback purposes.

6. Ensure that all of your responses are visible on screen and are not hidden within cells. Your answers will be presented to the examiner exactly as they appear on screen.

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.

Question 1

HC plc is the parent company of the HC group. HC plc's subsidiaries operate in a variety of industries and are located in the UK and internationally. You work as an audit senior for Welfold, a firm of ICAEW Chartered Accountants. Welfold is the auditor of HC plc, HC group and all its subsidiaries.

You are assisting the HC audit engagement manager, Sara Yang, with the final review points arising from the audit of HC plc and the consolidation for the HC group for the year ended 31 May 2020. The audit completion meeting is scheduled for next week.

Sara gives you the following briefing:

"HC plc appointed Maisie Judge, an ICAEW Chartered Accountant, as the new Head of Treasury on 1 April 2020. Maisie worked for an investment bank before joining HC plc and she manages HC plc's investments and financial assets.

"The HC plc finance director retired on 10 March 2020, just before Maisie joined HC plc. As there is no replacement finance director, Maisie is acting in that role. I have concerns that some of her financial reporting knowledge is out of date.

"I have provided you with extracts from the HC group's financial statements for the year ended 31 May 2020, including the accounting policy note for financial assets (**Exhibit 1**).

"The audit planning for financial assets was completed in February 2020, prior to Maisie's appointment. The planning indicated that there were no significant changes from the year ended 31 May 2019 and financial assets were assigned a low level of audit risk. Last week, an audit senior, Jane Smith, performed some procedures on financial assets and has prepared some audit notes (**Exhibit 2**).

"An audit assistant has also brought some matters to my attention in relation to Maisie (**Exhibit 3**).

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

1) For each of the matters in Jane Smith's audit notes (Exhibit 2), set out and explain the correct financial reporting treatment in HC plc's financial statements and, where relevant, the HC group financial statements, for the year ended 31 May 2020. Show appropriate journal adjustments and explain any implications for the accounting policy note (Exhibit 1).

2) Calculate, taking into account your journal adjustments, the revised profit before tax and other comprehensive income for HC plc and for the HC group for the year ended 31 May 2020 (Exhibit 1).

3) Identify and explain the additional audit risks for financial assets arising since the audit planning was completed in February 2020.

4) Set out the key audit procedures that we should perform in respect of:
    a. Konditori Ltd's investment in Clik Ltd
    b. HC plc's corporate loans

5) Explain the ethical implications for Welfold and for Maisie, arising from Maisie's roles and from the matters highlighted by the audit assistant (Exhibit 3). Set out the actions Welfold should take."

Requirement

Prepare the working paper requested by the engagement manager, Sara Yang.

Total: 40 marks

<u>Note:</u>

You are not required to make any adjustments for current and deferred taxation

Exhibit 1: Extracts from draft financial statements

Accounting policy note for financial assets for the year ended 31 May 2020

Investments in subsidiary companies are stated at cost less any allowance for impairment.

On initial recognition of other investments in equity instruments, an irrevocable election is made to measure each investment at fair value through other comprehensive income, with any fair value gains or losses accumulated in other components of equity.

Corporate loans are measured initially at fair value plus directly attributable transaction costs and thereafter at amortised cost less impairments. The objective of the portfolio within which the corporate loans are held is to collect contractual cash flows.

Extract from statements of profit or loss for the year ended 31 May 2020

	HC plc (parent)	HC (group)
	£000	£000
Profit before tax	8,500	95,600
Other comprehensive income	–	–

Extract from statement of financial position for the year ended 31 May 2020

Financial assets	HC plc (parent) 2020	2019
	£000	£000
Equity investments (shares)		
Investments in subsidiary companies	5,000	5,000
Other investments in equity instruments	43,150	10,000
	48,150	15,000
Other financial assets		
Corporate loans	9,840	15,390

Exhibit 2: Audit notes on financial assets – prepared by audit senior, Jane Smith

I have reviewed the financial asset balances in HC plc's financial statements at 31 May 2020, as set out below.

a) Investments in subsidiary companies

There has been no change to the group structure since the previous year end. I have agreed the total cost of the subsidiaries of £5,000,000 to the consolidation schedules for the HC group.

b) Other investments in equity instruments

	Fair value at 31 May		
	2020	**2019**	**Historical cost**
	£000	**£000**	**£000**
Alma plc (800,000 shares)	–	10,000	6,000
VLA plc (320,000 shares)	18,150	–	18,150
Investment	25,000	–	25,000
	43,150	10,000	

The investments in shares in Alma plc and VLA plc represent less than 10% of the share capital of those companies.

- Alma plc shares

On 2 April 2020, Maisie authorised the sale of the Alma plc shares because its share price increased to £17 per share. Maisie calculated that this transaction resulted in a gain of £3,600,000, which she recognised in the statement of profit or loss.

I agreed this transaction to the contract note and ensured that the cash was correctly recorded.

- VLA plc shares

On 3 April 2020, Maisie bought 320,000 shares in VLA plc, a client of the investment bank where she used to work. Maisie recognised the shares at 'fair value through profit or loss' and the broker's fee for acquiring the VLA shares has been recognised in profit or loss.

The bid-offer spread for one VLA share at 3 April 2020 was:

At 3 April 2020	£55.45 – £56.72

The investment has now fallen in value as the bid-offer spread for one VLA share at 31 May 2020 was as follows:

At 31 May 2020	£54.45 – £55.72

I confirmed that the carrying amount at 31 May 2020 of £18,150,400 valued each share at £56.72.

- £25,000,000 investment

This transaction was carried out by the finance director who has now left HC plc. I have found out the following information:

On 25 February 2020, HC plc transferred £25,000,000 in cash to its 100% owned subsidiary Konditori Ltd, a high street retailer which sells clothes, food and other goods. In recent years, Konditori food sales have been very successful.

On 1 March 2020, Konditori entered into an arrangement with Rosen plc, a national supermarket chain, to set up a new company, Clik Ltd, which will operate a joint online distribution network. Konditori invested £25,000,000 provided by HC plc, in 50% of the shares of Clik Ltd. Rosen owns the remaining 50% of Clik's shares.

Konditori has recognised the £25,000,000 cash received from HC plc as a non-current liability and its investment in Clik as an expense of £25,000,000 in its operating costs for the year ended 31 May 2020.

Maisie has not made any other adjustments in respect of Clik Ltd in either the HC plc individual financial statements or the HC group financial statements.

As I have just found out this information, I have not had time to complete any audit procedures.

I have set out below a summary statement of profit or loss for Clik for the 3-month period from 1 March 2020 to 31 May 2020:

	£000
Revenue	14,000
Operating costs	(34,000)
Tax	2,000
Loss after tax	(18,000)

c) <u>Other financial assets − Corporate loans</u>

At 31 May	**2020** **£000**	**2019** **£000**
Corporate bonds in Reggs plc	4,860	10,410
Loan to JUP plc	4,980	4,980
	9,840	15,390

- Corporate bonds in Reggs plc

On 1 June 2018, HC plc purchased corporate bonds in Reggs plc, with a par value of £12,500,000, for £10,000,000. The bonds mature at par on 31 May 2023 and pay annual fixed interest at 4.72%. HC plc recognised the bonds at amortised cost as the objective of holding them was to collect contractual cash flows. The implicit interest rate is 10% per annum.

On 31 May 2020, Maisie sold 50% of the Reggs plc corporate bonds with a par value of £6,250,000 for £6,000,000.

The following journal is recorded in HC plc's financial statements for the sale of the bonds.

		£000
Debit	Cash	6,000
Credit	Bonds	6,000

Being sale of 50% of the Reggs plc bonds.

I have agreed the sale proceeds of £6,000,000 to the sale contract and to the bank.

- £4,980,000 loan to JUP plc

On 31 May 2019, HC plc made a secured loan of £5,000,000 to a supplier, JUP plc. The loan has an annual interest rate of 8% and is repayable in full on 31 December 2020. The loan objective is achieved by collecting contractual cash flows and the loan is measured at amortised cost.

On 31 May 2019, the loan had a low credit risk and the probability of default in the next 12 months was 2% with lifetime credit losses estimated at £1,000,000. An impairment of £20,000 was recognised.

On 1 May 2020, a credit rating agency indicated that JUP was experiencing financial difficulty and lowered its credit rating as there was a significant increase in credit risk. The expected credit losses over the remaining life of the loan were estimated at £1,000,000.

Maisie has made no adjustments in the financial statements for the year ended 31 May 2020 to reflect the information from the credit rating agency received from the credit rating agency on 1 May 2020.

I have downloaded the report from the credit rating agency and confirmed the lower credit rating.

Exhibit 3: Notes from audit assistant

After an audit meeting I had a brief conversation with Maisie.

She told me that she is enjoying the challenge of acting as finance director as well as her role as head of treasury. She said that it has been really helpful to have contacts from her previous job with the investment bank.

She also told me that she agreed a generous profit-related bonus with the HC board because of the extra responsibility. Maisie will receive a bonus if HC plc’s profit before tax for the year ended 31 May 2020 is greater than £7,000,000.

So far it looks like she will achieve this based on the draft financial statements.

I did not know that she was on a profit-related bonus. I just thought I would draw this to your attention.

Maisie also mentioned that she understood that the audit will be put out to tender shortly and hopes that Welford would be tendering for the audit.

Question 2

You are Alan Khan and you work as a financial accountant at React Chemicals plc (React), an AIM-listed company based in the UK. React manufactures and supplies chemicals to customers in the UK. It prepares financial statements to 31 July.

The React finance director gives you the following briefing:

"The board has set out two proposals for the year ending 31 July 2021. The board needs to understand the financial reporting implications of these proposals.

> Proposal 1 relates to the distribution of chemicals and the board is considering two alternative contracts, A and B (**Exhibit 1**).
>
> Proposal 2 relates to a new share option scheme which will be open to all employees (**Exhibit 2**).

"I have also provided forecast financial information, including information about tax treatments, for the year ending 31 July 2021 (**Exhibit 3**). The forecast information does not include any impact from the board's proposals.

Instructions from finance director

"I would like you to prepare a briefing paper for the board in which you:

(1) Set out and explain the appropriate financial reporting treatment, including the impact on current and deferred tax for:

- Proposal 1 – Distribution costs (Exhibit 1). Address both Contract A and Contract B; and
- Proposal 2 – Share option scheme (Exhibit 2).

Include relevant journal adjustments.

(2) Assuming that React signs Contract B with Dutton (Proposal 1) and grants the share options (Proposal 2), calculate the total tax charge to be shown in React's statement of profit or loss for the year ending 31 July 2021 and React's total current and deferred tax liability as at 31 July 2021.

(3) Prepare revised forecast financial information for the year ending 31 July 2021 (Exhibit 3). Include your adjustments for Contract B (Proposal 1), the share option scheme (Proposal 2) and both current and deferred tax."

Requirement

Prepare the briefing paper requested by the finance director.

Total: 30 marks

Exhibit 1: Proposal 1 − Distribution costs

Transportation of products to customers is a complex and costly part of React's business.

From 1 August 2020, React will produce a new chemical which can only be transported in special containers. React has identified two potential distributors, TrensFar and Dutton, that can deliver the chemical safely. They have offered the following lease contracts:

<u>Contract A − TrensFar</u>

TrensFar will transport React's product by road, using tankers. A tanker consists of an engine and a separate container. TrensFar owns the tankers and will also provide drivers.

TrensFar can use its containers to transport chemicals for different customers, but containers require cleaning if different chemicals are transported.

TrensFar's contract with React will be for four years. It states that deliveries to React's customers can take place only on Mondays and Tuesdays each week. The contract specifies the maximum and minimum quantity for each delivery. React will email a weekly delivery schedule to TrensFar, informing it of the delivery quantities for the following week. The estimated annual cost of the contract is £5,000,000 and TrensFar will invoice React on a monthly basis, based on the quantity delivered and distance travelled.

Some TrensFar containers will be stored at React's premises, so that React can load the chemical the day before the scheduled delivery. React cannot use the containers other than as specified in the contract with TrensFar.

The contract specifies that TrensFar can collect any containers that are being stored by React and use them for other TrensFar customers.

<u>Contract B – Dutton</u>

Dutton will supply larger containers than TrensFar. Dutton will transport containers by road and rail to React's customers.

The contract price has two elements, supply of containers and transport:

- Supply of containers

  React will have the use of 15 specific containers for 9 years. Dutton owns the containers. Each container is designed for the particular type of chemical which React produces. The 15 containers will be stored at React's premises and will be used only by React. Dutton will be responsible for any repair work and cleaning and must provide a substitute container during any period when a container is not available.

  On 1 August 2020, React will pay a lease set-up fee of £80,000. The cost of the supply of containers element of the contract will be £4,000,000 per annum payable in arrears. React's incremental borrowing rate is 6% per annum.

- Transport to React's customers

At React’s request, Dutton will collect the container, transport it by road and rail to React’s customers and will return the container to React’s premises. React can make requests for delivery at any time.

The cost for the transport element of the contract will be based on an agreed rate, according to the number of deliveries and the distance travelled. The estimated annual cost of the transport element of the contract is £1,000,000.

Exhibit 2: Proposal 2 − Share option scheme

On 1 August 2020, React will set up a share option scheme which will be open to all employees.

100 employees will join the scheme on 1 August 2020. Each employee will be granted 2,600 options. Each option permits the holder to subscribe for one share in React. The fair value of each option at 1 August 2020 is £3.60 and the exercise price is £3.80.

The share options will vest when profit increases by 20% in any year, or by an annual average of 14% in any two consecutive years. The scheme will lapse after three years if these targets are not met.

An employee must be in continuous employment with React until the vesting date for their share options to vest.

React has prepared the following projections:

At 31 July	**2020**	**2021**	**2022**
Profits increase by	−	12%	18%
Price per share	£7.30	£8.60	£8.70

No employees are expected to leave the company in the next three years.

React's board expects that the share options will vest on 31 July 2022 and therefore there will be no employee cost to record in the year ending 31 July 2021.

Exhibit 3: Forecast financial information for the year ending 31 July 2021

Forecast summary statement of profit or loss for the year ending 31 July 2021

	£000
Revenue	23,731
Gross profit	20,174
Total depreciation	(530)
Other operating costs	(6,384)
Operating profit	13,260
Finance costs	(125)
Profit before tax	13,135
Tax (**to be completed**)	(x)
Profit for the year	13,135

Forecast summary statement of financial position for the year ending 31 July 2021

	£000
Non-current assets	
Plant and equipment	21,247
Current assets	26,567
TOTAL ASSETS	47,814
Equity	
Share capital (£1 shares) and other reserves	11,810
Retained earnings	17,290
	29,100
Non-current liabilities	
Borrowings and other financial liabilities	4,264
Deferred tax liability **at 1 August 2020**	1,741
	6,005
Current liabilities	
Trade and other payables	12,709
Current tax payable (**to be completed**)	(x)
	12,709
TOTAL EQUITY AND LIABILITIES	47,814

Tax information
In the tax jurisdiction where React operates, accounting profit and taxable profit are calculated using the same rules except for the following:

- Plant and equipment

No tax allowance is available for accounting depreciation. Instead, in the year in which an asset is capitalised (including assets capitalised under lease contracts), tax depreciation is available for plant and machinery at the rate of 30% of the asset cost recognised in plant and equipment. Thereafter, an annual writing down allowance of 18% is available on the brought forward tax base. The current tax rate is 25% and there are no expected changes to this tax rate in the future.

When the forecast financial statements for the year ending 31 July 2021 were prepared, no additions to plant and equipment or disposals from plant and equipment were included and accounting depreciation of £530,000 was recognised.

The deferred tax liability at 1 August 2020 arises from a temporary difference on plant and equipment as follows:

	£000
At 1 August 2020	
Carrying amount of plant and equipment	21,777
Tax base of plant and equipment	(14,813)
	6,964
Deferred tax liability at 25%	1,741

- Share option expense

A tax allowance arises only when a share option is exercised. The tax allowance is based on the option's intrinsic value at the exercise date. The intrinsic value is the difference between the market price of the share at the exercise date and the exercise price of the option.

Question 3

You are an audit senior working for Hyall and Forbes, ICAEW Chartered Accountants. You are assigned to the audit of NuTyre plc for the year ending 30 September 2020. NuTyre is listed on the London Stock Exchange. It manufactures and fits its own brand of car tyres and exhausts and operates in the UK and internationally.

This is your first time on the NuTyre audit and the audit manager briefs you as follows:

“I need your help to plan the NuTyre audit for the year ending 30 September 2020.

“NuTyre is a challenging audit because, although the company has no subsidiaries, it has 2 manufacturing divisions and 13 retail divisions. Each division has its own management team. All 15 divisions use the same accounting system, but financial and other controls differ between divisions.

“The company manufactures exhausts at its manufacturing division in the UK and tyres at its manufacturing division in India.

“During the year ended 30 September 2019, NuTyre had three retail divisions in the UK, India and France. Each retail division operates between four and ten sites, selling and fitting tyres and exhausts to vehicles owned by individuals.

“In October 2019, NuTyre acquired retail sites in ten additional countries, establishing retail divisions in Germany, Sweden and eight other countries.

“The retail model is similar in all the countries in which NuTyre operates.

“In the year ended 30 September 2019, Hyall and Forbes performed audit procedures in the UK, India and France. We will need to think carefully about scoping the audit for the year ending 30 September 2020. For example, we will need to identify which divisions are significant components for the purposes of our audit to identify where we carry out more detailed audit procedures. I don’t think it will be practicable to visit all 15 manufacturing and retail divisions and their various sites. However, in total they are material, so we need to perform some audit procedures for these elements of the business.

“Planning materiality for the NuTyre audit has been set at £130,000.

“NuTyre produces management accounts which identify separately the results for each manufacturing or retail division. I’ve provided you with summary information from the management accounts for the nine months ended 30 June 2020 (**Exhibit 1**).

“I have also provided notes from my recent meeting with NuTyre’s finance director, Jud Lever (**Exhibit 2**). He explains how NuTyre’s management reporting has evolved this year and highlights issues at some divisions. He asks for our guidance on following up an alleged fraud and on disclosure requirements.

Audit manager's instructions

"What I need you to do is:

(1) Calculate relevant accounting ratios as preliminary analytical procedures on the summary information from the management accounts (Exhibit 1).

(2) Use the results of your analytical procedures, together with the other information provided, to:

(a) identify any matters that you believe Hyall and Forbes should investigate further as we plan the audit of NuTyre for the year ending 30 September 2020.

(b) produce an extract from the audit plan which, for each manufacturing division and retail division:

- states whether that division is a significant component and explains why; and
- outlines the extent of the audit procedures we should perform at that division. (I do not require detailed individual audit procedures, but I do need a justification of the extent and scope of audit testing required for each division).

(c) provide Jud with guidance on the divisional financial reporting disclosures that should be included in the NuTyre financial statements for the year ending 30 September 2020. Explain your guidance and set out any additional information you require to reach a conclusion on the disclosures required.

(3) Respond to Jud's request regarding the fraud allegations from the Belgium employee (Exhibit 2), setting out:

(a) the specific procedures Hyall and Forbes could perform to investigate the occurrence and extent of the alleged fraud; and

(b) the controls which NuTyre could introduce to minimise the likelihood of a fraud of this nature being committed in future by a divisional manager."

Requirement

Respond to the audit manager's instructions.

Total: 30 marks

Exhibit 1: Summary information from NuTyre's management accounts for the nine months ended 30 June 2020

	Notes	Product	Revenue	Operating profit/(loss)
			£000	£000
Manufacturing divisions	1			
UK		Exhausts	4,061	51
India	2	Tyres	4,801	1,680
Total manufacturing			8,862	1,731
Retail divisions	2			
UK		Exhausts	2,051	428
		Tyres	2,135	320
India		Exhausts	723	291
		Tyres	2,692	807
France		Exhausts	626	234
		Tyres	448	120
Germany		Exhausts	253	27
		Tyres	1,239	(35)
Sweden		Exhausts	477	97
		Tyres	1,354	203
Other: 8 small divisions	3	Exhausts	1,093	208
		Tyres	3,466	520
Total retail			16,557	3,220
Total retail and manufacturing			25,419	4,951
Less:				
Inter-division revenue	1		(8,862)	
Less:				
Head office costs				(2,303)
Total			16,557	2,648
Summary by product:				
Exhausts			5,223	1,336
Tyres			11,334	3,615
Head office				(2,303)
Total			16,557	2,648

Divisional assets at 30 June 2020	Notes	Total assets
		£000
Manufacturing division:		
UK		2,395
India		3,484
Retail division:	4	
UK		2,018
India		1,539
France		410
Germany		781
Sweden		954
Other: 8 small divisions	3	2,182
Head office		263
Total		14,026

Notes

1. The manufacturing divisions sell only to NuTyre's retail divisions.

2. Old tyres removed from customer vehicles can sometimes be refurbished and sold as reconditioned tyres. This refurbishment work is performed by NuTyre's manufacturing division in India. When a retail division sends tyres to India to be refurbished, no inter-divisional sale is recorded. The Indian manufacturing division bears all associated transport costs.

3. The eight small divisions are all similar in size.

4. Retail division site assets comprise the premises and equipment used for the fitting of tyres and also inventory.

Exhibit 2: Notes from meeting with Jud Lever, NuTyre finance director – prepared by audit manager

Management reporting

Jud explained that, following the establishment of additional divisions in Germany, Sweden and 8 other countries, NuTyre's management accounts now include more analysis of divisional results, both geographically and by product.

This information is reviewed monthly by the executive management team and used to assess the performance of the divisions and to make decisions about any further investment. It is also used to set prices for inter-divisional sales, so that the company's overall tax burden is minimised.

The management team's focus is primarily on the geographical analysis, as the countries in which NuTyre operates have very different regulatory environments and market conditions. Each manufacturing and retail division pays tax in the country in which it operates. Tax rates vary between countries with a particularly high rate in the UK and a low rate in India.

Issues identified

- An employee at the small retail division in Belgium has contacted Jud and alleged that the division's finance manager, Henri Pinot, is defrauding NuTyre. The employee alleges that Henri is taking tyres which could be refurbished and, instead of sending them to NuTyre's manufacturing division in India, is selling them for his own benefit.

  The employee also alleges that Henri has made unauthorised payments to Pinot Ltd, a company owned by his wife. Henri has recorded these as consultancy costs in the division's financial statements.

  Jud wants our help to investigate these allegations and the NuTyre audit committee has asked us to recommend controls that NuTyre could introduce to prevent fraud of this type.

- Total assets in France look low. Jud told me that it is common in France to expense equipment in the statement of profit or loss, rather than capitalising it.

Disclosure requirements

In the past, NuTyre provided minimal divisional analysis in its published financial statements. Jud has asked Hyall and Forbes to provide guidance on whether any additional disclosure is necessary now that the company has more divisions. The Board wants to give as little detail as possible, as it believes detailed information might benefit its competitors.