



ADVANCED LEVEL EXAMINATION

MONDAY 19 JULY 2021

(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

The final audit visit for Panther started last week and you have joined the audit team as audit senior. Jason Green, an audit assistant, has also joined the audit team for the final audit visit.

The engagement manager for the Panther audit, Albert Ramsay, gives you the following briefing:

“You will have reviewed the interim audit information prepared by Ben Brown, the previous audit senior. You will also have familiarised yourself with the data for Panther for the 11 months ended 30 November 2020.

“Data for December 2020 has now been imported into the data analytics software from Panther’s nominal ledger, so the full year nominal ledger data for the year ended 31 December 2020 is now available.

“Jason followed up on the two interim audit matters set out by Ben Brown and has carried out some further audit work. As a result, Jason has set out three audit issues (**Exhibit 1**).

“Jason has also performed preliminary analytical procedures for revenue for each type of metal and alloy in comparison with last year (**Exhibit 2**) and he has added some brief comments.

“The Panther board is concerned about how the volatility of metal prices affects the value of inventories and impacts profit. The board has provided an illustrative example of a hedging transaction prepared by Paul Parker (**Exhibit 3**).

“Materiality has been set at £165,000, but performance materiality has not yet been finalised.”

Instructions

- (1) In respect of each of the three audit issues identified by Jason Green (Exhibit 1), review relevant transactions in the data analytics software; and
 - Set out and explain the appropriate financial reporting treatment, including correcting journal entries.
 - Identify and explain the key audit risks.
- (2) From Jason’s preliminary analytical procedures for revenue (Exhibit 2), select three revenue accounts which you regard as having the highest audit risk. For each of these three accounts:
 - Explain and justify why you have selected the account.

- Identify individual transactions which give rise to key audit risks and explain the nature of these risks.
 - Set out the information and explanations that you need from Panther's management in respect of the audit risks identified.
- (3) Determine and justify an appropriate level of performance materiality for the audit of Panther's revenue.
- (4) Set out and explain the financial reporting treatment for the illustrative example hedging transaction proposed by Paul (Exhibit 3).

You should include relevant journals. Explain how the suggested hedging transaction may reduce the volatility of future reported profits.

Requirement

Respond to the audit engagement manager's instructions.

Total: 40 marks

Exhibit 1: Audit issues – prepared by Jason Green, audit assistant

Audit Issue 1 – Pro forma invoices

At the interim audit, Ben Brown raised a concern regarding whether Panther has appropriate and effective controls over transactions using pro forma invoices. I have investigated further and have identified a pro forma invoice in the Account code Nickel 4003 in April 2020 posted by Alain.

A final invoice for this amount was posted later in 2020 when the nickel was delivered to the customer.

Audit issue 2 – Sale to YYM

YYM has been a customer of Panther for many years. YYM is a wholesaler and global distributor of metals and alloys, based in South Africa.

In December 2020, Panther sold £342,556 of chromium to YYM. (The sale is recorded in Account code 4012 Chromium). In the sales agreement, YYM agreed to assume risk for the chromium and had the right to control the destination and timing of delivery. YYM had agreed to sell this chromium to one of its German customers, Zeinn.

YYM therefore asked Panther to store the chromium in its warehouse on a bill-and-hold basis until February 2021. This was to avoid the costs of transport to South Africa and then later to Germany. Panther agreed to this request from YYM. This chromium was included in the inventory count at 31 December 2020 and recognised in inventory at its cost to Panther of £270,500. I have checked and confirmed that the cost is correct.

Audit Issue 3 – Goods in transit

On 6 December 2020, a ship set sail to deliver tungsten to a customer, GTEX, in San Diego on the west coast of the US. A pro forma invoice amounting to £450,562 was prepared.

The tungsten was in transit for some weeks and the ship was due to arrive in the San Diego on 27 December 2020.

On 21 December 2020, Julie, the Panther accounts assistant, emailed GTEX's purchase ledger department. She informed them that the tungsten would be held at the port in San Diego until GTEX paid the outstanding amount owing from previous sales of £352,411. This amount had been due for payment on 30 November 2020.

On 2 January 2021, after some negotiation, GTEX made a payment on account of £150,000 in respect of the total outstanding amount owing.

Following the receipt of the payment on account, Panther agreed to release the tungsten held at the San Diego port. The goods were eventually delivered to GTEX on 15 January 2021.

Because the goods had left Panther's factory, they were not included in inventory at 31 December 2020. I verified this by reviewing the inventory listing. The cost price of the tungsten was £395,500.

Exhibit 2: Preliminary analytical procedures for revenue – prepared by Jason Green

Account Code	Account Description	Prior Year £	Current Year £	% change	Brief comments prepared by Jason Green
4000	Nickel Based Alloys	6,041,028	12,178,537	102%	
4001	Cobalt Based Alloys	1,516,635	2,357,616	55%	
4003	Nickel	(73,923)	337,199	556%	Movement already explained by Audit issue 1
4004	Other Raw Materials	292,047	296,846	2%	Consistent with previous year, no significant fluctuations
4005	17/4 ph type	74,967	137,191	83%	
4007	Tungsten	2,778,353	3,186,947	15%	Consistent with previous year, no significant fluctuations
4008	Niobium	2,065,017	2,537,320	23%	Consistent with previous year, no significant fluctuations
4011	Titanium	703,088	693,235	(1)%	Consistent with previous year, no significant fluctuations
4012	Chromium	161,075	827,775	414%	Movement already materially explained by Audit issue 2 Invoice to YYM in December 2020 for £342,566 on a 'bill-and-hold' arrangement
4013	Molybdenum	3,495,861	5,511,292	58%	Per Paul, Panther accountant, sales of molybdenum have increased following acquisition of two key customers. The increase is in line with budget.
4014	Tantalum	6,500,389	3,673,605	(43)%	Paul was not sure what had happened to Tantalum sales this year.
4015	Hafnium	2,868,814	1,499,248	(48)%	Large sale in February but then small amounts – per Paul, Panther no longer sells this type of metal.
4017	Toll Cutting	687,500	638,035	(7)%	

4018	Cobalt	99,914	-	(100)%	
4019	Aluminium	304,435	337,796	11%	
4020	Monel	1,943	98,270	4958%	One large sale in July
4021	Rhenium	198,446	7,778	(96)%	Per Paul, Panther no longer sells this type of metal.
4024	Maraging	-	22,940	N/A	
4025	Turnings - (Unit 8 Sales)	10,440	-	(100)%	
4026	Zirconium	44,082	345,426	684%	One-off transactions – per sales department, not a metal that Panther sells frequently.
4028	Dense alloy	1,200,479	137,556	(89)%	Confirmed with sales department that Panther currently no longer makes this type of alloy.
4029	Low Grade to Sell	351,045	257,740	(27)%	
4030	MP35N	194,941	64,763	(67)%	
4031	Refine/Reclaim	-	1,941	N/A	
4040	Sales - Processing	166,316	161,789	(3)%	
Total revenue		29,682,894	35,310,842		

Totals subject to roundings

Exhibit 3: Illustrative example hedging transaction

Nickel makes up a large majority, by volume and value, of the nickel alloys produced by Panther. The selling price for nickel alloys achieved by Panther is heavily dependent on the market value of the nickel content at the time of the sale.

The Panther board wishes to reduce fluctuations in future cash inflows from the sale of nickel alloys currently held in inventory. It wants to do this by hedging the cash flows from the nickel alloys which are to be sold from inventory. It will use nickel commodity futures contracts as the hedge.

Panther has used this type of hedging in the past, and there is strong evidence from previous contracts that it is effective.

Paul has prepared the following illustrative example based on a hedge which is expected to take place on 30 September 2021:

	Quantity	Cost price per tonne	Inventory cost
	Tonnes	£	£
Estimated nickel alloy in inventory at 30 September 2021	540	12,600	6,804,000

The sales value of the nickel alloy at 30 September 2021 is estimated to be £7,540,000 if sold at that date. However, Panther does not expect to sell the nickel alloy until 31 March 2022, when it knows a regular customer will need a delivery.

On 30 September 2021, Panther will sell futures contracts for 540 tonnes of nickel at £14,000 per tonne. The contracts will mature on 31 March 2022.

On 31 December 2021, the fair value of the inventory of nickel alloy is expected to be £7,330,000. At 31 December 2021, the futures price for nickel for delivery on 31 March 2022 is expected to be £13,500 per tonne.

Question 2

E-Van Ltd is a component manufacturer for the electric vehicle industry. The Sennhauser family owns 100% of E-Van's ordinary shares and the board is comprised entirely of Sennhauser family members.

You are Jo Maine, the assistant to Hanna Sennhauser, the finance director. You and Hanna are both ICAEW Chartered Accountants.

Yesterday evening Hanna sent you the following email:

Email to Jo Maine

The Sennhauser family intends to sell all its shares in E-Van and has identified a potential buyer, Karpart Ltd, which is E-Van's largest customer.

As part of Karpart's due diligence for the acquisition, the Karpart board has requested the financial statements of E-Van for the year ended 30 June 2021 as soon as they have been finalised. The reported profit of E-Van for that year will be one factor in determining a valuation for the E-Van shares.

Draft financial statements for E-Van for the year ended 30 June 2021 are provided for you in **Exhibit 1**.

The E-Van board wants to present the company's results as favourably as possible to maximise the sale price of E-Van's shares. However, the board recognises the need to comply with IFRS. In particular, the other directors on the E-Van board have requested that I review the financial reporting treatment of the following three areas:

- property, plant and equipment (PPE)
- investment property
- the net defined benefit pension liability.

I have looked at these and provided you with my proposed adjustments (**Exhibit 2**) to implement the board's request. The financial statements (Exhibit 1) do not yet include any of my proposed adjustments.

So that I can report to the board, I would like you to prepare a working paper for me in which you:

- (1) Set out and explain, for each of the three areas identified above, your recommended financial reporting treatment in E-Van's financial statements for the year ended 30 June 2021. The recommended treatment should comply with

IFRS while maximising reported profit. Justify and calculate any differences from my proposed adjustments. Include journals.

- (2) Prepare revised draft financial statements for E-Van for the year ended 30 June 2021 (Exhibit 1), which reflect your recommendations. Show your workings.

Telephone call

Shortly after sending the email, Hanna telephoned you and made the following comment:

“I sent you an email earlier today. I want to emphasise how important it is to report a high profit figure and maximise the price we achieve for the sale of E-Van’s shares. I did not want to put this in writing but I would like you to prioritise this over complying with IFRS.”

“I am planning to retire in six months. Clearly, I will be able to recommend you as my successor if you help me.”

Requirements

1. Prepare the working paper requested by Hanna Sennhauser; and
2. Explain the ethical implications for you arising from Hanna’s comment and the actions you should take.

Total: 30 marks

Ignore any adjustments for current and deferred taxation

Exhibit 1: Draft financial statements for E-Van for the year ended 30 June 2021

Draft statement of comprehensive income for the year ending 30 June 2021

	£000
Revenue	<u>50,353</u>
Operating profit	10,655
Finance costs	(6,150)
Profit before tax	<u>4,505</u>
Other comprehensive income:	
Remeasurement (loss) on net defined benefit obligation (Exhibit 2, note 3)	(3,480)

Draft statement of financial position as at 30 June 2021

	£000
Assets	
Non-current assets	
Property, plant and equipment (Exhibit 2, note 1)	83,700
Investment property (Exhibit 2, note 2)	24,200
Current assets	39,500
Total assets	<u>147,400</u>
Equity and liabilities	
Equity	
Ordinary share capital (£1 shares)	50,000
Other reserves	5,000
Retained earnings	12,600
	<u>67,600</u>
Non-current liabilities	
Net defined benefit pension liability (Exhibit 2, note 3)	54,000

Non-current payables and provisions	7,000
	<hr/>
	61,000
Current liabilities	18,800
	<hr/>
Total equity and liabilities	147,400
	<hr/>

Exhibit 2: Hanna's proposed adjustments

Note 1 – PPE: depreciation of production line

I carried out a review of E-Van's accounting policy for plant and equipment. E-Van set up a new production line on 1 July 2019 for £36 million. E-Van recognised this production line at cost and has depreciated it on a straight-line basis over seven years with an £8 million residual value in accordance with its accounting policy.

A depreciation charge on this basis is included in the draft financial statements for the year ended 30 June 2021.

I asked the production manager whether he could justify a longer useful life for this production line. He told me that it has been clear since July 2020 that demand from our customers for the car parts produced on the production line is likely to end in June 2024. As a result, the production line would be sold at that date.

However, I have obtained the electric vehicle component manufacturer industry averages as shown below:

	Industry average
Useful life – number of years	8
Residual value as % of cost	30%

- Proposed adjustment

I propose that the depreciation charge for this production line should be revised as from 1 July 2020 to reflect the average useful lives and residual values used by the electric vehicle component manufacturer industry.

Note 2 – Investment property

On 1 July 2015, E-Van bought a freehold office building for £27.5 million. The office building had a 50-year useful life at that date and a zero residual value.

The office building was used as the company's head office until 1 July 2020, when E-Van moved its head office to another property.

The freehold office building previously used by E-Van as its head office, was leased out to a third party under a 10-year lease and reclassified by E-Van as an investment property.

At 1 July 2020, E-Van chose to recognise the office building under the cost model for investment properties. It continued to depreciate the office building over its remaining useful life and included a depreciation charge in the draft financial statements for the year ended 30 June 2021.

- Proposed adjustments

From the change of use on 1 July 2020, I propose that instead of choosing the cost model, E-Van should choose the fair value model for the office building in accordance with IAS 40.

To establish the fair value, I did some research and obtained details of two office buildings of similar size to E-Van's head office which were sold in the local area in the past year.

One office building was sold at a public auction for £30 million; the other was sold for £35 million to an international consortium seeking to make its first purchase in the UK property market.

I think that we should use the higher of these two figures as the fair value of E-Van's head office building. The fair value at 30 June 2021 can be assumed to be the same as the fair value at 1 July 2020.

Note 3 – Net defined benefit pension liability

The present value of the defined benefit obligation and the fair value of the plan assets at 30 June 2021 were provided by E-Van's actuary.

The changes in the fair value of the assets and the present value of the liabilities over the year are reflected in the draft financial statements for the year ended 30 June 2021 as follows:

	Fair value of plan assets	Present value of obligation	Net defined benefit pension liability
	£000	£000	£000
At 1 July 2020	16,000	(67,000)	(51,000)
Interest 2%	320	(1,340)	(1,020)
Contributions paid	3,500		3,500
Current service cost		(2,000)	(2,000)
Less: Benefits paid to retired members	(3,300)	3,300	
	16,520	(67,040)	(50,520)
Remeasurement	1,480	(4,960)	(3,480)
	18,000	(72,000)	(54,000)
At 30 June 2021	18,000	(72,000)	(54,000)

- Proposed adjustments

- IAS 19 requires that the net interest cost and the liabilities of the pension scheme are discounted using the interest rate applicable to high-quality corporate bonds. We currently use 2% per annum based on AA-rated corporate bonds. However, I propose instead that a BBB investment grade corporate bond interest rate of 4.2% rate would be acceptable and should be used. As a result of using the higher interest I estimate that the net defined benefit pension liability at 30 June 2021 will reduce to £35 million.
- E-Van made an offer to the scheme's retired members to give up any future pension increases in return for a higher current pension which will remain constant. By 15 July 2021, nearly all the members had accepted this offer. The actuary informed me that this will result in a past service curtailment gain of £3.8 million for the year ended 30 June 2021. However, the actuary has not included this adjustment in the figures provided above. I propose that this adjustment should be recognised in the draft financial statements for the year ended 30 June 2021.

Question 3

You are an audit senior at Hughes Watson LLP (HW), a firm of ICAEW Chartered Accountants. Numilla plc, an audit client of HW, is listed on the London Stock Exchange. It is the parent company of a group which supplies wind turbines and other equipment to the renewable energy industry in the UK. You have been assigned to the group audit of Numilla for the year ended 30 June 2021.

You receive the following briefing and instructions from the Numilla group audit manager, Alex Matuke:

“On 30 June 2021, Numilla acquired 80% of the issued ordinary share capital of Localex Inc, a company based in Utopia. An assistant in Numilla’s corporate finance team has provided background notes on the acquisition (**Exhibit 1**) and the Numilla financial controller has set out his preliminary calculation of goodwill arising on the acquisition of Localex (**Exhibit 2**). We need to complete our audit procedures on this goodwill.

“Please review all of the information I have provided (Exhibit 1 and Exhibit 2) and:

- (1) In respect of the calculation of goodwill on the acquisition of Localex:
 - a) Identify and explain fair value adjustments and any errors or omissions made by the Numilla financial controller. Where possible, quantify the effect of each fair value adjustment, error or omission on goodwill, showing all relevant figures.
 - b) As far as the information permits, set out a corrected calculation of goodwill in the functional currency and the amount to be recognised in Numilla’s consolidated statement of financial position at 30 June 2021.

Where appropriate, use an annual discount rate of 5%.

- (2) Explain the key audit risks that HW should address in its audit of the goodwill arising on the acquisition of Localex. For each key audit risk identified, set out the appropriate audit procedures for the year ended 30 June 2021.”

Requirement

Respond to Alex Matuke’s instructions.

Total: 30 marks

Exhibit 1: Background notes on the acquisition of Localex – prepared by an assistant in Numilla’s corporate finance team

Localex is Numilla’s first acquisition outside the UK. Localex operates an energy supply business in Utopia. It also manufactures wind turbines which the Numilla group intends to sell in the UK.

Localex has developed a small wind turbine, known as the MiniMax. This can be used by individual households or small businesses. The MiniMax is technically superior to similar products on the UK market and can be manufactured more cheaply in Utopia than in the UK. Following its acquisition by Numilla, Localex will continue to supply energy in Utopia. Localex will also expand its manufacturing facility so that it can supply MiniMax to both the UK and its local market.

The acquisition

On 30 June 2021, Numilla acquired 80% of the issued ordinary share capital of Localex from the company’s chief executive, Mattie Sven. Mattie still owns the remaining 20% of issued ordinary share capital. Mattie will continue as Localex chief executive under a three-year employment contract expiring on 30 June 2024.

The currency in Utopia is the \$, which is also the functional currency of Localex.

Consideration

Consideration for the 80% of Localex ordinary shares acquired by Numilla was structured as follows:

- Cash of \$1 million paid on 30 June 2021.
- 2 million ordinary shares in Numilla plc issued on 30 June 2021, when the market price per share was £4.20.
- 500,000 ordinary shares in Numilla plc to be issued on 31 July 2024 if the Localex financial statements show average annual growth in profit before taxation of at least 10% over the three-year period ending 30 June 2024. I believe that there is only a 40% probability that this target will be achieved. It is estimated that the Numilla plc price per share on 30 June 2024 will be £5.

Net assets

The Localex draft financial statements for the year ended 30 June 2021 show net assets with a carrying amount of \$5 million comprising:

	Notes	\$ million	\$ million
PPE			
- Freehold property – at valuation	1		3.0
- Plant and equipment at depreciated cost			2.7
			<u>5.7</u>
Research and development costs for MiniMax			1.6
Current assets			2.9
Current liabilities:			
- Decommissioning liability	2	1.5	
- Other		<u>3.7</u>	(5.2)
Net assets			<u>5.0</u>

Notes

1. Localex uses the revaluation model in respect of freehold property. I believe that the carrying amount of freehold property is equivalent to its fair value.
2. The decommissioning liability relates to a fossil-fuel power station which is recognised in plant and equipment. Localex is legally obliged to dismantle this power station at the end of its useful life on 30 June 2026. The liability has been calculated using an estimated cost at 30 June 2026 of \$1.9 million and a discount rate of 5% per annum. Localex estimates that, on 30 June 2026, a third party would charge \$3.3 million to assume this liability.

Tax

In Utopia, company taxable profits are equal to accounting profits. The Utopian tax rate is 7.5%.

The UK tax rate is 19%.

Exchange rate

The exchange rate on 30 June 2021 was £1 = \$0.8.

Exhibit 2: Calculation of goodwill on the acquisition of Localex – prepared by Numilla financial controller

	Notes	£000
<u>Consideration</u>		
Cash		1,000
2 million shares at £4.20		8,400
Professional fees incurred in respect of the acquisition and associated issue of shares		100
Non-controlling interest – 20% of \$5 million, translated at exchange rate of £1 = \$0.8	1	1,250
Total consideration		<u>10,750</u>
<u>Less: Net assets</u>		
As reported in the Localex draft financial statements at 30 June 2021	2	5,000
Fair value adjustments:		
– Contractual right to supply power and equipment in Utopia	3	1,600
– Provision for UK patent costs	4	<u>(125)</u>
Total net assets		<u>6,475</u>
Goodwill		<u>4,275</u>

Notes

1. It is Numilla group policy to value the non-controlling interest using the proportion of net assets method.
2. Localex prepares its financial statements in accordance with IFRS and adopts the same accounting policies as Numilla group.
3. Localex has an exclusive licence to supply power in the Southern Region of Utopia until 30 June 2030. Based on anticipated net cash inflows from this contract, I have calculated that its value in use is \$1.28 million (£1.6 million) higher than its carrying amount at 30 June 2021. I have made a fair value adjustment to reflect this.
4. Following the acquisition, Numilla plans to patent Localex's MiniMax wind turbine in the UK and other markets. I have therefore included a provision for the estimated cost of obtaining this patent.

