ADVANCED LEVEL EXAMINATIONS

Lotus

(3.5 HOURS)

CORPORATE REPORTING

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

Marks breakdown

Question 1	30 marks
Question 2	40 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 2, 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 **Icicle plc**

Icicle plc is an AIM listed company that manufactures satellite navigation equipment for cars. You are Dean Claire, an ICAEW Chartered Accountant working on a six-month contract at Icicle.

Jacqueline Hyde, Icicle's Chief Executive, has asked you to advise the company on deferred tax issues in relation to the year ended 31 March 20X9. This is because the finance director has suffered a long-term illness and is unable to work at present.

Jacqueline provides you with a file (**Exhibit 1**) prepared by a member of the finance department, which contains a number of transactions that have financial reporting implications, including deferred tax issues.

Jacqueline also provides you with extracts from the draft financial statements for the year ended 31 March 20X9 (**Exhibit 2**). No adjustments in respect of deferred tax have been made in these draft extracts.

She asks you to prepare a briefing note which provides explanations and calculations of the financial reporting implications, including deferred taxation, for each of the transactions in the file (**Exhibit 1**) on the consolidated financial statements for the year ended 31 March 20X9. Also, Jacqueline asks you to redraft the extracts provided (**Exhibit 2**), providing a comprehensive summary of the transactions leading to the revised figures. She requests that you then calculate the consolidated basic earnings per share.

Jacqueline asks you to use the working assumption that Icicle will continue to pay corporation tax at the current rate of 23%.

Requirement

Prepare the briefing note requested by Jacqueline Hyde. **Total: 30 marks**

Exhibit 1: Deferred tax issues identified by accounts department

(1) **Non-current assets**

At 1 April 20X8, Icicle owned factory equipment that was acquired on a variety of dates, and qualifies for capital allowances for tax purposes at 20% reducing balance per annum from 1 April 20X8. On this date, the equipment had a carrying amount of £6.4 million and a tax base of £3.4 million. The original cost of the equipment was £9.6 million, and none of the equipment is more than four years old at 1 April 20X8. On 1 October 20X8 Icicle purchased additional factory equipment for £2.2 million. Icicle has depreciated all factory equipment on a straight-line basis over five years. The factory equipment is the only asset category on which deferred tax was recognised in the financial statements for the year ended 31 March 20X8.

In addition, Icicle purchased land which cost £5.8 million on 1 April 20X5. The land was revalued to £15 million at 31 March 20X9, representing its fair value at that date. A surplus of £9.2 million was credited to other comprehensive income.

The factory equipment and the land are the only tangible non-current assets owned by Icicle.

(2) **Acquisition of a subsidiary**

On 1 January 20X9, Icicle acquired 100% of the ordinary shares of Snowball Ltd for £4 million cash. At the acquisition date, Snowball had net assets with a carrying amount of £2.6 million in the statement of financial position, which is the same as the tax base. The board of Icicle believes these net assets have a fair value of £3.4 million. The difference is due to the valuation of an intangible asset which the board has concluded has an indefinite life. Impairment tests have been completed which demonstrate no change is required to the carrying amount of any intangibles.

Icicle has sold goods to Snowball for a number of years prior to acquisition. In the year ended 31 March 20X9, Icicle generated revenues of £1.5 million from Snowball, of which 80% occurred after 1 January 20X9.

Icicle has a mark up on cost of 25%. At 31 March 20X9, Snowball has inventory purchased from Icicle for £600,000. No adjustment in respect of this inventory has been made in the draft extracts (**Exhibit 2**).

Snowball has provided audited financial statements for the three months ended 31 March 20X9 which disclose an after-tax profit of £200,000 which has been included in the draft extracts (**Exhibit 2**). Icicle has not prepared consolidated financial statements previously.

(3) **Warranty claim**

In April 20X8, Icicle introduced a satellite navigation system for bicycles, which it sells with a 36-month warranty. There were 100,000 units sold in the year ended 31 March 20X9 at an average sales price of £60. The board is unsure how many claims will be made in respect of the warranty, due to its recent launch. However the production department has estimated there will be product repairs in relation to these sales of 5,000, 8,000 and 7,000 units respectively in the three years ending 31 March 20Y0, 20Y1 and 20Y2, at an average repair cost of £25 per unit.

Early discussions with the tax authorities suggest that these warranty claims will only be allowed for tax purposes when the repairs take place. This is because Icicle has no history of such claims and therefore cannot make any credible estimate of cost.

No provision has been made for these warranties in the draft financial statements for the year ended 31 March 20X9.

The pre-tax annual rate of interest that reflects the time value of money and the risks relating to the project is 10%.

(4) **Tax losses**

Icicle has only been trading for a few years, and has not made any taxable profits to date. The directors are now highly confident of being able to utilise carried forward trading tax losses of £3.9 million at 1 April 20X9 against future taxable trading profits. Profits chargeable to corporation tax are anticipated to be at least £5 million in the year ending 31 March 20Y0, after breaking even for tax purposes in the year ended 31 March 20X9. No provision for deferred tax has been made in the financial statements for the year ended 31 March 20X8 in respect of these trading tax losses.

Exhibit 2: Icicle plc, draft extracts from the financial statements for year ended 31 March 20X9

Statement of profit or loss and other comprehensive income for year ended 31 March 20X9

	£'000
Profit before tax	1,830
Income tax expense (excluding deferred tax)	0
Profit for the year	1,830
Other comprehensive income	
Gains on property revaluation	9,200
Total comprehensive income for the year	11,030

Statement of financial position at 31 March 20X9

Equity	**£'000**
Ordinary shares of 50 pence each	1,000
Share premium account	6,800
Retained earnings	1,040
Revaluation reserve	9,200
Total equity	18,040

2 **Elephant Ltd**

To access the data analytics software please click here

Assume that the current date is 29 January 2019

The final audit visit for Elephant started last week and you have joined the audit team today as audit senior, having been busy completing another audit.

The engagement manager for the Elephant audit, Jake Moore, gives you the following briefing:

"You will have reviewed the interim audit information prepared by Helen Holden, the previous audit manager. 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's nominal ledger data for the year ended 31 December 2018 is now available.

"I share Helen's concern about cost of sales and work-in-progress being key audit risks. I have provided some notes relating to cost of sales (**Exhibit 1**).

"I asked Elaine Evans, a new audit assistant, to carry out some audit procedures in relation to work-in-progress. She has produced a working paper, summarising her work to date on these issues (**Exhibit 2**).

"I have received an email from Frank Wright providing some further details on the acquisition and financing of a new office in Paris later in the year (**Exhibit 3**).

"Materiality has been set at £30,000."

Instructions

Jake has assigned the following tasks to you.

(1) As part of audit planning:

- Review cost of sales, identifying and explaining the key audit risks. For each risk identified, set out the key information and explanations that you would require from management. Ignore payroll costs.
- Perform preliminary analytical procedures by comparing monthly cost of sales with monthly income. In so doing, identify and explain trends, relationships and potential audit risks.

You should identify and explain patterns shown in the data analytics software and identify any specific unusual transactions.

(2) In respect of the matters identified in **Exhibit 2**, relating to work-in-progress:

- Set out and explain the appropriate financial reporting treatment
- Identify and explain key audit risks
- Provide review comments on Elaine's audit work and set out key additional audit procedures that need to be carried out.

(3) In respect of the potential acquisition and financing of the new office in Paris, set out and explain the appropriate financial reporting treatment using the working assumptions set out by Frank Wright (**Exhibit 3**).

Requirement

Respond to the audit engagement manager's instructions.

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

Exhibit 1: Notes on cost of sales – provided by Jake Moore

I have taken the following draft account extracts from the Data Analytics Software for the year ended 31 December 2018:

	£
Income	3,075,999
Cost of Sales	(881,464)
Gross profit	2,194,535

The nominal ledger in the Data Analytics Software does not yet include any adjustments for work-in-progress.

I am concerned that some of the accounts making up cost of sales have increased substantially.

Exhibit 2: Audit working paper relating to work-in-progress – prepared by Elaine Evans, audit assistant

Discussion with Frank Wright

Frank informed me that no work-in-progress has currently been recognised in the nominal ledger and so there are currently no related entries in the Data Analytics Software. However, Frank confirmed his intention that, as indicated at the audit planning visit, for contracts that are incomplete at the year end, he wants to recognise all the related job costs incurred up to 31 December 2018 as work-in-progress in the published financial statements. He will make closing adjustments to achieve this before the financial statements are finalised.

Audit procedures

(1) I selected a sample of one item from accounts relating to cost of sales in the month of December 2018. I did this as a walk-through test to understand the system. I asked Elephant's accounts staff to explain the nature of work-in-progress transactions and then traced one item into the related job costing account for the relevant marketing contract. I inspected the related marketing contract and this had not been signed off at 31 December 2018, so I concluded that the contract was open (ie, had not been completed) at that date.

The sample item for the walk-through test was:

Account	Account number	Transaction ID	Description	£	Dates (Effective) (Posted)	Posted by	Document
Mock-ups	61050	PIN28911	37438 Always mock-ups for Nigeria x 8	3,536	25/12/2018 31/12/2018	F.Wright	PIN

(2) For the marketing contract I had identified using the walk-through test above, I traced a small sample of items comprising the cost entries in the relevant job costing account to the relevant nominal ledger accounts for the year ended 31 December 2018. All sampled items agreed with the related nominal ledger accounts, so I concluded that it is appropriate for the costs to be treated as work-in-progress at 31 December 2018. The contract has been included in Frank Wright's proposed list of work-in-progress.

I examined the sampled marketing contract and it was for a fixed price of £65,000 and it is due to be completed by 28 February 2019. There was only one main deliverable service on the contract, which was not split or analysed into separate deliverables.

The job costings for the marketing contract I selected were as follows:

Contract: tender for marketing contract for Nigerian healthcare products

Item	Total costs £	Description
Expenses relating to making the tender	1,541	Travel and legal costs required to deliver the tender proposal
Mock-ups	3,536	Two separate transactions for Mock-ups have been posted.
	1,984	Mock-ups are costs of materials used for digital marketing in visualising ideas, concepts and developing designs. Includes visual, graphic or physical representations of a marketing design.
Salaries and expenses of staff working on the contract	18,732	Salaries and expenses of staff delivering the digital marketing content. Of this total amount, there was £2,259 for time spent reperforming tasks in the contract, which were initially unsatisfactory. This extra time would not be recoverable from the client.
Allocation of central administration cost relating to all tender contracts	7,000	Allocation of Elephant's budgeted administrative total cost in proportion to the revenue generated by each contract.
Total contract costs at 31 December 2018	**32,793**	To be recognised as work-in-progress (Authorised by: Frank Wright)

Frank Wright has estimated that future costs to be incurred on this contract in 2019 should amount to about £35,000.

Exhibit 3: Potential acquisition and financing of new office in Paris – email from Frank Wright

To: Jake Moore, Audit manager
From: Frank Wright (finance director)
Date: 28 January 2019
Subject: New offices in Paris

Jake

You asked me for an update and for any further information on our plans to open a new office in Paris.

This is going really well and CorsaireCo, the building contractor, is ready to sign. However, I would rather have the bank's agreement to provide the financing before I sign on behalf of Elephant.

I forgot to mention when I met Helen in December that the acquisition of the new office was almost finalised by 30 November 2018. At that date, I started to worry about foreign currency risks and so took out a forward currency contract, at zero price, to purchase €1.8m on 1 August 2019 at an exchange rate of £1 = €1.2. As there was no initial cost of the forward currency contact it was not entered in the nominal ledger for the year ending 31 December 2018 and so it is not in the Data Analytics Software.

However, negotiations became difficult in early December 2018 and there was a delay while we all went away to think about the issues. I clearly made a mistake in entering into the forward currency contract too early, as it was always intended to hedge foreign currency risk for the acquisition of the Paris office. I plan to treat the whole of the fair value movement on the forward currency contract as a foreign currency cash flow hedge against the Paris office purchase. Please let me know if this is acceptable.

Our working assumptions are:

Cost of offices	€1.8m
Contract completion	Between 1 July and 1 September 2019
Bank loan applied for	£1.2m
Date of receipt of loan	31 March 2019
Date for signing office contract	31 March 2019

Actual and expected exchange rates are:

30 November 2018	£1 = €1.20
31 December 2018	£1 = €1.16
31 March 2019	£1 = €1.14
1 August 2019	£1 = €1.11

3 ETP

You are Steph Carter, an audit senior with J&K LLP, a firm of ICAEW Chartered Accountants which audits Erskin Technology plc (ETP).

You receive the following briefing from Lauren Haynes, the audit manager responsible for the ETP audit:

"Welcome to the ETP audit team. This week you are scheduled to plan the ETP audit for the year ending 30 September 20X4. It's important we get the planning completed so that we can focus on updating our controls work on revenue at our interim audit visit next month.

I'm aware that you have not worked on ETP before, so I have provided some background information from last year's audit file (**Exhibit 1**). I've also sent you a working paper setting out the results of preliminary analytical procedures performed last week by our audit assistant, Joshi Khan (**Exhibit 2**). Planning materiality has been set at £850,000.

Yesterday I received an email from Julie Barwell, ETP's financial controller (**Exhibit 3**). Julie is an ICAEW trainee Chartered Accountant. She has asked for our advice."

The audit manager Lauren Haynes's instructions

"In respect of the audit for the year ending 30 September 20X4,

(1) Prepare review notes on Joshi's work (**Exhibit 2**) in which you:

- Explain the weaknesses and limitations in the procedures he has performed. Perform additional analysis where you think this is required. Set out clearly the additional audit procedures you would like him to perform, and the queries you would like him to resolve when he returns to the client later this week to complete the preliminary analytical procedures.
- Identify and explain the financial reporting issues and related audit risks you have identified from the information provided, and outline, for each, the implications for our audit approach. Detailed audit procedures are not required at this stage.

(2) Prepare a briefing note that addresses Julie's request for advice and that identifies the ethical issues for Julie and for our firm and the actions Julie and our firm should take."

Requirement

Respond to the instructions from Lauren Haynes. **Total: 30 marks**

Exhibit 1: Background information on ETP from J&K's audit working papers for the year ended 30 September 20X3

ETP is a listed company which supplies data storage devices and secure archiving systems.

ETP has three main revenue streams, as follows.

Hardware

Hardware revenues are generated by sales of data storage devices which are manufactured for ETP by a third party manufacturer in Asia. These devices are sold under the 'Stor-It' brand name which was purchased by ETP for £5 million on 1 October 20X1, at which date the brand had a remaining expected useful life of 10 years. At the same date, ETP invested £1.6 million in patents for a new range of 'Stor-It' devices. These costs were capitalised as non-current assets. The new 'Stor-It' devices went on sale on 1 April 20X3 and were expected to have a market life of around four years from that date. Revenue from sales of hardware is recognised when the hardware is delivered.

Systems

Systems revenue is generated from the sale of complete archiving and data storage systems comprising hardware, software and related services. System projects typically take 6 to 12 months to deliver and revenue is recognised on confirmation by the customer that the project is complete.

Services

Service revenue is generated by sales of training and consultancy. This is a very competitive market segment. It has been historically important for ETP and remains a core part of the company's business plan. Service revenue is recognised as the service is performed.

Exhibit 2: ETP audit for the year ending 30 September 20X4 – Preliminary analytical procedures working paper prepared by Joshi Khan

This working paper considers the following key performance indicators identified by ETP:

- Revenue growth
- Gross margin
- Receivables – days sales outstanding (DSO)

This working paper compares actual performance reported in the company's interim financial statements for the six month period to 31 March 20X4, with:

- the budget; and
- the average performance of a comparator group of companies which was identified during the audit for the year ended 30 September 20X3 as being most closely aligned to ETP in terms of activity.

Comparisons are also made, if applicable, to performance in a prior period. Where actual results appear out of line with budget or the comparative data, explanations have been sought from Julie Barwell, Financial Controller, and notes from these discussions are documented below.

(1) **Revenue growth**

Total revenue for the six months ended 31 March 20X4 was as follows:

	£m
Hardware	25.4
Systems	100.3
Services	17.9
Total	143.6

Revenue growth for the six months ended 31 March 20X4

	Hardware %	**Systems %**	**Services %**
ETP			
Actual growth for six months to 31 March 20X4	(15.0)	25.0	12.0
Budgeted growth for six months to 31 March 20X4	5.0	10.0	1.0
Comparator group of companies			
Average growth for six months to 31 March 20X4	5.0	6.0	(2.5)
Notes	1	2	3

Notes

1 Hardware sales of Stor-It devices were disappointing in the first half of the financial year following the introduction of cheaper and more advanced products by ETP's competitors. From discussions with Julie, sales have continued to decline in the third quarter and storage space for hardware inventory is becoming a problem.

2 Systems sales were very strong in the first half of the financial year. ETP reviewed its revenue recognition policy for systems sales in October 20X3 and is now invoicing and recognising revenue and associated costs as each project progresses. This resulted in the recognition of additional revenue totalling £30 million on part-completed projects in the six months ended 31 March 20X4. The recognition of revenue on part-completed projects was not foreseen at the time the budget was prepared and hence actual performance was significantly better than budget.

3 Services revenues for training and consultancy were strong in the first half of the year despite an overall decline in this sector of the market. Julie attributes this strong performance to the introduction of an 'all in' advice package introduced by ETP's new sales director, Jess Homes. Customers pay an up-front annual fee and are then able to access telephone and online advice as and when they need it. They are also entitled to discounts of up to 20% for the company's training programmes. This new service has proved very popular and revenues of £5 million were received in the six months ended 31 March 20X4. The up-front fees are recognised as revenue on receipt as they are not refundable.

(2) **Gross margin**

	Hardware %	**Systems %**	**Services %**
ETP			
Actual margin for six months to 31 March 20X4	31.4	46.0	63.9
Budgeted margin for six months to 31 March 20X4	35.0	45.0	50.0
Actual margin for six months to 30 September 20X3	35.0	44.8	50.1
Comparator group of companies			
Average margin for six months to 31 March 20X4	42.0	44.7	50.3
Notes		4	5

Notes

4 Gross margin on systems sales for the six months to 31 March 20X4 is higher than budgeted as the new projects that started during the period have generated margins higher than those experienced on the older projects which have now been completed. These higher margins were, however, offset by a loss recognised on a new project for a government department. At 31 March 20X4, this project was approximately 40% complete and revenue of £3.6 million was recognised in the six months to 31 March 20X4. Costs incurred on this project in the period amounted to £4.6 million giving rise to a £1 million loss. The contract as a whole is expected to be loss making.

5 The gross margin on services revenues is higher than expected due to the recognition of £800,000 of training revenue relating to training courses held in September 20X3, but only invoiced in October 20X3. Related costs were recorded in September 20X3. Julie attributed this delay in invoicing to the appointment of Jess Homes, the new ETP sales director.

(3) **Receivables – Days sales outstanding (DSO)**

ETP	**Days**
Actual DSO as at 31 March 20X4	78.4
Budgeted DSO as at 31 March 20X4	66.0
Actual DSO as at 30 September 20X3	66.2
Comparator group of companies	
Average DSO for comparator group as at 31 March 20X4	65.0
Note	6

Note

6 Overall DSO increased to above the industry average and prior year, as customers were generally slow to pay invoices for stage payments on systems sales. In addition, a number of distributors for the 'Stor-It' hardware devices struggled to make timely payments as their sales of the product fell and inventory levels increased.

Exhibit 3: Email from ETP financial controller, Julie Barwell

To: LaurenHaynes@JK.com
From: JulieBarwell@ETP.com
Date: 21 July 20X4
Subject: Interim audit and sales director

Hi Lauren

In September 20X3, ETP appointed a new sales director, Jess Homes. Jess was asked to increase ETP's service revenue and will receive a substantial bonus if she achieves a target set by the board. I am concerned because she has asked me to implement changes to the recognition of services revenue. I feel that I cannot approach my line manager, the finance director, because Jess is his sister. I would like your advice on this matter.

I was surprised when I joined ETP that J&K was not asked to complete review procedures on our interim results. When I asked the finance director, he said that the board is reluctant to incur the additional cost and be open to this level of scrutiny. Please therefore provide me with a brief summary of the key benefits that an interim review and report by J&K would provide.

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