ADVANCED LEVEL EXAMINATION

MONDAY 20 JULY 2015

(3½ HOURS)

CORPORATE REPORTING

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

1. Ensure your candidate details are on the front of your answer booklet. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ball point pen only.

3. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

4. The examiner will take account of the way in which material is presented.

5. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

The questions in this paper have been prepared on the assumption that candidates do not have a detailed knowledge of the types of organisations to which they relate. No additional credit will be given to candidates displaying such knowledge.

IMPORTANT

Question papers contain confidential information and must NOT be removed from the examination hall.

DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK

You MUST enter your candidate number in this box

QUESTION 1

Congloma plc is a UK listed company and it is the parent of a group of manufacturing companies located across the UK. Your firm, A&M LLP, a firm of ICAEW Chartered Accountants, has audited Congloma and its subsidiaries for three years.

You are assigned to the group audit team for Congloma for the year ending 31 August 2015. Your manager, Harri Merr has asked for your help to finalise audit planning. Other audit teams from your firm are responsible for the individual audits of Congloma's subsidiaries.

You meet with Harri, who gives you the following instructions:

"I've provided some background information (**Exhibit 1**). The Congloma finance director, Jazz Goring, has asked A&M to assist her in determining how a number of significant transactions should be treated in the Congloma consolidated financial statements for the year ending 31 August 2015. She also wants to understand the overall impact of these transactions on the consolidated profit before taxation.

"I've forwarded her email to you (**Exhibit 2**), together with an attachment comprising briefing notes from the Congloma corporate finance team which provides some further details of the transactions (**Exhibit 3**). These briefing notes were presented at the Congloma board meeting in May 2015 before the significant transactions were completed. Jazz has assured me that none of the details changed when the deals were finalised, so we can use this information for audit planning purposes.

"I would like you to:

(1) Draft a response to Jazz's email (Exhibit 2) and its attachment (Exhibit 3). In your response you should:

   a) Set out and explain, for each of the transactions she identifies, the correct financial reporting treatment in Congloma's consolidated financial statements for the year ending 31 August 2015. Recommend and include appropriate adjustments and calculations; and

   b) Calculate the consolidated profit before taxation for the year ending 31 August 2015, taking into account the adjustments you have identified.

(2) Set out, in a working paper, the additional audit procedures that we will need to perform as a result of the transactions Jazz has identified. Include an explanation of the impact that the transactions will have on the scope of our audit procedures and the identification of components that we consider to be significant.

   The additional audit procedures that you identify should include those we will perform both at the significant component subsidiaries and head office. These procedures should only be those of relevance to our opinion on the Congloma consolidated financial statements for the year ending 31 August 2015. At this stage, I am not interested in the procedures we will need to perform in order to sign an audit opinion on each individual group company."

Requirement

Respond to Harri's instructions. **Total: 40 marks**

Exhibit 1: Background information provided by the audit manager, Harri Merr

Our experience of the Congloma audit is that the group is generally well managed and maintains reliable accounting records. We have noted, however, that the finance team's experience of more complex transactions is limited and they do not always make the correct accounting entries or appreciate fully the financial reporting implications of such transactions.

The scope of the work to be performed by the group audit team in respect of the group financial statements is as follows:

- Audit procedures on the group financial statements and consolidation;
- Direction and review of the audit procedures performed by other teams from our firm at all significant components; and
- Review procedures on the results of components which are not significant.

Based on the group's latest financial projections, I have determined planning materiality for the group audit at £350,000.

Exhibit 2: Email from Congloma Finance Director, Jazz Goring

To: Harri Merr
From: Jazz Goring
Date: 17 July 2015
Subject: Significant transactions

After a period of over a year with no acquisitions or disposals, June 2015 was a busy month for our corporate finance team. In addition to the information provided below, you will find further details in the attached briefing notes from the Congloma corporate finance team which were presented at our board meeting in May 2015 (Exhibit 3).

The board is pressing me for a forecast of the consolidated profit before tax for the year ending 31 August 2015. Therefore it would be helpful to have your advice on the financial reporting treatment of the transactions set out below. Before accounting for the effect of any adjustments arising from these transactions, our latest forecasts show a consolidated profit before tax of £7 million for the year ending 31 August 2015.

Further investment in Oldone Ltd

In 2005, Congloma subscribed £9.6 million for an 80% shareholding in Oldone on the incorporation of the company. At that date, Anthony Myers, the Oldone chief executive subscribed for the remaining 20% of Oldone shares.

On 1 June 2015, Anthony retired and sold his shares in Oldone to Congloma for £4 million. Oldone is expected to make a profit before taxation of £500,000 in the year ending 31 August 2015. As for all our group companies, Oldone's profits are not seasonal, but accrue evenly throughout the year.

The identifiable net assets of Oldone at 31 May 2015 were £14 million and, in our interim financial statements at that date, we recognised a non-controlling interest of £2.8 million, using the proportion of net assets method always adopted by Congloma. I will instruct an expert valuer to determine the fair value of Oldone's assets so that I can calculate the goodwill to be included in the consolidated financial statements for the year ending 31 August 2015. However, I need your advice on how to eliminate the non-controlling interest balance of £2.8 million from the consolidated statement of financial position at 31 August 2015.

Issue of convertible bonds

On 1 June 2015, Congloma raised £10 million through an issue of convertible bonds to third party investors. Further details are included in the attached briefing notes (Exhibit 3). For the time being, I have recognised the £10 million as a liability.

Investment in Neida Ltd

On 1 June 2015, Congloma acquired 45% of Neida's issued ordinary share capital and voting rights for £3 million. Neida's remaining ordinary shares and voting rights are currently held equally by the two individuals who founded the company. Congloma has an option to acquire a further 20% of Neida's ordinary share capital in the future.

Neida is engaged in developing practical applications for Lastlo, an innovative new material. We expect that the use of Lastlo will improve the durability and performance of a number of Congloma's products.

I believe that Congloma's holding of 45% of Neida's ordinary share capital and voting rights gives it significant influence and so propose to account for Congloma's investment in Neida as an associate. As you will see from the attached briefing notes (Exhibit 3), Neida has very few assets or liabilities, so the key impact on the group financial statements will be the recognition of the investment of £3 million.

Disposal of 75% interest in Tabtop

On 30 June 2015, 75% of the ordinary shares and voting rights in Tabtop Ltd, which was wholly owned by Congloma, were sold to a third party for £6 million. The carrying amount of the net assets (excluding goodwill) of Tabtop on 30 June 2015 was £5.6 million and the carrying amount of goodwill relating to Tabtop in Congloma's consolidated statement of financial position at that date was £1.5 million. Therefore I have calculated, and propose to include, a group profit on the sale of £0.3 million (£0.3 million = £6.0 million - (75% of £5.6 million) - £1.5 million).

Further details of this transaction are included in the attached briefing note (Exhibit 3).
I propose to equity account for our non-controlling interest following the share sale. The disposal should save you some time on the audit compared to last year, as now you will not need to perform group audit procedures on Tabtop.

Impairment of investment in Shinwork Ltd

Congloma has an 80% holding of the ordinary share capital of Shinwork Ltd.

Demand for Shinwork's products has fallen and cash flow projections show that its business will have a value in use of £9.2 million at 31 August 2015. We will therefore need to record an impairment in our group financial statements for the year ending 31 August 2015.

I am not quite sure how to calculate this impairment charge from the information I have and would welcome your advice. It would be helpful if you could highlight any other financial reporting points that I should consider.

At 31 August 2015, key financial data for Shinwork is projected to be as follows:

	£ million
Carrying amount of net separable assets	8.0
Carrying amount of goodwill relating to Shinwork in Congloma consolidated statement of financial position	4.0
Non-controlling interest (determined using the proportion of net assets method)	1.6

Exhibit 3: Briefing notes from the Congloma corporate finance team, presented to the Congloma board meeting on 21 May 2015

Issue of convertible bond

Proposed terms for the convertible bond issue have now been agreed. On 1 June 2015, Congloma will raise £10 million by issuing 100,000 5% convertible bonds, each with a par value of £100. Each bond can be converted on or before its maturity date of 31 May 2018 into 10 shares in Congloma plc. Interest will be payable annually in arrears.

By issuing a convertible bond, we not only obtain longer-term finance for the group, but also secure a lower interest rate. The annual interest rate for similar debt without the conversion rights would be 8%.

Investment in Neida

We propose to proceed with the acquisition of 45% of the issued share capital of Neida for £3 million on 1 June 2015. We will also have a call option to acquire, from the two founding shareholders, a further 20% of Neida's ordinary share capital and voting rights for £1.5 million. Neida expects to exercise this option before 1 June 2020.

The draft shareholder agreement states that the board of Neida will comprise the two founding shareholders and two individuals nominated by Congloma. Most decisions will be made by a majority of the directors, but decisions about major research and development projects cannot be made without the agreement of both of the Congloma-nominated directors.

Neida is expected to make a loss of £300,000 in the year ending 31 August 2015 and the projected carrying amounts of its net assets at the date of acquisition (1 June 2015) are as follows.

	£'000
Property, plant and equipment	150
Net current assets	50
Net assets	200

Given the nature of these assets and liabilities, their fair values are equal to their carrying amounts.

Disposal of 75% interest in Tabtop

Tabtop has been making losses for a number of years and is also incurring net cash outflows to an extent that the Congloma group no longer wishes to fund. Its projected loss for the year ending 31 August 2015 is £3 million. We have received an offer of £6 million for 75% of the Tabtop ordinary shares which we believe we should accept. In addition, Congloma will retain a holding of 25% Tabtop's ordinary share capital, which experts tell us would have a fair value of £1 million. Congloma would continue to exercise some influence on the business through a seat on the board.

QUESTION 2

Heston plc is a listed company which manufactures engines. It has four autonomous divisions, which operate from separate factories. Heston has no subsidiaries.

You recently joined Heston as deputy to the finance director, Edmund Rice. Edmund sent you the following email.

To: Deputy finance director
From: Edmund Rice, finance director
Date: 20 July 2015
Subject: Finalisation of the annual report – year ended 30 June 2015

The past few years have been difficult for Heston, but a new chief executive, Franz Zinkler, was appointed in 2014 and he is beginning to change things. Despite this, the year ended 30 June 2015 was again a challenging year. I have provided you with a document giving some background information about Heston and its recent history (**Exhibit 1**).

We need to publish our financial statements shortly. Draft financial statement information has been prepared (**Exhibit 2**), but there are a number of issues which will require adjustment (**Exhibit 3**).

I need to provide an explanation of Heston's financial performance for the year ended 30 June 2015 and its position at that date. This is for the finance director's section of the management commentary in the annual report. I also need to make a presentation to financial analysts about Heston's financial performance and position following publication of the annual report. This will include some tough questions about the financial statements and the company's underlying performance.

I need your assistance with the following:

1. I would like you to:
   - Set out and explain the financial reporting adjustments required in respect of the issues in Exhibit 3; and
   - Prepare an adjusted statement of profit or loss for the year ended 30 June 2015 and an adjusted statement of financial position at that date in a form suitable for publication (including comparative figures for the year ended 30 June 2014, in the form that they would appear in the financial statements for year ended 30 June 2015). Do not worry about the tax or deferred tax effects of your adjustments at this stage.

2. To help me to prepare my section of the management commentary and to help me answer questions, please analyse Heston's performance and position for the year ended 30 June 2015. Include calculations and use the adjusted financial statements. Outline any further information needed, so I can ask somebody to investigate.

Requirement

Respond to the instructions of the finance director.

Total: 30 marks

Exhibit 1: Company background – prepared by the finance director

Heston produces engines. Heston has four divisions which are not separate subsidiaries and are part of the Heston plc legal entity; they are autonomous and operationally independent of each other. Each of its four separate divisions produces a different type of engine for: cars, motor bikes, boats and lawn mowers.

Trading has been difficult for all the divisions in recent years, but particularly for the Lawn Mower Division, because there was a major new entrant into this industry in August 2014. The chief executive, Franz, therefore decided that Heston should sell off the Lawn Mower Division (Exhibit 3).

For the other three divisions, the key risk was a potential fall in future sales volumes. Such a fall would affect Heston significantly because about 70% of cost of sales comprises fixed manufacturing costs, which need to be incurred irrespective of sales volumes. To counter the risk of falling volumes, Franz decided to reduce all selling prices in these three divisions by 10% from 1 July 2014.

Financial analysts have responded favourably to these decisions, but have been enquiring about their impact on profit.

Exhibit 2: Draft financial information for the year ended 30 June 2015 – prepared by the finance director

Draft financial information for the statement of financial position at 30 June

ASSETS	**2015 £'000**	**2014 £'000**
Property, plant and equipment	113,660	120,400
Development costs	10,380	10,380
Inventories	32,300	23,200
Trade and other receivables	36,100	30,400
(Overdraft) / Cash	(8,400)	5,600
	184,040	**189,980**
EQUITY AND LIABILITIES		
Share capital	37,000	37,000
Retained earnings	85,220	68,520
Long-term borrowings	22,000	39,000
Trade and other payables	31,600	39,400
Current tax payable	4,420	6,060
Provision for redundancy costs	3,800	-
	184,040	**189,980**

Draft financial information for the statement of profit or loss for the year ended 30 June

	2015 £'000	**2014 £'000**
Revenue	436,000	451,700
Cost of sales	(306,180)	(318,500)
Distribution costs and administrative expenses	(107,200)	(101,400)
Finance costs	(1,500)	(1,500)
Income tax expense	(4,420)	(6,060)
PROFIT FOR THE YEAR	**16,700**	**24,240**

Exhibit 3: Issues requiring adjustment in the financial statements – prepared by the finance director

1. Disposal of the Lawn Mower Division

Impact on results

On 1 January 2015, Franz decided to dispose of the Lawn Mower Division, which had recently started making losses. The Heston board formally approved the decision on 1 March 2015 and the division's assets were advertised for sale at their fair value from 1 April 2015.

Heston intends to sell only the division's non-current assets (including its brand name, GrassGrind). It is expected that these assets will be sold to a range of different buyers.

The land and buildings are expected to be sold at their fair value of £13 million and plant at its fair value of £7 million. Selling costs are expected to be 4% of the fair value for these assets.

The Lawn Mower Division brand name, GrassGrind, including the legal right to trade under that name, is expected to realise only £800,000. The brand was internally generated by Heston and so is not recognised in the financial statements.

Draft financial information for the year ended 30 June 2015 (Exhibit 2) includes the following amounts in respect of the Lawn Mower Division:

	2015 £'000	**2014 £'000**
Revenue	92,000	119,300
Cost of sales	(72,084)	(77,400)
Distribution costs and administrative expenses (Note)	(33,800)	(34,700)
	(13,884)	7,200
Income tax credit/(charge)	2,600	(1,400)
(Loss)/profit after tax	(11,284)	5,800

Note: Staff working in the Lawn Mower Division will be made redundant when the division is sold and a provision for redundancy costs of £3.8 million has been recognised in distribution costs and administrative expenses for the year ended 30 June 2015.

Impact on property, plant and equipment

Heston uses the cost model for property, plant and equipment.

An analysis of the property, plant and equipment figure in the draft financial statements is as follows:

	Land	Buildings	Plant and equipment	Total
	£'000	**£'000**	**£'000**	**£'000**
Lawn Mower Division**:**				
Cost at 30 June 2014 and 30 June 2015	5,600	6,000	12,000	23,600
Accumulated depreciation at 1 July 2014	-	(960)	(3,400)	(4,360)
Depreciation charge for the year ended 30 June 2015	-	(120)	(860)	(980)
Carrying amount at 30 June 2015	5,600	4,920	7,740	18,260
Continuing activities: (ie the other three divisions)				
Carrying amount at 30 June 2015	32,200	34,700	28,500	95,400
Total carrying amount at 30 June 2015	37,800	39,620	36,240	113,660

The buildings are being depreciated over a 50-year life to a zero residual value. The plant and equipment is being depreciated on a 10% reducing balance basis. The company's policy is to recognise all depreciation charges in cost of sales.

There were no acquisitions or disposals of property, plant and equipment during the year ended 30 June 2015.

2. Cash flow hedge

On 1 May 2015, Heston entered into a contract to purchase 6,000 tonnes of steel. The contract is for delivery in September 2015 at a price of £165 per tonne. Heston uses steel to make most of its engines and makes regular purchases of steel.

At 30 June 2015, an equivalent new contract, for delivery of 6,000 tonnes of steel in September 2015, could be entered into at £158 per tonne.

Heston does not intend to take physical delivery of the 6,000 tonnes of steel, but intends to settle the contract net in cash, then purchase the actual required quantity of steel as regular production needs arise.

The contract is designated as a cash flow hedge of the highly probable forecast purchase of steel. All necessary documentation was prepared to qualify the contract as a cash flow hedge. No accounting entries have been made in the draft financial statements.

QUESTION 3

You are Jan Jenkins, an audit senior with Brine & Weel (BW) LLP, a firm of ICAEW Chartered Accountants which is engaged as auditor to Homehand Ltd. Homehand manufactures and sells production machinery to the food processing industry.

You are working on the final stages of the audit of Homehand for the year ended 31 March 2015. Your predecessor, Min Wall, is on study leave. You receive the following email from the manager responsible for the Homehand audit, Leigh Moore:

To: Jan Jenkins
From: Leigh Moore
Date: 20 July 2015
Subject: Finalisation of Homehand audit for the year ended 31 March 2015

I attach to this email a schedule of uncorrected misstatements prepared by Min Wall (**Exhibit 1**) together with Min's audit procedures on current and deferred tax (**Exhibit 2**), which are incomplete.

As the misstatements identified by Min (Exhibit 1) do not appear to be material, the Homehand finance director told me that he does not wish to adjust for these, or make any further adjustments we may identify. However, I have told him that we will need to consider audit adjustments when we have completed all our procedures. In particular, we will need to take into account, not only the overall level of any uncorrected misstatements, but also their effect on individual line items within the financial statements.

I would like you to review the schedules prepared by Min (Exhibits 1 and 2) and prepare a file note for me in which you:

(1) Explain the financial reporting issues you have identified and recommend appropriate adjustments.

(2) Prepare a revised schedule of all uncorrected misstatements, including your adjustments from (1) above. Identify and explain the misstatements, if any, that we require Homehand to correct.

(3) Set out the audit procedures we need to perform to complete our audit of the current tax and deferred tax balances.

(4) Identify and explain the ethical issues for our firm and any actions you believe we should take.

Requirement

Respond to Leigh Moore's instructions.

Total: 30 marks

Exhibit 1: Schedule of uncorrected misstatements for the year ended 31 March 2015 - prepared by Min Wall

Planning materiality for Homehand is £120,000. Misstatements below £6,000 are regarded as clearly trivial and are not reported to those charged with governance.

Last year (ie the year ended 31 March 2014) there was only one uncorrected misstatement, an under-provision of warranty costs of £60,000.

The schedule below does not include any adjustments arising from my audit procedures on current and deferred tax (Exhibit 2) as these procedures are incomplete.

Description of misstatement	Statement of profit or loss		Statement of financial position	
	Dr £'000	Cr £'000	Dr £'000	Cr £'000
1. Over-provision of warranty costs due to error in formula used to derive general provision for warranty.	-	75	75	-
2. Estimated over-valuation of inventory based on a sample testing of inventory costs.	115	-	-	115
3. Understatement of cost of sales due to lease of production machinery (see Note below).	34	-	-	34

Note – Lease of production machinery

On 1 April 2014, Homehand recognised as revenue £44,000 received from a customer, HodFoods Ltd, in respect of a lease of production machinery.

The sales director explained to me that instead of selling the machinery outright for £123,000, Homehand instead leased it to HodFoods over its three-year life. The lease requires three payments of £44,000, paid annually in advance. The annual market rate of interest would have been 8%.

HodFoods made the first lease payment of £44,000 on 1 April 2014. However, the machinery is still included in Homehand's inventory at its production cost of £102,000. Therefore I believe that there is an overstatement of Homehand's inventory and an understatement of cost of sales of £34,000 (being £102,000 divided by three years). BW's tax department has informed me that the tax treatment and accounting treatment of leases are the same.

Exhibit 2: Audit procedures on current and deferred tax - prepared by Min Wall

Current tax liability

I have reconciled the current tax liability in the statement of financial position at 31 March 2015 to the prior year balance as follows:

	£'000
Current tax liability at 1 April 2014	465
Current tax expense for year ended 31 March 2015 (Note 1)	436
Taxation paid in respect of the year ended 31 March 2014 (Note 2)	(512)
Current tax liability at 31 March 2015	389

Note 1: Current tax expense for year ended 31 March 2015

The current tax expense of £436,000 is the amount expected to be paid by Homehand to the tax authorities for the year ended 31 March 2015. This has been calculated by Karen Barnes, a trainee ICAEW Chartered Accountant who works in the Homehand finance department. I have performed audit procedures on the tax computation prepared by Karen as detailed below:

	£'000	Audit procedures
Profit for the year ended 31 March 2015	2,050	Agreed to the draft financial statements.
Add back: Expenses not deductible for tax purposes:		
Depreciation of non-current assets for accounting purposes and disallowed for tax	1,185	Agreed depreciation charges to audit working papers. There were no disposals of non-current assets in the year.
Warranty cost	350	Agreed to analysis of warranty costs - see below.
Other non-deductible expenses	45	Not material so no detailed procedures performed.
Deduct**:** Capital allowances for tax purposes	(1,450)	Confirmed with BW tax department that the capital allowances are calculated correctly according to tax law.
Taxable profit for the year ended 31 March 2015	2,180	
Tax at 20%	436	Recalculated tax due

Explanation of warranty costs

BW's tax department informed me that the tax rules in respect of warranty costs are:

- Increase/decrease in the warranty provision is disallowed for tax purposes;
- Warranty costs paid are allowed as tax deductions.

I agreed Karen's tax adjustment for the warranty cost above to an analysis of the warranty provision as follows:

	£'000
Warranty provision at 1 April 2014	400
Warranty costs paid in the year	(150)
Charge for warranty costs per the statement of profit or loss	350
Warranty provision at 31 March 2015	600

Note 2 – Taxation paid in respect of the year ended 31 March 2014

Karen Barnes informs me that the tax payment of £512,000 was higher than the £465,000 liability recognised in the financial statements for the year ended 31 March 2014 because of an arithmetical error found by the tax authority on the company tax return which Karen had filed on 1 November 2014. Karen revised and re-filed the company tax return and Homehand paid the revised amount of tax of £512,000 on 1 January 2015.

When revising the company tax return for the year ended 31 March 2014 Karen noted a further error. Legal expenses of £105,000 were treated as tax-deductible when they should have been added back as non-deductible expenses. As the amount is not material, Karen does not propose to notify the tax authority of this error.

Deferred tax balance

Karen has provided the following analysis of the deferred tax balance at 31 March 2015:

	£'000
Taxable temporary difference	
Carrying amount of plant and equipment at 31 March 2015	6,400
Tax base of plant and equipment at 31 March 2015	(5,300)
	1,100
Deductible temporary difference	
Warranty provision at 31 March 2015	(600)
	500
Deferred tax balance (20%)	100

The deferred tax liability at 31 March 2014 was £87,000. Therefore, as the difference is not material, Karen proposed that it is not worth adjusting the deferred tax liability at 31 March 2015. I have therefore not carried out any further audit procedures.

I have identified the following further issue which may require adjustment to the current and deferred tax liabilities:

PLEASE TURN OVER

Share option scheme

An expense of £450,000 is included in the statement of profit or loss for the year ended 31 March 2015 in respect of share options granted on 1 April 2014. The share option expense is based on 1,000 options vesting for each of 450 employees on 31 March 2017. Each option has an exercise price of £4 and had a fair value of £3 at 1 April 2014.

The BW tax department informed me that Homehand will receive a tax deduction only when the options are exercised and that this will be calculated on the basis of the options' intrinsic value at that date. (The intrinsic value is the difference between the share price and the exercise price on the exercise date). The price of one Homehand share at 31 March 2015 was £8.50.