ADVANCED LEVEL EXAMINATION

MONDAY 5 NOVEMBER 2018

(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

You are Trina Briggs, an ICAEW Chartered Accountant, working for Dealy and Brant (DB), a firm of ICAEW Chartered Accountants. DB has audited Zmant plc and its subsidiaries for some years and you are the audit manager for the Zmant group audit.

Zmant plc supplies specialist audio equipment and has several 100%-owned subsidiaries. Zmant and its subsidiaries have a 30 September year end. During the year ended 30 September 2018, Zmant made the following acquisition:

Investment in KJL

Zmant made an investment in KJL, a company that produces and sells audio equipment to Zmant. KJL is based in Otherland where the currency is the Otherland $ (O$).

On 1 January 2018, Zmant bought 60% of the issued ordinary share capital of KJL for O$52,800,000. On acquisition, there were no fair value adjustments needed to the carrying amounts of the assets and liabilities of KJL.

On 1 January 2018, Zmant made a loan of O$21,000,000 to KJL, at an annual interest rate of 6%, repayable at par on 30 September 2020.

KJL prepares its financial statements under IFRS and has a 30 September year end. DB is not the auditor for KJL.

DB's individual audits of Zmant and its subsidiaries are almost finished and the audit of the consolidation is now in progress. The DB audit partner responsible for the Zmant group audit has given you the following briefing:

Briefing from audit partner

"KJL was identified as a significant component in the group audit plan. KJL is audited by Welzun, an audit firm based in Otherland. The audit plan included an assessment of Welzun's professional qualifications and independence and no issues were noted. We performed a review of KJL's financial statements for the year ended 30 September 2018 and identified two matters of potential significance to the group audit:

- Research and development (R&D) expenditure of O$10,700,000
- Income tax receivable balance of O$8,025,000

"We asked Welzun to prepare a report explaining these two matters and the audit procedures that it performed. I have provided you with Welzun's report (**Exhibit 1**).

"Zmant has a new finance director, Janet Gray, who is an ICAEW Chartered Accountant. She has asked for help in finalising Zmant's consolidated financial statements and has sent some extracts and queries to me (**Exhibit 2**). She has also sent me a newspaper article published in the Otherland News (**Exhibit 3**) which I find very concerning.

"I need you to prepare a working paper in which you:

(1) For each matter in Exhibit 1:

- set out and explain the appropriate financial reporting treatment for KJL's financial statements for the year ended 30 September 2018;

- identify and explain any weaknesses in the audit procedures completed by Welzun; and

- set out any additional audit procedures that should be performed by DB and by Welzun to provide assurance for the group audit opinion.

(2) Set out and explain the appropriate adjustments for the financial reporting queries raised by Janet (Exhibit 2) for the year ended 30 September 2018 for:

- the individual financial statements of Zmant
- the consolidated financial statements of Zmant.

(3) Calculate goodwill to be recognised for KJL in Zmant's consolidated financial statements for the year ended 30 September 2018. Assume Zmant uses the proportion of net assets method to value the non-controlling interest in KJL.

(4) Explain the ethical issues for DB arising from the newspaper article (Exhibit 3) and any related matters. Set out and explain how DB should respond. Advise Janet on any actions she should take."

Requirement

Prepare the working paper requested by the audit partner.

Total: 42 marks

Exhibit 1: Report on matters of significance to the group audit - prepared by Welzun, KJL's auditor

We set out below our report on the matters of significance identified by DB in its review of KJL's financial statements for the year ended 30 September 2018.

Audit procedures have been performed in accordance with component materiality determined by DB at O$1,800,000.

Research and development (R&D) expenditure of O$10,700,000

The government in Otherland gives generous tax relief for R&D costs provided that the costs are expensed in the statement of profit or loss. O$10,700,000 has been expensed in the year ended 30 September 2018, comprising the costs of the following two R&D projects:

Project Sound: O$7,900,000

Project Sound commenced on 1 January 2018. The project's objective was to adapt an existing speaker produced by KJL for the car industry. The project started after L-Motors, a customer of KJL, requested a customised speaker for its cars. On 1 April 2018, L-Motors placed a large order for the speaker. Costs of this project, which have been expensed to the statement of profit or loss, are:

	O$'000
Materials for prototype model	1,725
New computer equipment - bought on 1 January 2018	1,700
Salary costs of development staff	
• incurred after 1 April 2018	1,270
• incurred before 1 April 2018	790
Registration fees for design	910
Car used for speaker testing - bought on 1 January 2018	555
Allocated general overheads	950
	7,900

As each cost was less than component materiality, no detailed audit procedures were performed.

We asked KJL whether the computer equipment and the car should have been included in PPE rather than expensed.

- KJL informed us that the cost of the computer equipment was expensed because it was being used for this project. If capitalised, this computer equipment would have been written off over two years under KJL's depreciation policy.

- KJL informed us that, since completion of the project, the CEO of KJL has driven the car. Including the cost of the car in PPE would result in a personal tax liability for the CEO under Otherland tax rules.

Project Entertain: O$2,800,000

The project's objective is to determine the success of product events. KJL obtains new business by arranging product events for existing and potential customers. A product event involves sales staff and other KJL personnel entertaining customers with food and drink and at the same time demonstrating and selling KJL's products. KJL paid O$2,800,000 to a public relations company, GetGo, which made all the arrangements for the product events and carried out analysis of the new business generated.

We agreed the cost of O$2,800,000 to invoices from GetGo, authorised by KJL's CEO, and to the bank statements. We requested a copy of GetGo's report showing the analysis of the new business generated and we were told by KJL that GetGo will provide the report in 2019.

Income tax receivable balance of O$8,025,000

The income tax receivable balance is in respect of a tax refund for R&D expenditure. Welzun's tax department confirmed that a tax refund will be received based on the following formula:

250% x R&D expenditure included in the statement of profit or loss x 30% tax rate.

Welzun's tax department confirmed that KJL pays tax at 30% and that the receivable balance of O$8,025,000 has been correctly calculated. As the R&D tax claim was prepared by Welzun's own tax department, no audit procedures were performed.

Exhibit 2: Financial statement extracts and queries from Janet Gray

Extracts from financial statements for the year ended 30 September 2018

	Zmant group £'000	**KJL O$'000**
Equity		
Share capital	10,000	25,000
Retained earnings at 1 October 2017	9,200	45,000
Profit for the year	2,200	15,000
	21,400	85,000

Janet Gray's queries

Before I complete the consolidation of KJL with Zmant, I would like your advice on the correct financial reporting treatment of the following:

Loan to KJL £3,500,000

In Zmant's statement of financial position, there is a receivable balance of £3,500,000 which represents the O$21,000,000 loan made to KJL on 1 January 2018.

My predecessor translated the O$21,000,000 loan using the exchange rate at 1 January 2018, which was £1 = O$6.0. The exchange rate at 30 September 2018 was £1 = O$4.8.

I do not know whether I need to include any adjustments for exchange differences because, under Zmant's and KJL's tax jurisdictions, there is no tax payable on exchange differences recognised in the statement of profit or loss. Instead, gains and losses are taxed at 20% when the loan is repaid. In any case, I understand that the balances will cancel on consolidation.

Inventory

In the year ended 30 September 2018, Zmant bought goods from KJL for £5,500,000. KJL charges Zmant a mark-up of 35% on cost. There are no intra-group trading balances outstanding at the year end between KJL and Zmant.

Zmant's inventory at 30 September 2018 includes £2,500,000 of goods which were bought from KJL. I believe I need to adjust for the intra-group profit. I have calculated the adjustment as follows, but I am not sure that it is correct:

Profit on goods bought by Zmant from KJL = £5,500,000 x 35%	£1,925,000
Profit on goods bought by Zmant from KJL for 9 months from 1 January 2018 to 30 September 2018 = £1,925,000 x 9/12	£1,443,750
£1,443,750 translated at the average rate for the period from 1 January 2018 to 30 September 2018 of £1 = O$5.7	O$8,229,375

The journal is:

DR KJL Retained earnings	O$8,229,375
CR KJL Inventory	O$8,229,375

Exhibit 3 Article from the Otherland News - sent by Janet Gray

Otherland News: 31 October 2018

An Otherland government official has resigned after accusations of corruption were made following his attendance at a ‘product event’ paid for by KJL. The official, who is the husband of a KJL board member, attended the 5-day event at a luxury spa hotel. An undercover journalist reported that the guest list for the event comprised KJL’s directors and their families and a representative from L-Motors, a long-standing customer of KJL.

A former KJL finance assistant told the Otherland News that KJL is manipulating its financial statements to claim large refunds of tax. The Otherland tax authority stated that it investigates any incidence of tax fraud.

QUESTION 2

You are Aiden Clark, an ICAEW Chartered Accountant. You have recently been appointed as financial controller at Chelle plc, a company listed on the London Stock Exchange. Chelle was incorporated 15 years ago to import delicatessen products, such as olive oil and luxury tinned goods, to the UK. Suppliers deliver goods to Chelle's distribution centre near London and Chelle's own vans transport goods to the company's customers (supermarket chains and smaller retailers). The company's year end is 31 October.

Between the years ended 31 October 2010 and 31 October 2016, Chelle experienced steady growth in revenue and profits. However, the company has become less profitable in the years ended 31 October 2017 and 31 October 2018 and its share price has fallen.

Chelle's directors own 20% of the company's ordinary shares. The remaining shares are owned 40% by several institutional investors and 40% by individual investors. Each investor owns no more than 5% of the company's ordinary shares. A significant source of finance for Chelle is long-term convertible bonds. The bonds will mature at the end of October 2020.

Chelle's finance director is on long-term sick leave. The financial controller, Joe Bold, left Chelle in early November 2018. Before he left, he prepared draft financial statements for the year ended 31 October 2018 **(Exhibit 1)** and notes on outstanding matters **(Exhibit 2)**.

Jen West, Chelle's managing director, emails you:

> Chelle has not been doing well. The depreciation of £ sterling since June 2016 has increased costs. Profits have suffered as a result. Revenues have been adversely affected by increased competition. The board is concerned about the company's cash flows over the next year or two. As you are new to the company, you can help us by providing a fresh interpretation of the draft financial information (Exhibit 1).
>
> The company's shareholders are not happy because of the falling share price. Chelle did not declare a dividend for the year ended 31 October 2018. This was the first time in many years that a dividend was not declared and some of the directors think we should recommence paying dividends as soon as possible. The board wants to know when Chelle can start paying dividends again.
>
> Please:
>
> (1) Set out and explain any adjustments required to the draft financial statements for the year ended 31 October 2018, in respect of the outstanding matters (Exhibit 2). Provide supporting journal entries.
>
> (2) Prepare a revised statement of profit or loss for the year ended 31 October 2018 and a revised statement of financial position at that date. Include calculations of earnings per share and diluted earnings per share.
>
> (3) Prepare a report to the board, analysing the key elements of the financial position, performance and cash flow for the year ended 31 October 2018, in comparison with the two previous financial years. Use your revised financial statements and other information provided.

(4) Calculate the amount of Chelle's legally distributable reserves at 31 October 2018, providing explanations to support your calculations.

Requirement

Respond to Jen West's email.

Total: 30 marks

Ignore deferred tax

Exhibit 1: Chelle plc draft financial information for the year to 31 October 2018 prepared by Joe Bold

Draft statement of profit or loss and other comprehensive income

	2018 £'000 Draft	2017 £'000 Final	2016 £'000 Final
Revenue	30,600	31,800	35,700
Cost of sales	(22,803)	(23,044)	(25,444)
Gross profit	7,797	8,756	10,256
Operating costs	(8,235)	(7,904)	(6,996)
Finance costs	(500)	(617)	(609)
(Loss)/profit before tax	(938)	235	2,651
Tax	178	(47)	(530)
(Loss)/profit for the year	(760)	188	2,121
Other comprehensive income	–	(273)	46

Additional information

	2018	2017	2016
Earnings per share	To be calculated	1.9p	21.2p
Dividend per ordinary share	Nil	1p	2p
Chelle share price at 31 October	980p	1139p	1711p

£1 = 100 pence (p)

Draft statement of financial position

	2018 £'000 Draft	2017 £'000 Final	2016 £'000 Final
Non-current assets			
Property, plant and equipment	53,675	51,497	48,574
Financial asset	1,503	1,503	1,776
	55,178	53,000	50,350
Current assets			
Inventories	2,770	2,910	3,307
Trade receivables	7,710	7,503	7,997
Tax asset	178	–	–
Cash	–	525	2,273
	10,658	10,938	13,577
TOTAL ASSETS	65,836	63,938	63,927
Equity			
Share capital (£1 shares)	10,000	10,000	10,000
Other components of equity	913	913	913
Available-for-sale reserve	503	503	776
Retained earnings	37,294	38,054	37,966
	48,710	49,470	49,655
Long-term liabilities (5% convertible bonds)	9,603	9,603	9,486
Current liabilities			
Trade payables	6,304	4,818	4,256
Tax payable	–	47	530
Bank overdraft (limit £5 million)	1,219	–	–
	7,523	4,865	4,786
TOTAL EQUITY AND LIABILITIES	65,836	63,938	63,927

Extracts from draft statement of cash flows

	2018 £'000 Draft	2017 £'000 Final	2016 £'000 Final
Net cash inflows from operating activities	11,316	11,173	10,516
Net cash (outflows) from investing activities	(13,060)	(12,821)	(8,462)
Net cash (outflows) from financing activities	–	(100)	(200)
Change in cash	(1,744)	(1,748)	1,854
Cash brought forward	525	2,273	419
Cash carried forward	(1,219)	525	2,273

Exhibit 2: Notes on outstanding matters in respect of the financial statements for the year to 31 October 2018 - prepared by Joe Bold

1. Convertible bond instrument

On 31 October 2012, Chelle issued a £10 million 5% convertible bond for proceeds of £10 million. The bond is repayable at par on 31 October 2020, but can instead be converted at that date, at the choice of the bondholders, into one new ordinary share for every £10 unit held. At the date of issue, the market interest rate for similar debt without conversion rights was 6.5%. Interest was paid on 31 October 2018 and recorded in finance costs, but I have not made any other accounting entries in respect of the convertible bond in the year ended 31 October 2018.

2. Available-for-sale financial asset

Several years ago, Chelle paid £1 million for 100,000 of the 1,500,000 £1 ordinary shares of Spence plc, its main supplier of refrigeration equipment. The available-for-sale reserve relates entirely to these shares. I have not recorded any entry in respect of the financial asset since the 31 October 2017 year end. The price of one ordinary share in Spence plc at 31 October 2018 was £18.50.

3. Tax

The applicable corporation tax rate during the financial year ended 31 October 2018 can be assumed to be 19%, chargeable on accounting profits before tax. A current tax credit, calculated at 19%, can be recognised in respect of accounting losses.

QUESTION 3

Solvit plc is a listed company supplying accounting software and related services to education and public-sector customers. Some of Solvit's customers purchase only software but others enter into multiple element contracts, purchasing software together with customisation, integration and maintenance services.

Kanes LLP, a firm of ICAEW Chartered Accountants, recently won the audit of Solvit from Fenn Yo LLP, following a competitive tender. You are a senior working for Kanes LLP and have been assigned to the audit of Solvit for its financial year ending 31 March 2019.

The audit manager calls you into her office:

"I need you to help plan the audit of Solvit for the year ending 31 March 2019. The Audit Committee Chair has requested that we present our audit plan at next week's Audit Committee meeting and has asked that this plan sets out our initial assessment of the key audit matters we expect to include in our audit report.

"I have provided you with extracts from last year's audit report (**Exhibit 1**) so that you can see the key audit matters that Solvit's previous auditor, Fenn Yo LLP, identified. This is a good starting point for us, but we will need to update last year's key audit matters and identify additional key audit matters. It's important that where we identify a key audit matter, we are precise about the audit objectives and where the greatest audit risk arises.

"I have also provided notes from my meeting with the Fenn Yo LLP audit partner and manager (**Exhibit 2**) and a summary of points from my initial audit planning meeting with the Solvit Finance Director, Sam Browne (**Exhibit 3**).

"I need you to do the following:

(1) In respect of the key audit matters to be included in our plan for the Solvit audit for the year ending 31 March 2019:

   a) Explain why the key audit matters identified by Fenn Yo LLP (Exhibit 1) continue to be relevant and explain how each of these has changed this year.

   b) Identify additional key audit matters for this year's audit and explain the factors which have led you to select each of them as a key audit matter.

(2) For **each** of the key audit matters identified in (1) above:

   a) Identify the relevant financial reporting standard and explain how it should be applied to the key audit matter in Solvit's financial statements for the year ending 31 March 2019.

   b) Explain the specific audit objectives and set out the audit procedures to provide assurance in respect of the key audit matter.

(3) Draft a brief response to the Finance Director's question (Exhibit 3) about the likely impact of IFRS16, *Leases*, on Solvit's financial statements for the year ending 31 March 2020."

Requirement

Respond to the audit manager's instructions.

Total: 28 marks

Exhibit 1 – Extract from last year's audit report on the financial statements of Solvit plc for the year ended 31 March 2018 - prepared by Fenn Yo LLP

Key audit matters

Revenue recognition

We identified revenue recognition as a key audit matter because the allocation of revenue to each component of a sale (software, services and maintenance), when sold together in a bundle, requires the application of judgment. We assessed this risk to be greatest in larger, more complex transactions, where there is increased likelihood of multiple components or the delivery of customised software.

Our audit procedures focused on the larger, more complex revenue transactions with the objective of checking that the allocation of revenue between components was consistent with the terms of the sale contracts and in line with Solvit plc's accounting policy. In particular, we audited the basis upon which management had calculated the fair value attributable to the components of revenue. Our audit procedures identified one contract where, because of a calculation error, too much revenue was allocated to the initial software supplied rather than deferred to cover future maintenance. An adjustment of £1.3 million was recorded to correct this error.

Provision for onerous lease

We identified as a key audit matter the provision of £1.4 million made by management to reflect the anticipated net future cost of leased office premises no longer required by Solvit. Offices in London were vacated during March 2018 with 15 years of the lease term remaining. Judgement was required to assess both the period for which the premises would remain empty and the level of rental income the premises would generate once sublet to a new tenant.

We reviewed the lease, together with professional advice received by Solvit about the rental market in London. Our objective was to challenge the judgements made by management in determining the assumptions to be used in the calculation of the provision. We then recalculated the provision based on the assumptions selected. We concluded that the provision made was reasonable.

Exhibit 2: Kanes LLP audit manager's notes from handover meeting with Fenn Yo LLP audit partner and manager

These notes summarise key points from my meeting with the Fenn Yo LLP audit partner and manager responsible for the Solvit audit for the financial years ended 31 March 2016, 2017 and 2018. They clearly knew the client well and could provide helpful insights into the work they performed and their audit report.

In addition to meeting with the engagement partner and manager, we performed a detailed review of the Fenn Yo LLP audit working papers. This review identified no issues with the audit procedures performed or the conclusions reached.

Key points from meeting with the Fenn Yo audit team

- Materiality for the year ended 31 March 2018 was set at 5% of profit before taxation, giving a materiality figure of £1 million.

- The error noted in revenue recognition was a calculation error and arose in March 2018 when a new revenue accountant was appointed. He lacked the experience of his predecessor and made an error in determining the separate prices of the component parts.

- The provision for the onerous lease was calculated on the assumption that the property would remain empty for two years. The property would then be sublet for the rest of the lease term, at a rent sufficient to cover all Solvit's rental cost. No discounting was applied, as the effect of the time value of money was considered immaterial.

- In addition to the revenue error identified, there was one other item on the schedule of misstatements. This was in relation to the allowance for aged receivables where a judgemental excess allowance of £700,000 was identified. This was not adjusted in the financial statements.

- In addition to the key audit matters included in the audit report for the year ended 31 March 2018, Fenn Yo also considered the presumed risk of material misstatement arising from management override of controls. Management was judged to have a relatively low incentive to overstate results for the year, as Solvit had far exceeded the target performance required for the maximum management bonus to be paid. Therefore, Fenn Yo did not identify this as a key audit matter.

Exhibit 3: Summary of meeting with Solvit Finance Director, Sam Browne – prepared by Kanes LLP audit manager

<u>Revenue</u>

A typical customer relationship for Solvit starts with a contract for the supply of software. In most cases this is standard software for which the customer pays a one-off, up-front licence fee.

However, there are also complex contracts under which Solvit supplies standard software together with other elements such as customisation, integration and maintenance services. At the end of the contract period, customers can renew the maintenance agreement at the standard price quoted in Solvit's price list.

Customisation and integration services are also sold separately at standard day rates.

Sam commented that applying IFRS15 for the first time from 1 April 2018 was challenging and he has relied heavily on Solvit's revenue accountant.

Revenue for the six months ended 30 September 2018 is at the same level as the same period last year but is £5 million lower than forecast. This is largely because sales of new software for the education market have grown more slowly than expected because of issues with the software. The education market has proved to be very price-competitive and Solvit has incentivised customers to purchase its software by giving large discounts on maintenance agreements for up to three years.

<u>Management bonus</u>

Lower than budgeted revenues for the six months ended 30 September 2018 have resulted in lower than expected profit and Solvit will need to perform exceptionally well in the second half of the year to meet its profit target. Sam is confident that it will do so and has therefore accrued half of the maximum management bonus for the year in the results for the six months ended 30 September 2018.

<u>Receivables</u>

The new education clients have been slow to settle their debts and receivables days have increased from 45 days at 31 March 2018 to 75 days at 30 September 2018. The allowance for receivables remains at the same level as at 31 March 2018, as Sam is confident that most receivables will be paid once the issues with the software are sorted out.

<u>Onerous leases</u>

The London offices vacated in March 2018 were sublet with effect from 1 August 2018 and so the entire provision of £1.4 million has been released. The sub-tenant has a break clause and can choose to terminate the arrangement after five years, but Sam is hopeful that the sub-tenant will remain longer than this. A rent-free period of six months was given but, after that initial period, the rent received will be equal to the rent which Solvit pays under the lease.

Sale and leaseback

On 1 October 2018, Solvit sold its northern office property to a property company for £18 million and leased it back. The lease has a term of 10 years and rentals of £600,000 per annum paid quarterly in advance. Immediately prior to the transaction with the property company, the office property had a carrying amount of £11 million and a fair value of £15 million. It has an estimated remaining useful life of 20 years.

Sam informed me that Solvit does not intend to adopt IFRS16 *Leases* early. However, he would like to understand its impact when it is adopted in the financial statements for the year ending 31 March 2020. In addition to the lease transactions discussed above, Solvit has operating leases for cars and equipment with terms of 3 to 10 years and combined annual rentals of £1.3 million.