ADVANCED LEVEL EXAMINATION

Crocus

(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 Analytic - software, the link can be found above the word processing area.

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

Important Information:

Please read this information carefully before you begin your exam.

Starting the exam

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

Preparing your answers

Answer all questions.

Respond directly to the exam question requirements. Do not include any content of a personal nature, such as your name.

Only your answer in the word processing area will be marked. You must copy over any data for marking from the spreadsheet area to the word processing area.

Issues during the exam

If you encounter any issues during the exam you should tell the invigilator (centre) or online chat support (RI) as they may be able to resolve the issue at the time. Neither the invigilator nor the online chat support can advise you on how to use the software.

Ending the exam

When the exam timer reaches zero, the exam will end. To end the exam earlier, go to the last question and click the right-hand arrow button, then click the **Submit** button to close the exam.

After the exam

We will invite you to complete a student survey after the exam.

If you believe that your performance was affected by issues which you raised during the exam, you should submit a special consideration application to ICAEW, **within 7 days of the exam**, as per ICAEW's published policy. If you are sitting remotely please refer to anything of note which occurred and will have been recorded, for use as evidence to support your case.

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1 **Elephant Ltd**

To access the data analytics software please click here

Assume that the date is 2 February 2019

You are part of Lister's team that has just commenced the final audit visit for Elephant.

The engagement manager for the Elephant audit, Jake Moore, has followed up on the large contract with Spooks identified by Helen during the planning visit in early December by contacting Frank for further information. Frank's reply is provided as **Exhibit 1**.

Jake has sent an email providing you with instructions for the final audit **(Exhibit 2)**.

Materiality has been set at £30,000.

Requirement

Respond to the instructions from Jake contained in his email (**Exhibit 2**). Use your firm's audit software to support your answers where appropriate.

Ignore any adjustments for current and deferred taxation. **Total: 40 marks**

Exhibit 1: Email from Frank Wright regarding Spooks contract

From: Frank Wright
To: Jake Moore
Date: 28 January 2019
Subject: Contract with Spooks

Hi Jake,

Further to your enquiry, I am pleased to say that we did win the contract with Spooks. In fact, it was agreed just after your planning visit.

Under the contract, Elephant will design and conduct an online marketing campaign, to increase Spooks' membership base.

The initial contract term is 18 months beginning on 7 December and the total price of the 18 month contract has been agreed at £300,000.

One of the difficulties in negotiating the contract was getting Spooks to agree to an upfront deposit. Due to the significant resources that Elephant has to commit to this contract, it was finally agreed that a proportion of the contract price would be payable on 7 December as a non-returnable deposit.

An invoice was issued for the deposit on 7 December, and I posted entries to the nominal ledger to recognise a trade receivable the same day.

The contract with Spooks specifies four distinct phases:

(1) Website design concept
(2) Preparation of artwork and graphics
(3) Creation of website
(4) Digital marketing campaign to attract traffic to website

We consider that the fourth phase of the contract, the digital marketing campaign, represents 40% of the total contract price.

Spooks will sign off on each phase to confirm acceptance before Elephant proceeds to the next stage. The website design concept was completed and signed off by Spooks on 31 December 2018. We estimate that 5% of the contract relates to creating the website design concept.

The contract price less the deposit will be received in two equal amounts at the end of the third and fourth phases. In addition, Elephant will also receive a contract bonus dependent on the number of new subscriptions received by Spooks through the new website by the end of the contract. We confidently expect this bonus to be not less than £25,000.

In the event of the contract being terminated by Spooks on any grounds other than non-performance on the part of Elephant, there is a clause in the contract entitling Elephant to recover all costs incurred to date plus a 15% margin.

I have also just remembered that Spooks insisted on the inclusion of an option in the contract allowing them to extend the digital marketing campaign for a further 6 months at a pre-arranged fee. If this option is exercised it would extend the contract term to 24 months.

Exhibit 2: Email from Jake Moore

From: Jake Moore
To: Audit senior
Date: 2 February 2019
Subject: Final audit instructions – Elephant Ltd

Hi,

You will have reviewed the interim audit information prepared by Helen Holden after the audit planning visit. You will also have familiarised yourself with the data for Elephant for the 11 months ended 30 November 2018.

Data for December 2018 has now been imported into the data analytics software from Elephant's nominal ledger, so the full year nominal ledger data for the year ended 31 December 2018 is now available.

I would like you to focus on the audit of revenue and receivables.

Instructions

(1) Identify and explain reasons why trade receivables may be considered an area of significant audit risk. You should identify and explain patterns shown in the data analytics software and identify any specific unusual transactions.

(2) Evaluate the appropriateness of using the work of Steve, the internal auditor, with respect to reliance on Elephant's internal controls.

(3) Assuming that it is determined that you can place reliance on the work carried out by Steve, set out additional audit procedures that should be performed to enable you to place reliance on internal controls over receivables.

(4) In relation to the contract with Spooks (Exhibit 1):

- Explain the appropriate financial reporting treatment related to the deposit for the year ended 31 December 2018. Include correcting journal entries.
- Identify and explain the financial reporting implications of the option to extend the contract and set out the information that would be required to determine the appropriate treatment.
- Set out appropriate audit procedures that should be carried out. Include any additional information and explanations that you would require of management.

2 **Finney plc**

Finney plc is a UK-based company that produces engineering equipment for the mining industry. Finney has a number of investments both in the UK and overseas, as well as an active treasury function that trades in commodities.

You are Marina Bujnowicz, and you recently joined Finney as an ICAEW Chartered Accountant to help finalise the financial statements for the year ended 30 September 20X2.

You receive the following email from a director of Finney, Simone Hammond.

From: Simone Hammond
To: Marina Bujnowicz
Re: Financial Statements for year ended 30 September 20X2
Date: 3 November 20X2

Dear Marina,

Finney's treasury department has gathered together information relating to outstanding issues for inclusion in the financial statements (**Exhibit 1**). The Financial Controller, who is on holiday at the moment, has left a note about share appreciation rights (**Exhibit 2**). Draft financial statements are shown in **Exhibit 3.**

I need you to help finalise the financial statements in the light of these outstanding issues. Don't worry about any issues related to tax or deferred tax for now as I have asked someone else to look at these.

Regards

Simone

Requirement

(a) Prepare a briefing note for Simone Hammond, including any relevant calculations and journals, that sets out the financial reporting consequences for the year ended 30 September 20X2 of the issues contained in Exhibits 1 and 2.

(b) Re-draft the financial statements in Exhibit 3 in the light of your conclusions regarding the financial reporting issues identified.

Total: 30 marks

Exhibit 1: Outstanding issues from the treasury department

(a) **Investment in loan stock**

On 1 October 20X1 Finney acquired an investment in £3,000,000 8% loan stock at par. The investment meets the business model and contractual cash flows test and is therefore measured at amortised cost. The loan stock has an effective annual rate of interest of 10%. No repayments were made in the year ended 30 September 20X2.

Finney made the following estimates:

(1) At 1 October 20X1 there was a 5% probability that the borrower would default on the loan during the year resulting in a 100% loss.

(2) At 30 September 20X2 there is a 2% probability that the borrower will default on the loan before 30 September 20X3 resulting in a 100% loss.

The Treasury Department have provided a note that an impairment allowance of £150,000 had been recognised under IFRS 9, *Financial Instruments* when the bond was first acquired, but has not explained how this was calculated, or made any further entries for the accounting treatment of the asset during the year. It would be helpful if you could provide both.

(b) **Financial liability**

Finney provides loans to customers and funds the loans by selling bonds in the market. The liability is designated as at fair value through profit or loss. The bonds have a fair value decrease of £10 million in the year to 30 September 20X2 of which £2 million relates to the reduction in Finney's creditworthiness. Simone Hammond would like advice on how to account for this movement.

(c) **Copper inventories contract**

At 1 July 20X2 Finney had inventories of 1,000 tonnes of copper. The average historic cost of the copper was £9,200 per tonne.

To protect against a decline in copper prices, on 1 July 20X2 Finney entered into a futures contract, using a recognised commodities exchange, to sell 1,000 tonnes of copper for £9,200 a tonne. (The fair value of the futures contract at that date was zero.) The contract matures on 31 December 20X2. Our compliance department designated the futures contract as a fair value hedge of the copper inventory, and has determined that the IFRS 9, *Financial Instruments* hedging criteria have been met.

At 30 September 20X2, the fair value of the copper inventory had fallen to £8,200 a tonne and, at this date, the fair value of the original futures contract (written on 1 July 20X2) for 31 December 20X2 delivery was £950 per tonne. At 30 September 20X2, a new futures contract could be written for delivery of copper on 31 December 20X2 at £8,250 a tonne.

(d) **Investment in Coppery**

On 1 October 20X0 Finney bought two million shares at £1.60 each, representing a 0.9% shareholding, in Coppery plc. The shares were held for trading. Finney had recognised a gain of £300,000 for the year ended 30 September 20X1 in profit or loss.

On 1 April 20X2 Coppery was acquired by Zoomla plc, a large mining corporation. The terms of the deal were that shareholders in Coppery would receive, for each share they owned:

(1) on 1 April 20X2, two shares in Zoomla, worth £1.10 each; and

(2) on 1 April 20X3, cash of £0.15.

Finney has a weighted average cost of capital of 10%.

At 30 September 20X2, the market price of a Zoomla share was £1.20.

Exhibit 2: Share appreciation rights

On 1 October 20W9, Finney granted 300 share appreciation rights to each of its 200 managers. All of the rights vest after two years' service (on 30 September 20X1) and they can be exercised during the following two years up to 30 September 20X3. The fair value of the right at the grant date was £20. It was thought that 30 managers would leave over the initial two-year period and they did so. The fair value of each right was as follows.

Year	Fair value at the year end
	£
30 September 20X0	23
30 September 20X1	14
30 September 20X2	24

On 30 September 20X2, 40 managers exercised their rights when the intrinsic value of the right was £21.

The director wishes to know what the liability and expense will be at 30 September 20X2.

Exhibit 3: Draft financial statements as at 30 September 20X2

Draft statement of profit or loss and other comprehensive income of Finney plc for year ended 30 September 20X2

	£m
Revenue	194
Cost of sales	(111)
Gross profit	83
Operating costs	(31)
Operating profit	52
Finance income	3
Interest payable	(16)
Profit before taxation	39
Taxation	(8)
Profit for the year	31
Other comprehensive income	7
Total comprehensive income for the year	38

Draft statement of financial position as at 30 September 20X2

	£m
Non-current assets	
Property, plant and equipment	84
Investment in equity instruments	36
Other financial assets	10
Inventories	66
Receivables	56
Total assets	252
Share capital: £1 shares	75
Retained earnings	97
Other components of equity	24
Non-current liabilities	27
Current liabilities	
Trade payables	18
Overdraft	11
Total equity and liabilities	252

3 Maxvol

You are Bobby Barnes, an audit senior working for Lorray & Knight LLP (L&K), a firm of ICAEW Chartered Accountants. You are currently planning the audit of the Maxvol group for the year ending 31 December 20X4. Maxvol plc is a long-standing audit client and manufactures and distributes audio visual systems.

You receive a note from Liz Marchant, the manager responsible for the Maxvol audit:

"On 1 October 20X4, Maxvol acquired 75% of the issued share capital of Remixit Ltd. The Maxvol finance director, Gil Jones, has provided details of this acquisition, together with financial information for Remixit (**Exhibit 1**).

Remixit has historically been audited by SB Associates (SBA), a local firm of ICAEW Chartered Accountants, which also acted as Remixit's tax advisers. SBA completed the Remixit audit for the year ended 31 December 20X3 and then resigned as auditor in July 20X4.

Gil has asked L&K to take on the Remixit audit and I have arranged a meeting with him tomorrow to discuss this further. The first audit of Remixit for which we would be responsible would be for the year ending 31 December 20X4. This would need to be completed by 15 February 20X5 to meet Maxvol's reporting deadlines. Other services previously provided to Remixit by SBA would now be provided by Maxvol's internal financial reporting and taxation teams, so it is just the role of auditor that we are being asked to take on.

We have written to SBA requesting disclosure of information which might be relevant to our decision to accept or decline the Remixit audit appointment. SBA's reply is provided (**Exhibit 2**).

Last week an L&K audit senior visited Remixit for an initial meeting with Kieran Mannering, Remixit's financial controller, to gain more background information and to discuss the financial information provided by Gil. The notes of that meeting are also attached (**Exhibit 3**). In preparation for my meeting tomorrow with Gil, please review the documents I have left you and prepare a briefing note which addresses the following:

- Set out the ethical and professional issues that arise for L&K. Explain the implications for L&K, noting any actions that it should take. Identify any additional information that L&K should request.
- Use analytical procedures (financial statement analysis) to identify and explain the audit risks for the audit of Remixit for the year ending 31 December 20X4, assuming that we accept the Remixit audit engagement. For each risk, set out the key audit procedures you believe we should perform.

- Explain for the Maxvol group for the year ending 31 December 20X4:
  - the financial reporting issues which arise as a consequence of the Remixit acquisition; and
  - the group audit issues arising from the acquisition. Exclude any issues already raised for the Remixit audit, unless there are different implications for the group. Audit procedures are not required at the moment."

Requirement

Respond to Liz Marchant's instructions. **Total: 30 marks**

Exhibit 1: Details of Remixit acquisition provided by Maxvol finance director, Gil Jones

Remixit was incorporated eight years ago by Barry Gibbons, who is also its chief executive and who was its 100% shareholder until 1 October 20X4. Remixit develops and distributes audio mixing software and equipment. It has an excellent reputation for high-quality, specialist products.

On 1 October 20X4, Maxvol acquired 75% of the issued share capital of Remixit from Barry for an initial cash consideration of £16 million. A further cash consideration of £4 million is payable on 1 October 20X5 if Remixit's audited financial statements for the year ending 31 December 20X4 show a profit before taxation of at least £3 million. Barry is continuing as Remixit's chief executive, although the other directors on the Remixit board are now appointed by Maxvol.

Goodwill of £12.925 million (calculated as the consideration of £16 million less 75% of Remixit's net assets) was recognised in the Maxvol consolidated financial statements at the date of acquisition. Summary financial information for Remixit for the nine months ended 30 September 20X4 is shown below:

	Notes	9 months ended 30 September 20X4 Unaudited £'000	Year ended 31 December 20X3 Audited £'000
Statement of profit or loss			
Revenue		8,700	10,700
Cost of sales		(5,100)	(6,570)
Gross profit		3,600	4,130
Administrative expenses		(1,500)	(1,530)
Profit before interest and taxation		2,100	2,600
Interest expense		(75)	(100)
Income tax expense	1	–	(600)
Profit for the period		2,025	1,900
Statement of financial position			
Non-current assets:			
Property, plant and equipment	2	4,800	3,000
Current assets	3	3,700	2,700
Total assets		8,500	5,700
Equity	4	4,100	1,500
Non-current liabilities	5	1,450	1,500
Current liabilities	6	2,950	2,700
Total equity and liabilities		8,500	5,700

Notes

1 The taxation charge for the year ending 31 December 20X4 will be determined at the year end.

2 Remixit's property, plant and equipment comprises:

	£'000
Freehold land and buildings	3,000
Equipment	1,800
	4,800

Freehold land and buildings were revalued at 30 September 20X4 to £3 million. The valuation was prepared by an external valuer on the basis of the existing use of the freehold land and buildings. This resulted in a revaluation gain of £1.5 million. The site includes land which the valuer has suggested could be developed for residential purposes without impacting Remixit's business. If the site was valued on this basis, its total value would rise to £3.5 million. Equipment is carried at depreciated cost, based on an estimated useful life of five years.

3 Remixit's current assets comprise:

	20X4 £'000	20X3 £'000
Trade receivables	1,000	900
Inventory	2,500	1,300
Cash in bank	200	500
	3,700	2,700

4 An interim dividend of £1 million was paid on 15 June 20X4.

5 Non-current liabilities relate to a long-term bank loan. The portion of the loan that is repayable within 12 months of the year end is classified as current liabilities.

6 Remixit's current liabilities comprise:

	20X4 £'000	20X3 £'000
Trade payables	2,000	2,200
Loans and borrowings	550	500
Restructuring provision	400	–
	2,950	2,700

Exhibit 2: Response from SBA to letter requesting disclosure of any information relevant to L&K's decision to accept or decline the Remixit audit appointment

Dear Sirs,

Remixit Ltd

Thank you for your letter dated 24 October 20X4.

We have acted as auditor to Remixit for a number of years and resigned on 14 July 20X4, immediately after signing our auditor's report on the financial statements for the year ended 31 December 20X3.

We disclose below certain matters which we believe you should consider in deciding whether or not to accept the appointment as auditor of Remixit.

We are in a dispute with Remixit regarding £5,000 of audit fees in respect of the 20X3 audit. The fees relate to additional time which the audit team has had to spend carrying out additional audit procedures in respect of payroll. Remixit management has refused to pay this amount, and we are seeking arbitration on this matter.

We have been working with Remixit's chief executive, Barry Gibbons, on his personal tax matters and have obtained information which gives us some concern that, in the past, Remixit's management may not have been wholly open with us concerning the company's tax affairs.

We note from your letter that you anticipate requesting access to our audit working papers and regret that we will be unable to grant this or provide any further information on the matters identified above due to an ongoing fee dispute with Remixit and the restrictions on communication which the Remixit board has imposed.

Yours faithfully,

SB Associates

Exhibit 3: L&K audit senior's notes from meeting at Remixit

The notes below summarise the key points arising from a discussion with Kieran Mannering, Remixit's financial controller:

- Remixit has a very small finance team, comprising Kieran and two part-time assistants. Kieran reports directly to Barry Gibbons, who has always shown a close interest in the results and is involved in all key accounting judgements. Historically Kieran has relied on the SBA audit manager to provide assistance with any complex financial reporting questions and to draft the financial statements.
- To Kieran's knowledge, no material audit issues have arisen in recent years, although there was some discussion as to whether a five-year useful life remains appropriate for equipment given that the factory equipment is used for much longer than this and assets which are 15 to 20 years old are still in use.
- The relationship with the previous auditor, SBA, was good until delays in completing the 20X3 accounts caused a disagreement between the audit partner and Barry (who serve together on a local golf club committee) and SBA was asked to resign.
- Current liabilities at 30 September 20X4 include a £400,000 provision for restructuring following the acquisition by Maxvol.
- No provision has been made in respect of a claim of £475,000 for damages and loss of sales caused by a faulty audio mixing system supplied by the company. This claim was received from one of Remixit's major customers in August 20X4. Remixit's lawyer has advised that it is possible, but not likely, that the claim will succeed given the terms on which the sale was made and the fact that the warranty period had expired.
- As part of restructuring of Remixit's financing strategy, bank loans of £2 million are due to be renegotiated in the next accounting period. Kieran mentioned that Remixit's management will enter discussions with the bank to redeem the existing loan and take out a new loan with a longer repayment term. Initial conversations with the bank suggest that the bank is keen to review Remixit's ability to service its debts in the future before agreeing to any refinancing plan.

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