Financial reporting questions

1 Sagefoot plc

Sagefoot plc (Sagefoot) is a retailer that owns a chain of stores that sell books and other media. Sagefoot obtained a Stock Exchange listing several years ago. Rapid growth in profits and strong positive cash flow enabled it to acquire two rival chains as well as several independent retailers. However, in recent months sales and profits have been badly affected by the economic downturn. Several senior and long-serving members of staff have recently left the company due to poor morale and general dissatisfaction with the direction that the company appears to be taking.

You work as an interim finance director and have been appointed to Sagefoot to finalise the financial statements for the year ended 30 September 20X2. The previous finance director resigned due to serious illness.

You have received the following email from Rob Lovelace, the Managing Director of Sagefoot.

To: Interim@sagefoot.com
From: Rlovelace@sagefoot.com
Date: 4 November 20X2
Subject: Financial statements for the year ended 30 September 20X2

I know you've only just arrived, but I would value your views on several issues as a matter of urgency.

As you probably already know, we've had a less than wonderful year. The draft consolidated financial statements, prepared by the former finance director, showed a post-tax profit of £12.3m, including the post-tax and post-acquisition profit for the subsidiary, Foxpath Ltd, that we acquired during the year. However, the draft figures do not yet include the effect of the two performance related remuneration schemes that we set up during the year (details in **Exhibit A** below). Could you explain the financial reporting treatment that we should adopt and quantify the adjustments that we need to make to the draft financial statements?

The reason I need to get a rough idea of the impact of the remuneration schemes is that some of the Board want to look into the possibility of changing the terms of the directors' scheme to make it more favourable. I do not have time to go into the details at the moment and our ideas are far from being finalised. However, it would be helpful if you could explain, in outline, how a change in the terms and conditions of this type of remuneration scheme would be dealt with in the financial statements.

As well as the two remuneration schemes, we've had a number of unusual transactions during the year. These are detailed in **Exhibit B**, below. As far as I am aware, these have already been dealt with in the draft financial statements, but I would still appreciate your thoughts on the correct financial reporting treatment of these items. As far as you can, I'd like you to quantify the adjustments that you think should be made to the consolidated financial statements for the current year.

Another thing I'd like you to do is to calculate basic and diluted earnings per share, based on profit after tax adjusted for the effect of the remuneration schemes. I realise there will probably also be some kind of tax effect, but do not worry about this for the time being. Our tax advisers will help us to deal with that in due course. Details of the shares in issue at the start of the year are set out in **Exhibit C**.

Kind regards,

Rob

Requirement

Prepare a memorandum giving the information and explanations requested by Rob Lovelace.

Total: 25 marks

Exhibit A – Remuneration schemes

There are two separate schemes: one for directors; and one for senior employees.

(1) On 1 October 20X1 Sagefoot granted 100,000 share options to each of the eight directors. These options are due to vest on 30 September 20X4, provided that:

- the directors remain with the company until that date; and
- the company's share price is above £5 on 30 September 20X4.

Two of the directors are expected to leave the company by 30 September 20X4.

(2) On 1 January 20X2 the company granted 200 senior employees the rights to receive cash equal to the increase in the company's share price between the grant date and the vesting date, 31 December 20X7. Each employee's rights are based on 10,000 shares. The employees do not become entitled to the cash unless they remain with the company until 31 December 20X7.

During the year ended 30 September 20X2 five employees left the company. Past experience suggests that approximately 80% of the employees who joined the scheme will still be working for the company on 31 December 20X7.

Other relevant information is given below:

	Share price	Fair value of one share option	Fair value of rights to receive cash from one share
	£	£	£
1 October 20X1	4.40	1.00	0.75
1 January 20X2	4.50	1.30	0.90
1 April 20X2	4.60	1.50	1.00
30 September 20X2	4.70	1.40	1.00
Average for the year to 30 September 20X2	4.50		

Exhibit B – Unusual transactions during the year

(1) On 1 April 20X2 Sagefoot acquired 100% of the shares of another company, Foxpath Ltd (Foxpath), by issuing 2,000,000 £1 ordinary shares to Foxpath shareholders. A further 500,000 Sagefoot shares are issuable to Foxpath shareholders on 30 September 20X4, provided that the reported profit after tax of Foxpath exceeds £2m for the year ended on that date. Foxpath's draft financial statements for the year ended 30 September 20X2 show reported profit after tax of £1.85m, with these profits expected to increase by 6% in each of the two following years.

(2) Partridge Press Ltd, a publishing company has asked us to promote the debut novel of a new author. We have agreed to stock the book on a sale or return basis as the author is not a well-established writer. Although this is not a significant transaction this year we are likely to enter into more of these agreements in future.

We took delivery of 5,000 copies of the book on 1 July 20X2 under the following terms:

- We have the option to return any copies unsold after six months.
- We pay Partridge Press Ltd for the books sold at the end of each month based on that month's sales.
- The purchase price of each book is £7.25.
- We are required to sell the book at its cover price of £12.99.

At 30 September 20X2 2,000 copies had been sold, the majority of sales being made in August as a result of the publication of an article about the author in a popular magazine. We expect interest to tail off in the coming months and anticipate selling a further 750 copies in October to December. 800 books have been damaged on transfer between our stores when a delivery van was involved in an accident.

(3) We have also been preparing for the launch of the final instalment of the children's book series 'The Wicked Wizard'. Demand for this book is so high that we have started to take a 50% deposit from customers to reserve a copy. The book will retail at £9.00. At 30 September 20X2 25,000 customers have reserved this book which will be released on 1 November 20X2.

(4) On 1 October 20X2 the company made a 1 for 4 rights issue at £2.20 per share.

Exhibit C – Details of shares

The company had the following finance in place at 1 October 20X1:

6,000,000 ordinary shares of £1 each.

£1,000,000 6% convertible bonds. Each £1 bond is convertible to two new ordinary shares on 1 October 20X4. At 1 October 20X1 the carrying amount of the liability element of the bonds was £948,418 and the effective interest rate is 8%.

1,500,000 £1 ordinary shares under option to potential investors outside the company. The exercise price of each option during the year ended 30 September 20X2 was £2.70.

2 Tosca Group

Tosca, a public limited company in the house-building trade, is an audit client of the firm of ICAEW Chartered Accountants where you work as an audit manager. The partner responsible for the audit of Tosca has asked you to prepare some notes ahead of a meeting he is due to attend with the client's finance director to advise on some financial reporting issues that have arisen during the preparation of the financial statements.

You have been provided with the following information:

(1) Tosca acquired the following shareholdings in Cavaradossi and Scarpia:

	Date of acquisition	Retained earnings at acquisition	Share capital at acquisition	Share premium at acquisition	Share capital acquired	Fair value of net assets at acquisition
		£m	£m	£m	£m	£m
Cavaradossi	1 Nov 20X7	120	250	50	200	450
Scarpia	1 Nov 20X6	260	400	40	300	700

The consideration paid by Tosca for the investment in Cavaradossi was £380m and £550m was paid for the investment in Scarpia. There are no reserves in either company other than those shown above.

(2) There have been no new issues of shares in the group since 1 November 20X6 and the fair value adjustments have not been included in the individual companies' financial records. The group policy is to value non-controlling interests at the date of acquisition at the proportionate share of the fair value of the acquiree's assets acquired and liabilities assumed.

(3) The fair value of Cavaradossi's net assets exceeded their carrying amounts at acquisition by £30m. This was attributable to plant and equipment which had a remaining useful life of six years at 1 November 20X7.

(4) Cavaradossi entered into a futures contract during the year to hedge a forecast sale in the year ended 31 October 20X9. The futures contract was designated and documented as a cash flow hedge. At 31 October 20X8, had the forecast sale occurred, Cavaradossi would have suffered a loss of £1.9m and the futures contract was standing at a gain of £2m. No accounting entries have been made to record the futures contract.

(5) At 31 October 20X8, Tosca conducted an impairment test on Cavaradossi and Scarpia, which are both cash-generating units in their own right. The recoverable amount of Cavaradossi was found to be £520m (excluding any effect on net assets of the cash flow hedge) and there had been no impairment of Scarpia. The carrying amount of the net assets of Cavaradossi at 31 October 20X8 was £480m.

(6) On 31 October 20X8, Tosca sold some of its land (which had cost £8m) to Puccini Bank for £10m, its open market value determined by an independent surveyor. The terms of the agreement were as follows:

- Tosca has the right to develop the land at any time during the bank's ownership. For this right, Tosca has to pay all the outgoings on the land plus an annual fee of 5% of the purchase price.
- Puccini Bank maintains a memorandum account for the purpose of determining the price to be paid by Tosca, should Tosca ever re-acquire the land or any adjustments be necessary to the original purchase price. In this account will be entered the purchase price, any expenses incurred by Puccini Bank in relation to the transaction, a sum added quarterly (or on the sale by Puccini Bank of the land), calculated by reference to Puccini Bank's lending rate plus 2% per annum applied to the daily balance on the account; and from the account will be deducted the annual fees paid by Tosca to Puccini Bank.
- Tosca has the option to acquire the land at any time within five years from the date of sale; the acquisition price is to be the balance on the memorandum account at that time.
- On the expiry of five years from the date of acquiring the land, Puccini Bank will offer it for sale generally; and at any time before that it may, with the consent of Tosca, offer the land for sale.
- In the event of Puccini Bank selling the land to a third party, the proceeds of the sale shall be deducted from the memorandum account and the balance shall be settled between Tosca and

Puccini Bank in cash, as a retrospective adjustment of the price at which Puccini Bank originally purchased the land from Tosca.

- The finance director of Tosca entered into this transaction to raise finance without increasing the gearing ratio of Tosca. He has recorded the transaction as a normal disposal of property, plant and equipment.

(7) On 31 July 20X8, Tosca sold 140m of its 300m shares in Scarpia for consideration of £300m. Subsequent to the disposal, Tosca maintained significant influence over Scarpia. The fair value of the remaining shareholding at 31 July 20X8 was £340m. Scarpia's profit for the year ended 31 October 20X8 was £20m and no dividends were paid or proposed in the year. This disposal has not yet been accounted for and the group accountant has not included Scarpia in the group statement of financial position other than showing the carrying amount of the initial investment by Tosca (Cavaradossi has been fully consolidated subject to the above notes). Scarpia's statement of financial position as at 31 October 20X8 is shown as **Exhibit 2**.

Requirements

Prepare notes for a meeting with the finance director of Tosca plc. These should include:

2.1 An amended consolidated statement of financial position of the Tosca Group as at 31 October 20X8. **(19 marks)**

2.2 Explanations for each adjustment made, with a discussion of whether the finance director's proposed accounting treatment of the sale and the repurchase of land (item (6) above) is correct. **(6 marks)**

Total: 25 marks

Exhibit 1

Tosca Group
Consolidated statement of financial position as at 31 October 20X8

	£m
Non-current assets	
Property, plant and equipment	635
Goodwill	20
Cost of investment in Scarpia	550
Held to maturity investment	62.5
	1,267.5
Current assets	
Inventories	550
Trade receivables	240
Cash and cash equivalents	230
	1,020
	2,287.5
Equity attributable to owners of the parent	
Share capital of £1	500
Share premium	100
Retained earnings	696.5
	1,296.5
Non-controlling interests	101
	1,397.5
Non-current liabilities	440
Current liabilities	450
	890
	2,287.5

Exhibit 2

Scarpia
Statement of financial position as at 31 October 20X8

Assets	£m
Non-current assets	
Property, plant and equipment	400
	400
Current assets	
Inventories	300
Trade receivables	190
Cash and cash equivalents	110
	600
Total assets	1,000
Equity and liabilities	
Equity	
Share capital of £1	400
Share premium	40
Retained earnings	310
Total equity	750
Non-current liabilities	100
Current liabilities	150
Total liabilities	250
Total equity and liabilities	1,000

3 Timber Products plc

Timber Products plc was founded over 90 years ago and is well established as a household name in the manufacture and supply of furniture. The business was hit by the recent recession but now anticipates recovery. Nevertheless, working capital is still under pressure. In particular, the company is worried by its gearing levels and is concerned that the issue of preference shares will increase gearing. You are provided with the following information about the company.

(1) The company issued two blocks of preference shares on 1 October 20X5:

- The company issued 2,000,000 7% redeemable £1 nominal preference shares at a premium of 20p per share, paying issue costs of £100,000. Dividends are payable on 30 September each year. The shares are redeemable at the option of the holder on 30 September 20Y5 for £1.25 per share.

  The £2,000,000 nominal value of the preference shares and the £400,000 share premium are included under equity in the company's draft statement of financial position. The £100,000 issue cost is shown as an expense, under finance costs, in the draft statement of profit or loss and other comprehensive income.

  Discounting the above cash flows at 6.7% gives a net present value of zero.

- A further 3,000,000 convertible £1 preference shares were issued at par. These entitle the holder to an annual dividend of 4% per annum, payable on 30 September. On 1 October 20Y0 these will be convertible to one fully paid ordinary share for every preference share held. Issue costs were negligible.

  Discounting the cash flows payable over the life of this instrument at a rate of 6.7% would value them at approximately £500,000 as at 1 October 20X5.

  The £3,000,000 nominal value of these shares is included under equity in the company's draft statement of financial position.

(2) In addition, on 1 October 20X5 the company borrowed £5,000,000 under an agreement to pay interest of 7% on 30 September 20X6, 10% on 30 September 20X7 and a final payment of interest and capital totalling £5,514,000 on 30 September 20X8.

The borrowing is shown as a non-current liability in the draft statement of financial position at £4.65m, being the loan less the first year's coupon payment. No finance costs have been accrued as yet.

The effective rate of interest on the loan is 9% per annum.

(3) The company imports unseasoned hardwood and keeps it for five years under controlled conditions before manufacturing high quality furniture. On 1 October 20X5, it imported unseasoned timber at a cost of £4.9m. It contracted to sell the whole amount for £3.1m and to buy it back in five years' time for £5.0m.

This transaction has been treated as a sale for £3.1m in the draft statement of profit or loss and other comprehensive income. The buyer settled the associated receivable on 1 October 20X5.

The effective rate of interest on this transaction is 10%.

(4) The company manufactures and supplies retailers with furniture on a consignment basis, such that either party can require the return of the furniture to the manufacturer within a period of six months from delivery. The retailers are required to pay a monthly charge for the facility to display the furniture. The manufacturer uses this monthly charge to pay for insurance cover and carriage costs. At the end of six months the retailer is required to pay Timber Products plc the trade price as at the date of delivery. No retailers have yet sent back any goods to Timber Products plc at the end of the six month period. In the year ended 30 September 20X6 Timber Products plc had supplied furniture to retailers at the normal trade price of £10m, being cost plus $33^1/_3$%, received £0.5m in display charges, incurred insurance costs of £0.2m and carriage costs of £0.3m, and received £6m from retailers.

The £10m for the sale of the goods and the £0.5m display charge have been treated as revenue in the draft financial statements and the insurance and carriage costs have been treated as expenses.

The company's draft statement of financial position as at 30 September 20X6 is as follows:

Timber Products plc
Draft statement of financial position as at 30 September 20X6

	£'000	£'000
Property, plant and equipment		35,000
Current assets		
Inventory	30,000	
Receivables	20,000	
Cash	9,650	
		59,650
Total assets		94,650
Equity		
Ordinary shares (£1)		32,000
7% redeemable preference shares		2,000
4% convertible preference shares		3,000
Share premium		20,400
Retained earnings		25,000
		82,400
Non-current liabilities		
Loans		4,650
Current liabilities		7,600
Total equity and liabilities		94,650

According to the draft financial statements, the profit after tax for the year ended 30 September 20X6 was £8,000,000. A tax expert is to work out the final tax charge so ignore taxation aspects for now.

Finance director's request

The finance director has asked you, his assistant, for a report showing the following:

(a) The correct accounting treatment of each of the items numbered (1) to (4) above.

(b) Journal entries for the adjustments arising from your work in identifying the correct accounting treatments, and a restated draft statement of financial position to take account of your corrections.

(c) Calculations of the earnings per share and diluted earnings per share for the company.

Requirement

Respond to the finance director's request. **Total: 25 marks**

4 Hollinwell plc

Hollinwell plc operates in the engineering industry and prepares financial statements in accordance with IFRS. The management of Hollinwell plc was appointed during 20X5 following a prolonged period of underperformance against other companies in the engineering sector.

Hollinwell plc has several manufacturing facilities in the UK. Industry observers believe that significant additional investment in plant and equipment is required to improve productivity. Its costs of production are amongst the highest of companies in the sector. In the second half of 20X5 Hollinwell plc introduced a competitive, low price policy for its products.

You are a business analyst for Stannage plc. Stannage plc is a competitor of Hollinwell plc. The Chairman of Stannage plc has sent you some extracts from the 20X6 financial statements of Hollinwell plc and asked you to analyse them. He has been surprised by the increase in net profit and the strong cash flows of Hollinwell plc, given its pricing policy and its perceived cost structure.

Unlike its competitors, Stannage plc has successfully outsourced the manufacturing of component parts to low cost overseas economies in an attempt to improve profitability. The Chairman has provided you with the following performance indicators derived from the latest financial statements of Stannage plc:

Stannage plc – performance indicators

	20X6
Return on capital employed	14.7%
Gross profit margin	23.1%
Operating profit margin	12.0%
EBITDA/Revenue	27.0%
Revenue per employee	£28,100
Revenue growth (year on year)	0.3%
Cash return on capital employed	22.4%
Cash from operations to profit from operations	1.9 times

The following information has been provided for Hollinwell plc:

Hollinwell plc
Statement of profit or loss

	Year ended 30 Sept 20X6	**Year ended 30 Sept 20X5**
	£'000	£'000
Revenue	27,920	26,990
Cost of sales	(22,310)	(21,340)
Gross profit	5,610	5,650
Operating expenses	(2,410)	(2,680)
Profit from operations	3,200	2,970
Finance costs	(850)	(970)
Profit before tax	2,350	2,000
Tax	(530)	(650)
Net profit for year	1,820	1,350

No dividends have been declared in respect of earlier years.

Hollinwell plc
Cash flow statement

	Year ended 30 Sept 20X6		Year ended 30 Sept 20X5	
	£'000	£'000	£'000	£'000
Cash flows from operating activities				
Cash generated from operations (Note)		9,090		5,610
Interest paid		(950)		(1,240)
Tax paid		(430)		(710)
Net cash from operating activities		7,710		3,660
Cash flows from investing activities				
Purchase of tangible non-current assets	(6,510)		(3,010)	
Proceeds on sale of non-current assets	–		10	
Net cash used in investing activities		(6,510)		(3,000)
Cash flows from financing activities				
Borrowings repaid		(500)		–
Increase in cash and cash equivalents		700		660
Cash and cash equivalents brought forward		1,500		840
Cash and cash equivalents carried forward		2,200		1,500

Note: **Reconciliation of profit before tax to cash generated from operations**

	£'000	£'000
Profit before tax	2,350	2,000
Finance costs	850	970
Depreciation	4,210	3,950
Decrease/(Increase) in inventories	300	(230)
Decrease/(Increase) in receivables	700	(650)
Increase/(Decrease) in trade payables	680	(430)
Cash generated from operations	9,090	5,610

Extract from notes to the financial statements of Hollinwell plc

Accounting policy – tangible non-current assets

All tangible non-current assets are stated at cost less accumulated depreciation and impairment charges. Depreciation is computed using the straight-line method using estimates of average useful lives.

The useful lives and residual values of all tangible non-current assets were reassessed during the year. Changes to the pattern of consumption of economic benefits required changes to the useful lives and residual values of certain head office non-current assets. The change was accounted for as a change in accounting estimate in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The effect was to reduce the depreciation expense presented in operating expenses for the year ended 30 September 20X6 and future years by £320,000 per annum.

Additional information for Hollinwell plc

	20X6	**20X5**
Gearing (net debt/equity)	33.2%	41.2%
Operating profit margin	11.5%	11.0%
Return on capital employed (ROCE)	9.8%	9.3%
Average number of employees	1,170	1,210
Cash return on capital employed	28.0%	17.6%
EBITDA	£7,410,000	£6,920,000
Inventory turnover	4.1 times	3.4 times
Trade receivables collection period	92 days	99 days
Trade payables payment period	49 days	40 days

Requirements

4.1 Prepare a report analysing the financial performance and cash flows of Hollinwell plc. Your answer should identify matters that you consider require further investigation. **(13 marks)**

4.2 Comment on the usefulness of EBITDA (earnings before interest, taxation, depreciation and amortisation) when analysing the performance and cash flows of Hollinwell plc. **(2 marks)**

Total: 15 marks

5 Typoprinters Ltd

Typoprinters Ltd ('TP') is an established company in the printing industry. Its main activity is artwork and printing of letterheads and brochures. Its revenue is mainly from repeat business from its existing customers. Revenue has declined in recent years as many former customers are now able to design and print their own letterheads and use websites rather than brochures to promote their products. The company uses old printing machinery and production is labour intensive although relatively unskilled. It has owned the same city-centre premises for the past 40 years.

First Impressions Ltd ('FI') used to be a similar business to TP. However, a few years ago it appointed Cecilia Brown as the new managing director and she developed a new business strategy. The company moved away from traditional printing and expanded into designing logos and web page design, which were established as two separate divisions. It also invested heavily in computer equipment and bespoke software and employed skilled staff. The company moved from its city-centre premises to cheap rented accommodation in a rural location.

The draft financial statements of TP and FI for the year ended 31 August 20X6 are set out below.

Statements of profit or loss for the year ended 31 August 20X6	**Typo-printers Ltd (TP)**	**First Impressions Ltd (FI)**
	£'000	£'000
Revenue	9,200	8,700
Cost of sales		
Materials	(1,830)	(440)
Labour	(2,280)	(3,900)
Overheads	(2,100)	(2,200)
Gross profit	2,990	2,160
Distribution costs	(460)	(140)
Advertising costs	(70)	(180)
Administrative expenses	(350)	(370)
Profit from operations	2,110	1,470
Finance costs	(90)	(260)
Profit before tax	2,020	1,210
Tax	(670)	(310)
Profit for the year	1,350	900

Statements of financial position at 31 August 20X6	**Typo-printers Ltd (TP)** £'000	**First Impressions Ltd (FI)** £'000
Assets		
Non-current assets		
Property, plant and equipment	8,160	6,540
Current assets		
Inventories	650	60
Trade and other receivables	950	730
Cash and cash equivalents	20	10
	1,620	800
Total assets	9,780	7,340
Equity and liabilities		
Capital and reserves		
Issued capital – £1 ordinary shares	4,530	4,300
Retained earnings	2,960	100
Equity	7,490	4,400
Non-current liabilities		
Borrowings	1,000	2,600
Current liabilities		
Trade payables	550	20
Other payables	740	320
	1,290	340
Total equity and liabilities	9,780	7,340

Additional information

	Typo-printers Ltd (TP)	**First Impressions Ltd (FI)**
Gross profit percentage	33%	25%
Operating margin percentage	23%	17%
Earnings before interest, tax, depreciation, amortisation	£2,610,000	£2,880,000
Trade payables payment period – days	45	28
Average number of employees	270	161

Requirements

5.1 Compare and contrast the performance and financial position of TP and FI.

Your analysis should take into consideration the markets in which they operate. **(12 marks)**

5.2 FI has divisions in logo and web page design. Discuss the usefulness and limitations to investors in FI of segment reporting. **(3 marks)**

Total: 15 marks

6 Merton plc

Merton plc is a small listed company that operates in the independent music publishing sector. It signs contracts with recording artists and then produces and distributes their music either on compact disc (CD) or via downloads from its website. It also receives income from a range of music copyrights that it holds.

You are a business analyst for Merton plc. The finance director has asked you to prepare the first draft of an analysis of the financial statements for the year ended 31 March 20X7. He will use your notes and suggestions for further investigation as part of his preparations for a meeting with investors in Merton plc.

You are aware of the following principal business events that have happened during the year:

- A major recording artist was due to release a new music album in December 20X6. However, the release has been delayed until September 20X7. No other major recording artists released new music albums during the year.
- A contractual dispute with Eyemusic Ltd, an online music distribution company, resulted in the payment of a settlement of £2m to Eyemusic Ltd in February 20X7. This has been included in operating expenses.
- The sale of the classical music division. The division was responsible for the worldwide distribution of classical sheet music. It met the IFRS 5, *Non-current Assets Held For Sale and Discontinued Operations*, 'held for sale' criteria in January 20X6 and it was disposed of on 10 July 20X6.
- Major investment has been made over the past two years in the company's website. It allows customers to download digital music at high speeds. It has a niche following within its chosen markets.
- The company holds the copyrights to a large catalogue of old music that it has acquired over the past five years. Merton plc has received increasing levels of royalty income from this catalogue.

The following information has been provided for Merton plc:

Statements of profit or loss

	Year ended 31 March 20X7	**Year ended 31 March 20X6**
	£'000	£'000
Continuing operations		
Revenue	42,030	47,890
Cost of sales	(27,160)	(29,700)
Gross profit	14,870	18,190
Operating expenses	(7,460)	(5,360)
Profit from operations	7,410	12,830
Finance costs	(120)	(420)
Profit before tax	7,290	12,410
Tax	(2,550)	(4,350)
Profit from continuing operations	4,740	8,060
Discontinued operations		
Loss on discontinued operations	(550)	(2,300)
Profit for the year	4,190	5,760

Extract from statement of changes in equity for the year ended 31 March 20X7

	Retained earnings
	£'000
Balance at 1 April 20X6	2,670
Profit for the year	4,190
Final 20X6 dividend on ordinary shares (25.63p per ordinary share)	(2,050)
Balance at 31 March 20X7	4,810

A final dividend in respect of the year ended 31 March 20X7 of £4.0m (50p per share) was declared in May 20X7. This amount includes a special dividend of 24p per share in respect of part of the proceeds from the sale of the classical music division.

Statements of financial position

	At 31 March 20X7		At 31 March 20X6	
	£'000	£'000	£'000	£'000
Assets				
Non-current assets				
Property, plant and equipment		9,760		8,300
Intangibles		14,900		14,200
		24,660		22,500
Current assets				
Inventories	1,200		1,430	
Trade and other receivables	2,250		1,920	
Cash and cash equivalents	3,140		380	
	6,590		3,730	
Held for sale – Classical Music Division	–		2,500	
		6,590		6,230
Total assets		31,250		28,730
Equity and liabilities				
Capital and reserves				
Issued capital – £1 ordinary shares		8,000		8,000
Revaluation reserve – intangible assets		8,010		7,110
Retained earnings		4,810		2,670
Equity		20,820		17,780
Non-current liabilities				
Borrowings		3,760		3,330
Current liabilities				
Trade payables	3,250		2,320	
Taxation and other liabilities	3,420		5,300	
		6,670		7,620
Total equity and liabilities		31,250		28,730

Extract from notes to financial statements
Segmental revenue analysis

	Year ended 31 March 20X7 £'000	Year ended 31 March 20X6 £'000
Continuing operations		
Compact disc (CD)	24,310	34,050
Website downloads	15,610	12,050
Copyright licensing	2,110	1,790
	42,030	47,890
Discontinued operations		
Classical music	3,400	9,760

Additional information

	20X7	20X6
Gearing (net debt/equity)	3.0%	16.6%
Number of registered website users	267,400	219,100
Inventory turnover	22.6 times	20.8 times
Trade receivables collection period	19.5 days	14.6 days
Gross margin	35.4%	38.0%
Market share price (at 31 March)	420p	550p
Earnings per share	52.4p	72.0p
Current ratio (excluding held for sale asset)	0.99 times	0.49 times

Requirement

Comment on the performance, liquidity and investor ratios of Merton plc. Your answer should identify matters that you consider require further investigation. **Total: 20 marks**

7 Mayfield Ltd

Mayfield Ltd is a privately owned company operating in the media sector. It operates a number of public relations and product promotion activities. It has grown through a mix of organic investment and acquisition of small, growing competitors. The principal shareholders in Mayfield Ltd are high net worth individuals who have been seeking an exit from the company and a substantial return on their initial investment.

The financial performance of Mayfield Ltd had been poor for a number of years and on 1 June 20X6 a new management team was installed. The remit of the management team was simple – deliver a quick, short-term turnaround in performance with a view to assisting the existing shareholders to exit the business quickly, either through a sale or an Initial Public Offering (IPO).

You joined Mayfield Ltd in 20X4 as the financial controller. You are currently completing the annual financial statements for the year ended 30 September 20X6. You have just been to a meeting with the new Chief Executive Officer (CEO). He has aggressively managed the business since his appointment and wanted to talk to you about three outstanding financial reporting issues in respect of the financial statements for the year ending 30 September 20X6. He said:

'I expect that we will initiate an exit at the end of 20X7. It's really important that our financial performance shows a significant improvement over 20X5. I want you to devise the most advantageous accounting treatments for the four outstanding issues so that we can achieve our goals. However, I do not want our financial position to be compromised by whatever you come up with.'

He has asked you to prepare a briefing paper for him, showing any alternative treatments available and, in each case, to identify the one that would be most favourable for the 20X6 financial statements, without compromising 20X7. You have gathered the following information on the areas of interest to the CEO:

(1) Mayfield Ltd acquired the entire share capital of Burbage Ltd on 1 October 20X5. Burbage Ltd operates a defined benefit pension plan for its employees. At acquisition, Mayfield Ltd recognised the net pension asset in its consolidated financial statements at £1,000,000 comprising the fair value of the plan assets and the present value of the plan liabilities of £2,000,000 and £1,000,000 respectively. A related deferred tax provision of £246,400 was recognised at the same time. Mayfield Ltd and its subsidiaries, other than Burbage Ltd, all operate defined contribution pension schemes. No accounting policies for defined benefit pension schemes appeared in the consolidated financial statements of Mayfield Ltd in the prior year. The CEO wishes to treat any gain or loss on re-measurement of the net defined benefit asset/liability (actuarial gain or loss) in the most favourable way possible.

The pension scheme actuary for the Burbage Ltd pension plan had previously provided you with the following information for the pension scheme in respect of the year ended 30 September 20X6:

Yield on high quality corporate bonds at the start of the year	6%
Current service cost	£400,000
Benefits paid	£250,000
Contributions paid	£100,000
Present value of obligation at 30 September 20X6	£1,150,000
Fair value of plan assets at 30 September 20X6	£2,250,000

The tax base of the net pension scheme asset is nil.

(2) Mayfield Ltd has decided to adopt a strategy of developing marketing alliances with small, developing, media content providers. As part of this strategy it advanced an interest free loan of £1,000,000 to Freetext Ltd on 1 July 20X6. The loan is due for repayment on 30 June 20X8 and Freetext Ltd has used the funds to repay an equivalent loan at an interest rate of 10% per annum. The tax base of the loan is the same as its carrying amount. The CEO told you that this is a great deal. He continued,

'In return for the loan, I anticipate receiving future training, product and marketing benefits that'll be a far greater asset than the cost of financing the loan. I'd like to put the training asset on the statement of financial position at £20,000, being the value of the interest income forgone.'

(3) On 1 July 20X6 Mayfield Ltd sold a portfolio of investments for a consideration of £400,000 that had been classified as held to maturity in the financial statements for the year ended 30 September 20X5. The carrying amount of the portfolio at that date was £120,000. The CEO has passed you a board minute authorising the disposal, as there was a need to raise capital quickly to invest in product literature for a client and to provide short-term finance whilst other finance agreements

were negotiated. He told you to net the resulting gain off interest expenses, as the proceeds of the transaction reduced finance costs.

On 1 September 20X6 Mayfield Ltd purchased a strategic investment of 500,000 7% £1 preference shares, redeemable in 20X9, in YeeYee Ltd, a competitor company. The preference shares were issued, and are redeemable, at par. The acquisitive nature of Mayfield Ltd has created speculation that Mayfield Ltd will make an offer for the entire ordinary and preference share capital of the competitor. The fair value of each preference share at 30 September 20X6 had increased to £1.20. The tax base of the investments is the same as their cost. You cannot find any documentation about the transaction. You overheard the CEO telling a colleague:

'We need to classify them favourably. We can create backdated documentation to support this. We'll sell them shortly if we need the profit.'

Mayfield Ltd holds no other similar investments.

(4) The company acquired a property on 1 October 20X5 which it intended to sell. The property was obtained as a result of a default on a loan agreement by a third party and was valued at £8m on that date for accounting purposes which exactly offset the defaulted loan. The property is in a state of disrepair and Mayfield intends to complete the repairs before it sells the property. The repairs were completed on 31 October 20X6. The property was sold after costs for £12m on 9 November 20X6. The property was classified as 'held for sale' at the year end under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* but shown at the net sale proceeds of £12m, and a £4m revaluation gain recognised. Property is depreciated at 5% per annum on the straight-line basis but no depreciation has been charged in the year. The CEO believes that the revaluation gain of £4m will impress a potential buyer.

Requirement

Prepare the briefing paper requested by the CEO covering the financial reporting treatment of the four issues in the consolidated financial statements of Mayfield Ltd. **Total: 30 marks**

Assume Mayfield Ltd's rate of tax is 23%.

Note: IAS 12 requires the use of the liability method, which means that we use the tax rate in force when the liability reverses. This may not be 23%. However, for the purposes of this question, a simplifying assumption has been made that the rate will be 23%.

8 Breightmet plc

Breightmet plc, a listed company, is an online retailer of books, music, DVDs and electrical goods. The business has grown rapidly in the last five years, and has been making use of a number of different forms of financing.

You are Kirsty Farnworth, an ICAEW Chartered Accountant and senior at ICAEW Chartered Accountants Holcombe and Berry. Darcy Lever, the Finance Director of Breightmet, is away on paternity leave, and Julie Bradshaw, his assistant, has asked for your advice.

Breightmet's year end is 30 September 20X5. It is now 15 November 20X5, and Julie Bradshaw has sent you the following email:

From: jbradshaw@breightmet.com
To: Kirstyfarnworth@holcombeberry.com
Date: 15 November 20X5
Subject: Financial instruments

I am pleased you can help me out with the accounting for some of these financial instruments. As you will see (**Exhibit 1**) I have produced some draft figures for part of the statement of profit or loss and other comprehensive income – as far as profit before tax, but I would like to resolve some of these accounting issues before proceeding.

Mr Lever left details of the financial instruments concerned (**Exhibit 2**). I have added a note to each, stating how – if at all – I have accounted for the instrument in question.

Please draft a memorandum showing the appropriate treatment of the financial instruments, together with workings showing how you arrive at the figures. Could you also show the effect on draft profit before tax for the year ended 30 September 20X5?

Requirement

Prepare the memorandum required by Julie Bradshaw. **Total: 30 marks**

Exhibit 1 – Draft statement of profit or loss and other comprehensive income extract for the year ended 30 September 20X5

	£m
Revenue	4,000
Cost of sales	(2,200)
Gross profit	1,800
Distribution costs and administrative expenses	(800)
Finance costs	(200)
Profit before tax	800

Exhibit 2 – Financial instruments

Available-for-sale financial assets

Breightmet has available-for-sale financial assets, purchased on 1 October 20X4 for £80 million. At 30 September 20X5, the market value of these assets had fallen to £60 million.

J Bradshaw note: I have included this loss in finance costs.

Convertible bonds

3,000,000 5% convertible bonds with a nominal value of £100 each were issued on 1 October 20X4 at par and are due to be redeemed at par or converted at a rate of 20 ordinary shares for each £100 bond on 30 September 20X9. The prevailing market interest rate for similar five year non-convertible bonds is 7%. The five year annuity factor for a discount rate of 7% is 4.100.

J Bradshaw note: The finance director Mr Lever is under pressure from the board to reduce the gearing of Breightmet, as a covenant relating to the long-term borrowings is in danger of being breached. As he believes that the majority of the bond-holders will convert their bonds into shares, he recommended that I recognise the bonds at their par value in equity. Interest is paid annually on 30 September and has been treated as dividend and recorded directly in the statement of changes in equity.

Redeemable preference shares

Also on 1 October 20X4, Breightmet issued £500 million 8% preference shares at par, redeemable in ten years' time on 30 September 20Y4 (at par). The holders of the preference shares (the shareholders) have the right of redemption.

J Bradshaw note: I assume these should be accounted for in accordance with their legal form and have classified them as equity. The preference dividend paid has therefore been treated as an appropriation of profit.

Loan from Kearsley bank

Breightmet raised a loan with Kearsley bank of £40 million on 1 October 20X4. The market interest rate of 8% per annum is to be paid annually in arrears and the principal is to be repaid in 10 years' time. The terms of the loan allow Breightmet to redeem the loan after seven years by paying the interest to be charged over the seven year period, plus a penalty of £4 million and the principal of £40 million. The effective interest rate of the repayment option is 9.1%. The directors of Breightmet are currently restructuring the funding of the company and are in initial discussions with the bank about the possibility of repaying the loan within the next financial year.

J Bradshaw note: I am uncertain about the accounting treatment for the current loan agreement and whether the loan can be shown as a current liability because of the discussions with the bank, so I haven't accounted for it at all. How will profit be affected if it is expected that the loan is repaid early?

Loans to employees

Breightmet granted interest free loans to its employees on 1 October 20X4 of £200 million. The loans will be paid back on 30 September 20X6 as a single payment by the employees. The market rate of interest for a two year loan on both of the above dates is 6% per annum.

J Bradshaw note: I am unsure how to account for the loans, but for now I have classified them as 'loans and receivables' under IAS 39 *Financial Instruments: Recognition and Measurement*.

Loan to Phinferb Ltd

Breightmet loaned £200,000 to Phinferb Ltd on 1 October 20X3. I have found the details of this loan in a document produced by my predecessor, and the effective and stated annual interest rate for this loan was 8%. Interest is payable by Phinferb Ltd at the end of each year and the loan is repayable on 30 September 20X7. I have heard from a reliable source that Phinferb Ltd is in financial difficulties and is undergoing a financial reorganisation. It is likely that Breightmet will only receive £100,000 on 30 September 20X7 and no future interest payment. Interest for the year ended 30 September 20X5 has been received.

J Bradshaw note: I am a little unsure about the accounting treatment for the loan to Phinferb Ltd in the financial statements of Breightmet for the year ended 30 September 20X5. Would we treat this as an impairment?

9 Puckoon plc

Puckoon plc (Puckoon) is a listed company that makes breakfast cereals under its own brand name and also for supermarkets under their own brand labels. Puckoon sources the raw materials from external suppliers and also from its own farms.

You are Aasha Penesar, an ICAEW Chartered Accountant who has recently joined Puckoon as financial controller. You receive the following email from the chief executive, Terry Milligan.

To: Aasha Penesar
From: Terry Milligan
Date: 2 November 20X9
Subject: Financial Statements for the year ended 30 September 20X9

I have a meeting next week with the chairman of the Audit Committee to review the draft financial statements for the year ended 30 September 20X9. He is concerned in particular about interest cover, as we may be in breach of a bank covenant if this falls below a certain level.

I have attached an extract from the draft statement of profit or loss and other comprehensive income (**Attachment 1**) and file notes prepared by your predecessor in relation to some outstanding financial reporting issues (**Attachment 2**).

Using this information please prepare briefing notes for the meeting as follows:

- Advise on the appropriateness of the financial reporting treatment, making reasoned recommendations to adjust the draft financial statements.
- Set out any journal entries you consider necessary to correct the extract from the draft statement of profit or loss and other comprehensive income.
- Prepare a table showing your proposed adjustments to the draft operating profit and finance costs.

I do not need you to consider the tax effects at this stage.

Attachment 1 – Extracts from draft statement of profit or loss and other comprehensive income for year ended 30 September 20X9

	£'000
Profit or loss	
Revenue	46,800
Operating profit	1,600
Finance costs	(970)
Other comprehensive income	800

Attachment 2 – File notes prepared 15 October 20X9

The following items need the attention of my successor because I am unsure whether the appropriate financial reporting treatment has been adopted.

Wheat option

On 1 July 20X9 Puckoon purchased an option to buy 100,000 bushels of wheat for an exercise price of £120 a bushel on 1 January 20Y0. The cost of the option was £500,000. At 30 September 20X9 the fair value of wheat was £145 a bushel following unexpectedly poor harvests globally.

The cost of the option has been charged to profit or loss as an administrative cost and no other entries have been made. Puckoon does not intend to take physical delivery of the wheat.

Agricultural equipment

On 1 January 20X9 Puckoon was granted an option to buy some agricultural equipment on 1 December 20X9 for \$3m. At 1 January 20X9 the exchange rate was £1=\$1.50.

At 30 September 20X9 the exchange rate was £1=\$1.25. The equipment has a useful life of five years and has been included in non-current assets initially at a cost of £2m with subsequent depreciation of £300,000, on the grounds that I thought it was highly probable that Puckoon would take up the option to purchase. At the last board meeting on 2 September 20X9 it was agreed that the purchase is still highly probable to take place on 1 December. I have also credited a payable of £2m in current liabilities in the statement of financial position in respect of this transaction.

In relation to this contract, on 1 January 20X9 Puckoon also signed a forward contract to buy $2.8m at £1=$1.45 deliverable on 1 December 20X9 specifically to hedge against potential exchange rate losses. Puckoon's treasury manager documented the contract as a hedge in relation to the equipment purchase in the company records. The cost of this contract was £25,000 at 1 January 20X9 and this has been charged to profit or loss as an operating expense.

Staff issues

The directors announced in the staff newsletter in January 20X9 that Puckoon would pay a discretionary bonus of 4% of annual salary in respect of the year ended 30 September 20X9. This will apply to all staff still employed at 31 December 20X9, subject to satisfaction with an individual employee's performance and is instead of a pay rise for staff in the year ended 30 September 20X9. The total annual salary for the year ended 30 September 20X9 is £6m, excluding any bonuses, for our 250 staff. No bonus has been charged to profit or loss as payment will not take place until after 30 September 20X9.

At the last board meeting on 2 September 20X9 the directors decided to reduce staff costs and agreed a plan to make 40 employees redundant, with an expected redundancy cost of approximately £1.1m which has been charged as an operating expense in profit or loss. As yet, the redundancy plans have not been made public.

Puckoon operates a defined benefit pension scheme for senior employees. The assets of the scheme are held separately from those of the company in funds under the control of trustees. Information relating to the scheme is given below.

Andrew Bruce, the Senior Accountant who used to deal with the pension scheme left suddenly during the year. The directors are unsure how to account for the pension scheme, believing that Andrew Bruce's treatment was overly complicated. They propose that the £85,000 contribution paid by the company to the scheme in the year is the only amount to be recognised in profit or loss. The terms of the plan have been summarised by Andrew Bruce as follows.

- Employees contribute 6% of their salaries to the plan.
- Puckoon contributes, currently, the same amount as the employees to the plan for the benefit of the employees.
- On retirement, employees are guaranteed a pension which is based upon the number of years service with the company and their final salary.

The following details relate to the plan in the year to 30 September 20X9:

	£'000
Present value of obligation at 1 October 20X8	1,000
Present value of obligation at 30 September 20X9	1,200
Fair value of plan assets at 1 October 20X8	950
Fair value of plan assets at 30 September 20X9	1,125
Current service cost	100
Pension benefits paid	95
Total contributions paid to the scheme for year to 30 September 20X9	85

Gains and losses on remeasurement (actuarial gains and losses) are recognised in accordance with IAS 19 *Employee Benefits* (revised 2011).

The interest rate on high quality corporate bonds at 1 October 20X8 was 5%.

Assume cash contributions are received and pension payments are made at the year end.

Equity investments

During the year ended 30 September 20X9 Puckoon made investments in three companies as follows:

	Number of shares purchased	**Cost per share**	**Transaction costs**
Bentine plc	100,000	£4.50	£9,000
Secombe Inc	30,000	$11.90	£7,000
Edgington plc	25,000	£8.50	£5,000

None of these investments represents more than a 5% holding of the total issued share capital of each company.

All the transaction costs have been expensed in profit or loss as finance costs.

The purchases in Bentine plc and Secombe Inc were made on 17 June 20X9. Both these investments were made with no original intention to sell the shares. Bentine and Secombe are both suppliers of oats to Puckoon and the purchase was made in the hope of ensuring continuity of the supply of oats, which has been difficult to source at certain times during the year.

The investment in Bentine was measured at the cost of £450,000 at purchase. No changes have been made in the measurement of these shares since that date. The market price of Bentine's shares at 30 September 20X9 is a bid-offer spread of £8.00 – £8.10 each. A sales commission of 0.5% is normally charged by Puckoon's broker on all share disposals.

At 17 June 20X9 £1=$1.42. The investment in Secombe was initially measured at cost of £251,408 ($357,000/1.42). The investment was not remeasured at 30 September 20X9 when the bid-offer spread price for Secombe's shares was $10.60 – $10.90.

The shares in Edgington plc were purchased on 12 September 20X9 following a recommendation in a newspaper. They have been initially recognised at a cost of £212,500. The intention at that date was to sell the shares at a profit before the end of December 20X9 and therefore they were classified as at fair value through profit or loss in the statement of financial position. We are now thinking of holding these shares for a longer period as their dividend yield is quite attractive. The bid-offer spread price at 30 September 20X9 was £13.50 – £13.90 per share.

Requirement

Prepare the briefing notes requested by Terry Milligan. **Total: 30 marks**

Audit and integrated questions

These questions do not precisely reflect the style, length or standard of real exam questions, but are included to aid the learning process. Exam standard and exam style questions are available in the printed question bank.

1 Move-it Ltd

You are Aniela Zielinski, an ICAEW Chartered Accountant working in the assurance services department of Denham and Co, a firm based in Manchester. You have received the following email from Brian Nolan, one of the assurance partners in the firm:

To:	a.zielinski@denham.co.uk
From:	b.nolan@denham.co.uk
Date:	15 January 20X9
Subject:	Move-it Ltd audit for the year ended 31 December 20X8

Aniela,

I think you have already been told that you are going to take over as audit senior on the Move-it audit. Nick Seagrove is no longer available to carry out this role as he is needed to complete some extra procedures on another client.

To give you an overview of this client:

Move-it Ltd (Move-it) provides removal and storage services to domestic customers (who are moving house) and commercial firms (moving business premises), with the removal services accounting for 60% of the company's income. For the year ended 31 December 20X8 the draft results indicate a significant downturn of business and profits, with the company looking like posting its first loss in its 15 years of trading.

Nick and I attended a planning meeting with the chief accountant at Move-it and I attach the draft financial statements we were given (**Exhibit 1**) and Nick's notes from the meeting (**Exhibit 2**).

The audit strategy is needed for a team briefing next week. We also need to get an audit plan in place. I would like you to make a start on this by preparing:

(a) A section discussing circumstances that indicate doubts over the company's going concern status, and

(b) The audit plan in relation to going concern.

I would like to review these on Monday but if you have any queries in the meantime please let me know.

Brian Nolan

Requirement

Prepare the documents requested by the audit partner. **Total: 25 marks**

Exhibit 1 – Financial statements for the year ended 31 December 20X8

	Draft figures					
	20X8		20X7		20X6	
	£'000	£'000	£'000	£'000	£'000	£'000
Revenue						
Removal	9,718		11,445		10,873	
Storage	7,012		7,318		6,974	
		16,730		18,763		17,847
Cost of sales		15,915		16,868		16,045
Gross profit		815		1,895		1,802
Administrative costs		584		581		560
Profit from operations		231		1,314		1,242
Finance costs		252		152		143
Loss/profit before tax		(21)		1,162		1,099
Assets						
Non-current assets		19,106		19,405		18,303
Current assets						
Cash and cash equivalents	0		98		110	
Trade receivables	4,128		3,033		2,934	
Prepayments	487		503		476	
		4,615		3,634		3,520
		23,721		23,039		21,823
Equity and liabilities						
Current liabilities						
Overdraft	324		14		0	
Trade payables	1,788		1,386		1,319	
Other payables	152		146		138	
		2,264		1,546		1,457
Non-current liabilities						
Bank loan		0		15		50
Capital and reserves		21,457		21,478		20,316
		23,721		23,039		21,823

Exhibit 2

- The fall in revenue has been due to:
  - The loss of two major customers (retailers) for whom the company was their exclusive supplier of removal services. These customers, due to their high levels of growth over the last four years (which meant that they were regularly moving and establishing new premises), generated considerable revenue for Move-it.
  - The slowdown in sales to the domestic sector of the market due to the stagnation of the housing market.
- The fall in the housing market has also resulted in a major drop in the use of warehousing facilities. The managing director is considering selling one of the three warehouses owned by the company. The warehouses are currently included in the company's statement of financial position at nearly £16m but there are issues as to whether the factors affecting the domestic housing market are going to spread to the commercial property sector.
- During the year, twenty vehicles have been replaced, 15 of them financed by leasing arrangements and the rest financed by short-term bank borrowing. The leases are operating leases with three year terms of commitment. The overdraft facility is due for renegotiation in March 20X9.
- The management expect the company to return to profitability in 20X9 as tentative negotiations are expected to start with two new major commercial customers who, it is believed, will replace the lost customers. Sales are expected to increase back up to their 20X7 level.

2 Pure Foods Ltd

2.1 Pure Foods Ltd

Pure Foods Ltd is a private company that produces organic food products (mainly from imported ingredients). These are sold in a variety of outlets from specialised food shops to supermarkets.

The marketing director believes that the following are key selling points of the brand.

- All the ingredients, both from the UK and from many overseas countries, are organically produced and free from genetically modified (GM) products.
- Fair prices are paid to overseas producers (including fair wages).
- The company's processing plant in the UK is carbon neutral.
- Packaging makes use of recycled materials and is itself recyclable.

The directors want to produce a corporate responsibility report as part of the company's annual report. It is to include the four assertions above. Your firm, as the statutory auditor of Pure Foods Ltd, has been asked to produce an assurance report in relation to the social and environmental content of the corporate responsibility report.

Requirements

(a) Discuss the matters the audit engagement partner for Pure Foods Ltd should consider in relation to whether the firm could accept the engagement to report on the corporate responsibility report. **(7 marks)**

(b) In order to issue a report in relation to the four assertions, explain the matters that your firm, as auditors, should consider and describe the evidence that should be obtained. **(8 marks)**

2.2 Ebygum Ltd

Ebygum Ltd (Ebygum) is a company that has traditionally sold kitchen utensils (pots and pans, non-electrical cooking gadgets and other kitchen hardware goods) to retail outlets. The products have been sourced from approved suppliers in a number of countries, but mainly from the UK – this leads to relatively few delays in getting new inventories. Inventory is held at two warehouses located in different parts of the country.

During the last financial year Ebygum set up an e-commerce division of its business to sell the goods directly to customers. This involves customers being able to browse the product catalogue and then place orders and pay for goods (by either credit or debit card) online. Once an order has been placed and the payment approved, the details are automatically referred to the appropriate warehouse to initiate the delivery process. Inventory records are updated automatically and new orders for goods are automatically initiated based on predetermined reorder levels.

Requirement

There are a variety of business risks associated with e-commerce. Discuss these both generally and with specific reference to Ebygum. **(10 marks)**

Total: 25 marks

3 Childplay plc

Your client, Childplay plc ('Childplay'), is a major retailer of toys for pre-teen children with stores both on the high street and out-of-town shopping parks. Its year end is 31 December 20X7.

20X7 has been a year of rapid change and, as auditors, your firm has established the following in initial discussions with the client:

- A new regional management structure was adopted with a cut in the numbers of senior managers and with a major part of their income being made up of bonuses obtained by achieving aggressive regional sales targets and profitability.
- A new inventory control system was developed and installed towards the end of the year. Its implementation had not gone well but it is now considered to be operating reliably and accurately enough to provide year-end figures. The software company that developed, and is currently supporting, the system is run by the brother-in-law of Childplay's managing director.
- As a cost-cutting exercise, the number of part-time staff employed and the amount of overtime pay available to existing staff was curtailed during the busy Christmas period (and also into the new year for the annual sales). This is contributing to low morale among the sales staff and is putting additional pressure on regional management.
- Market conditions overall have been difficult with a major competitor closing down due to pressure on both revenue and margins.
- Obsolete toys are disposed of to charities without charge. Whether items are classified as obsolete or not depends on the decision of local management as there are no company-wide policies. The documentation raised to approve this process is fairly limited, with local management generally just making a note in the inventory records that such items have been written off and disposed of.
- The managing director is very keen to expand the business and has persuaded the board to follow his lead. Therefore the company is planning to go to the market to raise capital, via a share issue, to finance ambitious plans to expand into Europe and also increase its internet sales.
- In order to start implementing expansion plans as early as possible in the new year, the managing director has brought forward the planned date for release of the audited financial statements from the usual 31 March to 28 February.

Requirements

3.1 Explain the risks that should be considered by the auditors of Childplay in relation to fraudulent financial reporting and misappropriation of assets. **(15 marks)**

3.2 In relation to the risk of material misstatements, identify and explain the inherent and control risk factors that should be considered by an audit team of Childplay when planning the audit (other than those arising from fraudulent activity). **(10 marks)**

Total: 25 marks

4 Nucleus Ltd

Nucleus Ltd (Nucleus) is an engineering company which is now mainly operating in the area of nuclear power generation.

- The audit senior has established the following:
  - The company has operated a defined benefit pension scheme for many years, which, although not open to new members, still has a significant number of existing members. The obligations of the fund are £200m. Currently the plan assets are £180m with 30% of the value of the assets in the pension fund being in unquoted equity shares, 20% in non negotiable bonds and the remaining 50% in commercial property.
  - The company has speculated on future rises in the value of titanium by entering into a forward contract to purchase some metal in two years' time. Nothing has been paid up front to enter into this contract but the amount due is ultimately payable in $US. Nucleus Ltd does not buy or sell titanium as a normal part of its business.
- The internal audit department of Nucleus has been directed by the audit committee to perform a value for money audit of the company's training department, which is accounted for as a cost centre. The department runs an apprenticeship scheme for engineers which takes new recruits through programmes that, after two years of work experience, in-house training, distance learning and day release to a local college, results in a recognised qualification. This enables staff to work on projects that have to meet strict international quality standards.

Requirements

4.1 Outline the audit evidence the audit senior should obtain and the steps that should be taken to audit the pension scheme. **(9 marks)**

4.2 The audit senior has been asked to explain to a less experienced member of your audit team the business risks involved in Nucleus Ltd's forward contract. Identify those risks. **(9 marks)**

4.3 Outline the factors the head of the internal audit department would evaluate in the 'value for money' audit of the training department and how they might be measured. **(7 marks)**

Total: 25 marks

5 Sleeper Ltd

Your audit firm has recently been invited to accept appointment as external auditor to Sleeper Limited, a company that owns and operates a number of mobile phone stores within a 50-mile radius in the North West of England. You have not previously acted for Sleeper Limited, but your firm is auditor to Zelig Limited, a company which also operates mobile phone stores in many of the same locations as Sleeper Limited. Your audit firm has a total of seven partners located in three offices which are situated in major cities within the UK.

The existing auditors of Sleeper Limited have received notice from the company's directors that they are not to be re-appointed as auditors at the company's forthcoming Annual General Meeting. The management has given no reason for this course of action, although the existing auditors suspect that it is because they insisted on modifying the auditor's opinion for the previous accounting year, despite substantial pressure from management to issue an inappropriate unmodified auditor's opinion.

In the previous year, Sleeper suffered a fraud in respect of inventory. It was discovered during the audit that the year-end inventory quantities at two of the company's stores had been falsely inflated by the managers of both stores in order to cover up a substantial theft of mobile phones immediately before the year end.

Requirements

5.1 Identify and explain the professional ethical issues which you might need to consider in deciding whether or not to accept appointment as external auditor to Sleeper Limited. Recommend the possible safeguards that could be put in place to resolve these issues. **(6 marks)**

5.2 Set out the responsibilities and rights, including those under the UK Companies Act, of the current auditors of Sleeper Limited in relation to the proposed change in professional appointment. **(3 marks)**

5.3 Set out the respective duties of both the management and external auditors of Sleeper Limited in relation to the prevention and detection of fraud, and outline how these duties are discharged. **(6 marks)**

5.4 List the financial statement assertions which are relevant to the audit of inventory and, for each one listed, outline relevant audit procedures to test that assertion in respect of Sleeper Limited, if your firm does accept the audit. **(6 marks)**

Total: 21 marks

6 Progear Inc

Your firm has been engaged by the directors of Progear Inc (Progear), a company based overseas, to undertake a review of and provide a limited assurance report on the financial information of its UK branch. The terms of the engagement include making enquiries of management and applying analytical procedures to the financial information. The review is to cover the financial information for the **six months** ended 30 September 20X9.

Progear manufactures specialist protective clothing which is used by organisations operating in the medical, research and energy sectors. All products sold by the branch are supplied by Progear and the branch normally sells them at a mark-up of 25% on cost to the branch. However, quantity discounts are available for orders above specified levels. All customers are required to pay within 30 days but customers are offered an early payment discount if they pay within seven days of invoice date. In the previous three years, branch sales have increased steadily at rates between 4% and 6% in the corresponding six-month period.

You are preparing for your planning meeting with the financial controller of the branch and have obtained, in advance of the meeting, a copy of the draft financial information for the **six months** ended 30 September 20X9. During your preliminary review, you identified the following extracts from the financial information of the branch as matters to discuss at that meeting.

Statement of profit or loss	**Six months ended 30 September**	
	20X9	**20X8**
	£'000	£'000
Revenue	5,353	4,907
Cost of sales	(4,472)	(3,974)
Gross profit	881	933
Operating expenses	(747)	(646)
Profit from operations	134	287

Statement of financial position

	As at 30 September	
	20X9	**20X8**
	£'000	£'000
Current assets		
Inventories	994	951
Trade receivables	812	806

Requirements

6.1 Prepare briefing notes on the matters which you wish to discuss with the financial controller of the branch in respect of the information provided in the scenario. Your notes should refer to the results of your analytical procedures. **(13 marks)**

6.2 Describe the main contents of the limited assurance report to be issued following your firm's review of the financial information. **(7 marks)**

Note: You may assume that there are 180 days in a six month period. **Total: 20 marks**

7 WHAT

Welfare and Help for the Aged Trust (WHAT) is a not-for-profit company limited by guarantee. It has recently commenced operating from a community centre in your locality by providing facilities for the well-being of senior citizens.

WHAT receives income from the following sources:

- donations under deeds of covenant (contractual agreements to donate a specified amount for a specified number of years) entered into by individuals
- postal donations of cheques and cash
- door-to-door collections by volunteers with boxes, and workplace collections
- other donations (several mini-buses have been given, either new or second hand, by large businesses)
- grants from local authorities
- sales of refreshments at the community centre
- a variety of fund-raising events organised by voluntary helpers.

Although the company is not statutorily required to have an audit, the directors have appointed your firm to examine the accounts and report to the trustees about them.

Requirements

7.1 Briefly explain how this engagement to examine the accounts differs from an engagement as statutory auditor, and set out the approach that should be followed for any assurance engagement. **(5 marks)**

7.2 Describe the controls over the above income which you would expect WHAT to operate. For other donations you should describe the controls over the donated assets. **(15 marks)**

Total: 20 marks

8 Spirit Consulting Ltd

Your firm has recently been appointed as the external auditor of Spirit Consulting Ltd (Spirit) and you are the audit senior responsible for planning the audit for the year ended 28 February 20X1. Your firm has obtained professional clearance from the previous auditors who were not reappointed and no issues were identified that prevented your firm from accepting the engagement. The engagement partner has asked you to begin planning the audit by specifically considering revenue and receivables as she believes these to be high risk areas in Spirit's financial statements.

Spirit supplies management consulting services to a range of clients based in the UK and Europe. Spirit's consultants undertake specific assignments, the scope of which is agreed with each client at the start of the assignment. Assignments include advice on business strategy, marketing, financial and management controls and information technology. Clients pay for the time spent by consultants on an assignment (time contracts) or agree a fixed price with Spirit at the start of the assignment (fixed-price contracts).

Spirit maintains a computerised project costing system. Each client assignment has a unique project code in the system. Each week Spirit's consultants record their time spent on each client assignment against the relevant project code along with any expenses. Clients with time contracts are invoiced monthly based on time plus expenses recorded in the project costing system. Clients with fixed-price contracts are invoiced a proportion of the total contract price in accordance with the terms of the contract.

To help with planning you have obtained a copy of Spirit's accounting policy for revenue and receivables:

Accounting policies – revenue and receivables

Revenue represents the consideration received or receivable for consulting services on each client assignment provided during the year, including expenses. Expenses include mileage and accommodation.

Revenue from time contracts is recognised as the services are provided on the basis of time worked at an hourly or daily rate.

Revenue from fixed-price contracts is recognised over the contract term based on the stage of completion of each assignment compared to the total estimated services to be provided over the entire contract. Any expected loss on a contract is recognised immediately in the statement of profit or loss.

The amount invoiced (billed) to clients, but not yet received, is separately disclosed within receivables as trade receivables. Unbilled revenue on both time contract and fixed-price contracts is included as accrued income within receivables. Trade receivables are reduced by appropriate allowances for estimated irrecoverable amounts.

The following is an extract from Spirit's financial information:

Statement of profit or loss	**Draft Year ended 28 February 20X1**	**Actual Year ended 28 February 20X0**
	£'000	£'000
Fee income	108,277	125,903
Expenses billed to clients	10,154	9,935
Total revenue	118,431	135,838
Fee income per consultant	155	175
Operating profit	13,604	12,747

Statement of financial position – Receivables	**Draft Year ended 28 February 20X1**	**Actual Year ended 28 February 20X0**
	£'000	£'000
Trade receivables	12,156	15,932
Less allowance for receivables	(1,309)	(2,144)
	10,847	13,788
Accrued income	10,421	7,425
Total receivables	21,268	21,213

You also held a meeting with Spirit's financial controller and ascertained the following:

- Although draft total revenue is lower than in the prior year, Spirit is performing well compared to the industry as a whole where total revenues have declined by 16% on average.
- Spirit has submitted a loan application to its bank to fund an expansion into Asia. The bank requires the audited financial statements for the year ended 28 February 20X1 before making a decision on the application.
- In August 20X0, Spirit replaced its computerised project costing system with new project costing software. The company ran the new software in parallel with the existing system for six weeks after which it concluded the new software was functioning correctly and the old project costing system ceased to be used. Your firm was not involved in this process.
- Clients are invoiced in either UK sterling or the client's local currency depending on the terms of the contract.

Your firm's tax department is currently using the consulting services of Spirit to review your firm's business and marketing strategies for taxation services. Your firm's tax department decided to use Spirit's consultancy services because Spirit was recommended by Charles Tomm, a senior tax manager in the department, whose wife is a director at Spirit. You are aware that the audit engagement partner is planning to use a team from your firm's tax department, managed by Charles Tomm, to help with the audit work required on Spirit's corporation tax charge and liabilities in the year-end financial statements.

Requirements

8.1 Outline the process set out by the ICAEW Code of Ethics that your firm should have undertaken to obtain professional clearance from Spirit's previous auditors and explain the purposes of this process. **(6 marks)**

8.2 Using the information provided, together with the results of your own analytical procedures, explain why the engagement partner has identified revenue and receivables as high risk areas in Spirit's financial statements.

(11 marks)

8.3 Outline the procedures specifically relevant to the audit of revenue and receivables in Spirit's financial statements which you consider should be included in the audit plan. **(15 marks)**

8.4 Discuss whether any ethical issues arise as a result of the existing relationship between Spirit and your firm's tax department and state how your firm should address any ethical issues identified.

(8 marks)

Total: 40 marks

9 Hoop plc

Hoop plc is an AIM-listed company which operates in the food packaging industry. It provides a wide range of food products to UK and other European food retailers and food distributors.

You work for Rawls and Nosick LLP (RN), a firm of ICAEW Chartered Accountants. Hoop is an audit client of RN. RN is currently completing the audit for the accounting year ended 30 June 20X4.

You have been transferred to the Hoop audit to replace the current audit senior, Gary Kant, who was needed by another client. The engagement manager, Jane Leigh, provided you with some instructions:

'I am concerned about the completion of this audit, as Gary is no longer available. Additionally, the finance director is ill and the Hoop finance team lacks expertise on some financial reporting matters. As a result, they may need some guidance on the final adjustments to the financial statements. Gary has left several financial reporting and audit issues unresolved, which he has highlighted in his working papers (**Exhibit**).

'The planning materiality is £400,000 based on a profit before tax of £8 million and revenue of £42 million. The engagement partner's final review is scheduled for next week.

'In order to complete the required procedures on time, I would like you to prepare a working paper for the audit team in which, for each of the issues raised by Gary (Exhibit), you set out and explain:

- the appropriate financial reporting treatment; and
- the key audit risks and the detailed audit procedures.

'In addition, Hoop has been much more profitable this year, in comparison with recent years, and consequently Gary believes that the Hoop board may be trying to reduce the profit for the year, as much as possible, by its choice of accounting policies and estimates. I do not agree with Gary, but we need more evidence. Therefore, for the issues highlighted by Gary (Exhibit), please explain whether these give any evidence of manipulation of profit in order to understate reported income.

'I will ask the tax department to review the deferred tax and current tax at a later date, so do not worry about tax for now.'

Requirement

Respond to the instructions from the engagement manager, Jane Leigh. **Total: 23 marks**

Exhibit

Unresolved financial reporting and audit issues - prepared by Gary Kant

(1) **Pension obligation**

Hoop operates a defined benefit pension scheme for its employees, although the scheme was closed to new employees three years ago. Employees in the scheme are required to make contributions. I have completed the audit procedures on the scheme assets, valued at £19.4 million at 30 June 20X4, and these have been reviewed. The scheme assets at 30 June 20X3 also had a value of £19.4 million.

In respect of pension obligations, however, my audit procedures are incomplete. I have agreed the present value of the obligations with the actuary appointed by RN. I have also verified the cash contributions and the benefits paid to supporting documentation. I have not, however, had the chance to carry out any audit procedures in respect of the service costs, past service costs or interest costs. I am concerned about this as Hoop improved the pension benefits to all existing employee members of the scheme on 1 July 20X3, based on their historic service with Hoop.

The only entries made by Hoop during the year are in respect of the employer pension contributions and these payments have been treated as an expense.

Details of the scheme for the year ended 30 June 20X4 are as follows:

	£'000
Present value of plan obligations at 30 June 20X3	20,500
Present value of plan obligations at 30 June 20X4	22,700
Past service cost (effective from 1 July 20X3)	800
Current service cost	2,100
Pension contributions:	
Employer's pension contributions	1,000

Employees' pension contributions	900
Benefits paid	1,500

Annual market yield on high-quality corporate bonds with a similar maturity date:

At 30 June 20X3	4%
At 30 June 20X4	5%

The current service cost accrues evenly throughout the year. The contributions and benefits are paid on the 15th of each month during the year.

(2) **Change of accounting policy – inventories**

The Hoop directors have informed me that they wish to change the accounting policy for inventory measurement from first-in first-out (FIFO) to weighted average cost. Closing inventories measured for the years ended 30 June under the two different methods are as follows:

	20X3	**20X4**
	£'000	£'000
FIFO	785	795
Weighted average cost	782	786

I am concerned about the impact on profit of the change in the accounting policy for the year ended 30 June 20X4 and I am unsure about the audit procedures I need to perform in respect of this issue.

(3) **Revenue recognition**

Larger customers who order significant volumes of non-perishable produce require a production run which is specific to them. In the past, some of these customers have changed their minds after production has commenced and Hoop has been left with inventories which it cannot sell.

As a result, Hoop has introduced new contract terms. These require customers to pay a 20% cash deposit before commencement of production in order to reduce the risk of obsolete inventory.

At 30 June 20X4, an order for packaged foods produced for a large customer, DistribFoods plc, had been completed under these new contract terms. 30% of the goods, by value, were still in inventory at 30 June 20X4, while the remainder had been delivered to the customer on 14 June 20X4.

On 19 May 20X4 a 20% deposit of £90,000 was received by Hoop from DistribFoods for the entire order. Hoop recognised this £90,000 as revenue at that date, but did not recognise any other revenue for this contract in the year ended 30 June 20X4. The production cost to Hoop of this contract was £200,000, which has been recognised, in full, in cost of sales in the year ended 30 June 20X4.

10 Plumbdown Properties Ltd

Plumbdown Properties Ltd (PP) is an investment property company.

You are Jensen Jopling, an audit senior working for a firm of accountants and auditors, Walpole & Gladstone LLP (WG). WG is currently in the process of completing the annual audit of PP for the year ended 30 September 20X3.

The engagement manager, Ruth Rangle, has struggled to find enough experienced audit staff and, as a result, you have been asked to work on the PP audit, even though it is nearing completion. Ruth called you to a meeting to brief you.

Meeting with the engagement manager

Ruth opened the meeting: 'I have concerns about a number of issues that have arisen on the PP audit and I would like you to take responsibility for addressing these.

'I will provide you with a summary of the PP business background from the audit plan (**Exhibit 1**) and also a schedule of outstanding issues highlighted by the audit junior (**Exhibit 2**). I will also provide you with extracts from PP's management accounts (**Exhibit 3**), which are referenced to the outstanding issues schedule.

'I would like you to do the following.

- For each of the issues identified in Exhibit 2:
  - Set out and explain the correct treatment in the financial statements for the year ended 30 September 20X3; and
  - Highlight the audit procedures we should carry out. Just focus on the specific issues raised by the audit junior. I do not require a general list of audit procedures for investment properties.
- Produce a schedule showing all PP's investment properties including the total amount which should be recognised as investment properties in PP's statement of financial position at 30 September 20X3. Explain any further adjustments to the figures in Exhibit 3.'

Requirement

Respond to the instructions of the engagement manager. **Total: 23 marks**

Exhibit 1

PP Background

PP is an investment property company. It invests in a wide range of properties including retail outlets, residential, industrial, offices and land. PP's business model is based on income arising from both capital gains and rental incomes.

The entire ordinary share capital of PP is held by the Plumbdown family. They have made it known that they wish to sell their shares in the near future, either through a trade sale or by listing on the Alternative Investment Market (AIM) with a view to subsequent sale.

PP's financial performance has suffered as a result of falling commercial property prices. The Plumbdown family members have, to date, been unable to obtain what they consider to be a reasonable price for their shares. As a consequence, they are putting pressure on management to increase PP's asset values in its financial statements for the year ended 30 September 20X3, as they believe that this is the main factor which will determine the value of PP shares.

PP uses the fair value model to measure investment properties in its financial statements. Where an external valuer is required, PP has always used Kerry & Kenny LLP, a large firm of chartered surveyors with a good reputation. The directors of PP sometimes use an internal valuation for properties.

PP has no subsidiaries.

Exhibit 2

Outstanding audit issues: Prepared by audit junior

(1) **Manchester office building**

The Manchester office building has been owned by PP for many years and its fair value at 1 October 20X2 was £28.5 million. This value includes an air conditioning unit which was installed as an integral part of the building on 1 January 20X0 at a cost of £500,000. This unit has an estimated useful life of 10 years from that date, with a zero residual value and is being depreciated on a straight line basis. The unit's fair value is estimated to be equivalent to its carrying amount.

On 22 September 20X3, the air conditioning unit unexpectedly failed and was replaced, over the following week, by a new unit costing £800,000. The office building was valued at £26.8 million on 18 September 20X3. This valuation included the old air conditioning unit at its carrying amount, as the valuer was not aware at the time that it was about to fail. No adjustments have been made by PP to recognise either the failure of the old unit or the acquisition of the new unit.

(2) **Birmingham retail park**

On 30 June 20X3, the Birmingham retail park was acquired by PP from a rival investment property company, SpaceLand plc, under a 20-year operating lease. It was agreed that both land and buildings are held by PP under an operating lease, as the estimated life of the buildings is 50 years. The property satisfies the definition of an investment property so PP has recognised it at its fair value in the statement of financial position, even though it is held under an operating lease. The property is leased out by PP to third parties under operating leases ranging from 2 years to 19 years.

The fair values of the freehold for the Birmingham retail park were £19.6 million and £20.5 million at 30 June 20X3 and 30 September 20X3 respectively. The present values of the minimum lease payments of the 20-year lease contract were £13.4 million and £12.8 million at 30 June 20X3 and 30 September 20X3 respectively.

(3) **Disposal of shopping arcade in Inverness**

In 20W7, PP purchased a shopping arcade in Inverness for £20.2 million. This was financed, in part, by a 6% bank loan of £15.9 million. The interest is payable annually in arrears and the principal is repayable in 20X8. The bank held a fixed charge over the arcade. The loan was on a non-recourse basis (ie in the event of default by PP, the bank had no claim over any PP assets, other than the shopping arcade).

The shopping arcade, having been acquired during an economic boom, had suffered a significant reduction in fair value to £14.5 million by 1 October 20X2. Occupancy levels, and therefore rents received by PP, were also much lower than expected, being insufficient to service the interest payments on the 6% bank loan.

In September 20X3, PP renegotiated its agreement with the bank. Under the terms of the new agreement, PP undertook to:

- transfer full ownership of the shopping arcade to the bank; and
- assume a new liability to the bank of £1 million, at zero rate of interest, repayable at par on 30 September 20X5. This type of loan would normally attract an annual interest rate of 5%.

In return, the bank agreed that PP's undertakings in the bullet points above would be in full and final settlement of the outstanding loan of £15.9 million and that this loan would therefore be extinguished.

The agreement took effect on 30 September 20X3. At this date, the fair value of the arcade was £14.8 million. The carrying amount of the original loan in PP's financial statements at 30 September 20X3 was £15.9 million.

No accounting entries have yet been made by PP in respect of the property disposal, the new liability or extinguishing the loan.

Exhibit 3

Draft Management Accounts

Investment Properties schedule for year ended 30 September 20X3

Property	Fair value at 30/9/20X3	Change in fair value in 20X2/X3	Comments and references
	£m	£m	
Manchester office building	26.8	(1.7)	See Exhibit 2
Birmingham retail park	20.5	0.9	See Exhibit 2
Inverness shopping arcade	14.8	0.3	See Exhibit 2
Land in Wales – undeveloped	3.3	(0.4)	Future use not yet decided
Industrial development – Yorkshire	8.7	2.8	Commenced development in 20X1. Originally intended to lease out to third parties, but PP decided in October 20X2 to sell as soon as construction is completed in 20X4.
Total	74.1	1.9	

PP intends to recognise investment properties at £74.1 million in its financial statements for the year ended 30 September 20X3, based on the above schedule.

11 Stoghopper plc

Stoghopper plc manufactures machine tools for use by companies operating in the construction and mining industries. You are a senior working for Trot, Canter and Gallop LLP (TCG), a firm of ICAEW chartered accountants and registered auditors.

TCG is currently engaged in the audit of Stoghopper for the financial year ended 30 June 20X3. Whilst not initially allocated to the Stoghopper audit, you and some colleagues were reassigned to this client last week to replace a number of the original audit staff, who were injured in a road traffic accident.

Engagement manager's briefing

The engagement manager called you to a meeting: 'I realise that you have only just joined the Stoghopper audit, so I have provided some background notes about the company (**Exhibit 1**). Stoghopper has begun to establish overseas operations in Thailand in the past year. Nancy Noonan was carrying out the audit procedures relating to this new activity, but unfortunately she was in the car accident, so we cannot speak to her. I will, however, make her working papers available to you (**Exhibit 2**).

'For each of the three issues raised by Nancy (Exhibit 2), I would like you to:

- set out and explain the appropriate financial reporting treatment in the financial statements of Stoghopper for the year ended 30 June 20X3; and
- prepare notes describing the audit risks and related audit procedures. I do not want general audit risks, so please focus on each of the three issues.

'Do not worry about tax or deferred tax issues at this stage.'

Requirement

Respond to the instructions of the engagement manager. **Total: 23 marks**

Exhibit 1

Company background

Stoghopper was established more than 60 years ago as a manufacturer of high-value, high-quality machine tools for use in the global construction and mining industries. The company has grown steadily since incorporation, obtaining a listing on the London Stock Exchange 25 years ago.

In recent years, an increasing proportion of new business has come from exports. In the year to 30 June 20X2, Stoghopper's exports from the UK amounted to about one-third of its annual revenue of £300 million. About half of these exports were to East Asia.

Stoghopper's main manufacturing site is located in southern England. However, overseas customers, in East Asia in particular, were becoming intolerant of long lead times and increasing delivery costs.

As a consequence, Stoghopper decided to set up a production site in Thailand, from where exports to East Asian countries can be made more quickly and reliably than from the UK. A factory in Thailand was completed in June 20X2 and production of deep mine drilling instruments began on 1 July 20X2 (Exhibit 2 – Issue 3).

Revenue for the year ended 30 June 20X3 from the new Thai division amounted to £50 million.

The factory in Thailand is an operating division with local management, but it is not a separate subsidiary. Although day-to-day operations in Thailand are managed locally, most of the key decisions are taken by Stoghopper's main UK board.

The division's main bank account (the Number 1 account) is denominated in baht, the Thai currency. All payments for Thai operating costs are made from this bank account. Receipts from sales denominated in other currencies are paid into separate bank accounts for each currency, but it is company policy to convert into baht by daily transfer of all balances into the Number 1 account. No amounts have yet been remitted to the UK or converted into sterling.

Exchange rates were:

At 1 July 20X2	50.0 baht = £1
At 31 December 20X2	52.0 baht = £1
At 20 June 20X3	54.5 baht = £1
At 30 June 20X3	55.0 baht = £1

At 5 July 20X3	55.5 baht = £1
Average for year to 30 June 20X3	52.5 baht = £1

Exhibit 2

Audit working paper – prepared by Nancy Noonan

I have reviewed the activities of Stoghopper's Thai division and the following issues arose. I have not yet carried out any audit procedures in respect of these matters.

Issue 1 – Bank accounts

The Thai division's management maintains a positive balance in its Number 1 bank account. The cash balance per the bank statement at 30 June 20X3 was 440 million baht.

Originally, I was told that the Number 1 account was the only bank account with a non-zero balance at the year end. However, an amount of 2 million yuan was received into the division's Chinese currency (yuan) bank account from a Chinese customer on 20 June 20X3. This was not recognised in the accounting records or converted to baht until it was transferred into the Number 1 account on 5 July 20X3. The delay in conversion appears to be an oversight.

Exchange rates were:

20 June 20X3	5.0 baht = 1 yuan
30 June 20X3	5.1 baht = 1 yuan
5 July 20X3	5.2 baht = 1 yuan

Issue 2 – Loan to supplier

On 1 July 20X2, an interest-free loan of 400 million baht was made by Stoghopper to one of its Thai suppliers, The Rangoon Company (Rangoon), in order to enable Rangoon to purchase new and more advanced equipment to enhance the quality of its output. The loan is repayable at par on 30 June 20X4. Loans of equivalent risk in the marketplace have an annual effective interest rate of 6%.

Issue 3 – Deep mine drilling production line

On 1 July 20X2, the new production facility was set up in Thailand at a cost of 600 million baht. It produces Stoghopper's deep mine drilling instruments. The production facility had an estimated useful life of 6 years at 1 July 20X2, with a zero residual value.

In April 20X3, a competitor company to Stoghopper patented a more efficient production method to manufacture deep mine drilling instruments. The Stoghopper finance director recognised this development as an impairment indicator and carried out an impairment test at 30 June 20X3.

As a consequence of this exercise, the production facility was determined to have a value in use of 520 million baht and a fair value less cost to sell of 470 million baht at 30 June 20X3. The finance director therefore concluded that no impairment charge would be required and the normal depreciation charge should be made for the year.