

Strategic Professional – Options

# Advanced Audit and Assurance – United Kingdom (AAA – UK)

March/June 2019 – Sample Questions



**Time allowed:** 3 hours 15 minutes

This question paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – BOTH questions are compulsory and MUST be attempted

**Do NOT open this question paper until instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

AAA – UK

Think Ahead

**ACCA**

The Association of  
Chartered Certified  
Accountants

**Section A – This ONE question is compulsory and MUST be attempted**

- 1** You are a manager in the audit department of Snow & Co, a firm of Chartered Certified Accountants, and you are responsible for the audit of Margot Ltd. The company has a financial year ending 30 June 20X9, and you are about to start planning the audit.

Margot Ltd produces fruit-based food products using agricultural produce grown on its farms. Ben Duval, the audit engagement partner, met with the company's finance director last week to discuss business developments in the year and recent financial performance.

You are provided with the following exhibits:

1. An email you have received from Ben Duval, in respect of the audit of Margot Ltd.
2. Notes of a meeting which Ben held recently with the finance director of Margot Ltd.
3. A reference document prepared by Snow & Co containing an overview of the accounting requirements applied in the agriculture sector.
4. Extracts from the latest management accounts of Margot Ltd and accompanying notes, including the results of preliminary analytical procedures, which have been performed by a member of the audit team.
5. An email which the audit engagement partner received from Len Larch, a production manager working at one of the company's orchards and soft fruit farms.

**Required:**

**Respond to the instructions in the email from the audit engagement partner (Exhibit 1).** (46 marks)

Professional marks will be awarded for the presentation and logical flow of the briefing notes and the clarity of the explanations provided. (4 marks)

**(50 marks)**

**Exhibit 1 – Email from Ben Duval**

**To:** Audit manager

**From:** Ben Duval, audit engagement partner for Margot Ltd

**Subject:** Audit planning for Margot Ltd

**Hello**

I have provided you with some information in the form of a number of exhibits which you should use to help you with planning the audit of Margot Ltd for the financial year ending 30 June 20X9.

Using the information provided, I require you to prepare briefing notes for my own use, in which you evaluate the significant risks of material misstatement to be considered in planning the company's audit. You **should not** include risks of material misstatement relating to the valuation of the company's bearer plants or biological assets, which will be evaluated separately.

In your briefing notes, you should also design the principal audit procedures to be used in both the audit of the impairment of the factory, and the development cost capitalised in respect of the new packaging.

You should also discuss the matters to be considered in planning to use an auditor's expert in the audit of the fruit, which are recognised as biological assets of the company.

In Exhibit 5, I have provided you with an email I received from Len Larch, one of the company's production managers. In respect of this, in your briefing notes you should also discuss the audit implications of this email, recommending any further action to be taken by our firm.

**Thank you.**

## **Exhibit 2 – Notes of a meeting held on 28 February 20X9**

### **Meeting attendees:**

Ben Duval, audit engagement partner, Snow & Co  
Ayana Easton, finance director, Margot Ltd

### **Business background**

Margot Ltd was established 30 years ago by Jim Margot, who began processing the fruit grown on his family farm to make a small range of food products including canned fruit and fruit juice. The farm includes apple and cherry orchards and fields in which soft fruit including strawberries and blueberries are grown. The business was relatively small until ten years ago, when the company began to expand by acquiring more farmland with different crops, and building new production facilities. This extended the range of food products which could be processed, which now includes dried fruit and frozen fruit. The company sells its products under the 'Fructus Gold' brand name, and the goods are sold in major supermarkets and online on the company's website.

The company is not listed, and the Margot family members are the company's majority shareholders. Jim Margot retired several years ago, his daughter, Mia Margot, is the company's chief executive officer, and other family members hold positions in senior management.

### **Business developments in the year**

#### **Online sales**

In the last year, sales made through the company's website grew significantly. The finance director believes that this was in response to an advertising campaign costing £225,000, which promoted the 'Fructus Gold' brand and coincided with the launch of a new online sales portal on the company website designed to make online ordering easier. To encourage online sales, the company has regular special offers, with discounts periodically offered on a selection of product lines, and offers such as 'Buy One Get One Free' for a limited time on some products.

#### **Research and development**

Recently, concern over the level of plastic used in packaging has encouraged food producers to investigate the use of plastic-free packaging for their products. In July 20X8, the board approved a budget of £400,000 to be spent on research and development into new packaging for its products. By 28 February 20X9, £220,000 has been spent, with this amount being paid to ProPack, a firm of packaging specialists, to design and develop a range of plastic-free bottles, bags and containers. It is anticipated that the packaging will be ready for use in two years' time at which point the company will introduce it for use across its product range. ProPack is currently testing prototypes of items which have been developed, with encouraging results.

#### **Loan**

A loan of £375,000 was taken out during the year to support the company's research and development plans.

#### **Factory damage**

One of the company's several factories, used to process fruit and produce fruit juice, was damaged in August 20X8 when a severe storm occurred. High winds destroyed part of the factory roof, and heavy rain led to flooding and damage to machinery and processing equipment. The factory has not operated since the storm, and the finance director has performed an impairment review on the building and plant and equipment; details of the impairment review are given in the extract from the management accounts (Exhibit 4).

#### **Use of an auditor's expert**

The fruit growing on trees and the harvested agricultural produce are biological assets which were recognised at fair value of £3.1 million in the 20X8 audited financial statements. Due to the specialised nature of these assets, an auditor's expert will be used to provide evidence relating to their valuation. A resource document containing an overview of the accounting requirements in relation to the company's activities is provided in Exhibit 3.

**Exhibit 3 – Reference document – Extract from Snow & Co's internal technical guidance for audit staff working with clients in the agriculture sector**

**IAS® 16 *Property, Plant and Equipment* – Bearer plants**

Definition: A bearer plant is defined under IAS 16 as 'a living plant that:

- is used in the production or supply of agricultural produce;
- is expected to bear produce for more than one period; and
- has a remote likelihood of being sold as agricultural produce, except for incidental scrap sales.'

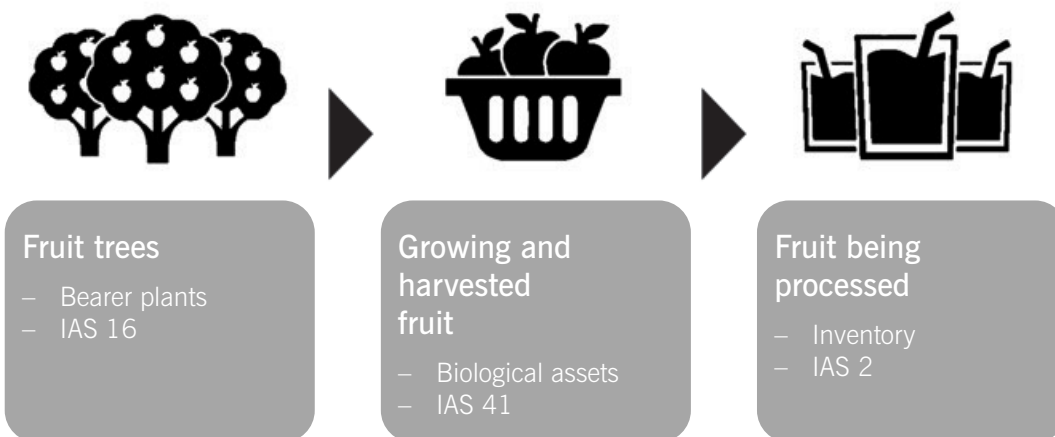
In line with the requirements of IAS 16, bearer plants are recorded at accumulated cost until they reach maturity and then they are depreciated over their useful life.

**IAS 41 *Agriculture* – Biological assets**

Produce growing on bearer plants, and harvested agricultural produce are biological assets and should be accounted for under IAS 41. Biological assets are measured on initial recognition and at subsequent reporting dates at fair value less estimated costs to sell, unless fair value cannot be reliably measured. A gain or loss arising on initial recognition of agricultural produce at fair value less costs to sell shall be included in the statement of profit or loss for the period in which it arises.

**IAS 2 *Inventories* – Agricultural produce**

When agricultural produce enters the production process, it should be accounted for under IAS 2.



#### Exhibit 4 – Extract from management accounts and results of preliminary analytical procedures

|                                                      | Note | As at 30 June<br>20X9<br>Projected<br>£'000 | As at 30 June<br>20X8<br>Actual<br>£'000 |
|------------------------------------------------------|------|---------------------------------------------|------------------------------------------|
| <b>Extract from statement of financial position:</b> |      |                                             |                                          |
| <b>Total assets</b>                                  |      | <b>12,500</b>                               | <b>11,900</b>                            |
| Included in total assets:                            |      |                                             |                                          |
| Intangible assets                                    | 1    | 525                                         | 50                                       |
| Property, plant and equipment                        | 2    | 6,150                                       | 6,470                                    |
| Total current assets                                 |      | 3,350                                       | 2,190                                    |
| Cash included in current assets                      |      | 760                                         | 750                                      |
| Current ratio                                        |      | 2.6                                         | 1.4                                      |
| Gearing ratio                                        |      | 28%                                         | 32%                                      |
| <b>Extract from statement of profit or loss:</b>     |      |                                             |                                          |
| <b>Total revenue</b>                                 |      | <b>35,600</b>                               | <b>32,750</b>                            |
| Online sales included in total revenue               |      | 2,495                                       | 1,310                                    |
| Operating margin                                     |      | 28%                                         | 26%                                      |
| Return on capital employed                           |      | 5%                                          | 4.5%                                     |
| <b>Profit before tax</b>                             |      | <b>2,100</b>                                | <b>1,900</b>                             |
| <b>Extract from statement of changes in equity:</b>  |      |                                             |                                          |
| Dividend payments                                    |      | 1,200                                       | 1,000                                    |

#### Notes:

##### 1. Intangible assets includes the following items:

|                                                    | 20X9<br>£'000 | 20X8<br>£'000 |
|----------------------------------------------------|---------------|---------------|
| Software development costs                         | 80            | 50            |
| Advertising costs relating to 'Fructus Gold' brand | 225           | 0             |
| Development costs in respect of new packaging      | 220           | 0             |
| <b>Total</b>                                       | <b>525</b>    | <b>50</b>     |

Software development costs of £30,000 were capitalised during the year, which relate to development of the online sales portal. The finance director suggests that both the software development costs and the advertising costs should be capitalised because the increased sales in the year are a direct result of the advertising campaign and improvements in the online sales portal.

The 'Fructus Gold' brand name is not recognised in the statement of financial position, as it is an internally generated asset. This accounting treatment has been confirmed as correct and in accordance with IAS 38 *Intangible Assets*. The notes to the 20X8 financial statements disclosed that the estimated fair value of the brand name is £18 million.

##### 2. Property, plant and equipment

The carrying amount of £6.15 million includes £880,250 relating to the storm-damaged factory (referred to in Exhibit 2) and its fixtures and fittings. The factory is a cash-generating unit for the purpose of impairment testing. The finance director has provided a summary calculation, detailing the following impairment review which indicates that an impairment loss of £210,250 needs to be recognised:

|                                          |                                |
|------------------------------------------|--------------------------------|
| Carrying amount at 31 August 20X8        | £<br>880,250                   |
| Recoverable amount                       |                                |
| Higher of: Fair value less costs to sell | 135,000                        |
| Value in use                             | 670,000                        |
| Impairment loss                          | (880,250 – 670,000)<br>210,250 |

The fair value less costs to sell has been estimated based on the sales proceeds which could be generated from selling the damaged machinery. The value in use is estimated based on the future sales which could be generated if the damage to the building is repaired and new machinery is put into the factory. The company is planning on carrying out the restoration and buying new machinery, at a total estimated cost of £450,000. This amount has been provided for within current liabilities, with a corresponding entry accounted for as a prepayment.

**Exhibit 5 – Email sent from Len Larch, employee of Margot Ltd, to Ben Duval, audit engagement partner**

**To: Ben Duval**

**From: Len Larch**

**Subject: Business practices**

**Hello Ben**

I obtained your contact details from your firm's website, I hope you don't mind me approaching you directly. I am emailing to voice some concerns over recent business practices at Margot Ltd.

In my role as production manager in one of the company's factories, I inspect samples of the fruit which comes into the factory from the company's farms, and speak to the farmers on a regular basis. Recently, several farmers told me that they have been instructed to use certain chemicals to spray the fruit trees, which should increase the fruit yield. However, some of these chemicals are prohibited for use in the UK because they can be toxic to humans.

While talking to one of my friends who is a production manager from another factory, it transpired that he had also become suspicious that banned chemicals are being used in the farms. He raised the issue with one of the company directors, who allegedly gave him £10,000 and asked him not to discuss it with anyone. My friend said that I should ask for the same sum of money, but I felt uncomfortable and thought I should tell someone from outside the company about what is going on.

Please do not mention my name if you decide to investigate this further.

**Thank you, Len.**

## Section B – BOTH questions are compulsory and MUST be attempted

- 2 (a) You are the manager responsible for the audit of Kilmister plc, a listed company specialising in the manufacture and installation of sound-proof partitions for domestic and industrial buildings. You are currently reviewing the draft auditor's report on the company's financial statements for the year ended 31 March 20X9. Extracts from the draft auditor's report are shown below:

### Independent auditor's report to the shareholders and directors of Kilmister plc

#### Basis for opinion

We conducted our audit of Kilmister plc (the Company) in accordance with International Standards on Auditing (UK) (ISAs (UK)). Our responsibilities under those standards are further described in the auditor's responsibilities for the audit of the financial statements section of our report. We are independent of the Company in accordance with the ethical requirements which are relevant to our audit of the financial statements in the jurisdiction in which the Company operates, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

#### Opinion

We have audited the financial statements of Kilmister plc (the Company), which comprise the statement of financial position as at 31 March 20X9, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, including a summary of significant accounting policies. In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as at 31 March 20X9, and of its financial performance and its cash flows for the year then ended in accordance with IFRS® Standards.

#### Material uncertainty regarding going concern

The Company is financed by a long-term loan from its bankers which is due for redemption in August 20X9. At the date of this auditor's report, the Company is in the process of renegotiating the loan but has not yet reached a final agreement with its bankers. It is our view that the loan finance is essential to the continued survival of the Company and that at the time of reporting, therefore, the absence of a finalised agreement represents a material uncertainty regarding going concern. The financial statements have been prepared on a going concern basis but do not make any reference to the loan redemption or the ongoing negotiations with the bank. As the external auditor, therefore, we are fulfilling our duty by bringing the matter to the attention of users of the financial statements.

#### Other information

The Company's principal activity is the manufacture and installation of sound-proof partitions for domestic and industrial buildings. The Company therefore engages in long-term contracts which are incomplete at the reporting date and which are material to its revenue figure. The installation process is complex and significant judgement is applied in assessing the percentage of completeness which is applied to calculate the revenue for the year. The significance of this judgement requires us to disclose the issue as other information which is relevant to the users of the financial statements.

#### Required:

#### Critically appraise the extract from the draft auditor's report for the year ended 31 March 20X9.

**Note:** You are NOT required to re-draft the extracts from the auditor's report. (10 marks)

- (b) Your firm, Eddie & Co, has asked you to perform an independent review of the working papers of Taylor plc, which is a listed entity and has been an audit client of your firm for the last eight years. The audit fieldwork is almost complete and as part of your review, you have been asked to advise the audit team on the drafting of their report to those charged with governance. Taylor plc is a discount food retailer which operates 85 stores nationally. The financial statements for the year ended 30 April 20X9 recognise revenue of £247 million (20X8 – £242 million), profit before tax of £14.6 million (20X8 – £14.1 million) and total assets of £535 million (20X8 – £321 million).

After a period of rapid expansion, 20X9 has been a year in which Taylor plc has strengthened its existing position within the market and has not acquired any additional stores or businesses. The company's draft statement of financial position for 20X9 includes a property portfolio of £315 million, all of which are legally owned by the entity. In the current year, the company has chosen to adopt a policy of revaluing its property portfolio for the

first time and this is reflected in the draft figures for 20X9. The audit work on property, plant and equipment included testing a sample of the revaluations. Eddie & Co requested at the planning stage that independent, external valuation reports should be made available to the audit team at the start of the final audit visit. A number of these documents were not available when requested and it took three weeks for them to be received by the audit team. The audit working papers also identify that on review of the non-current asset register, there were four properties with a total carrying amount of £11.1 million which had not yet been revalued and were still recorded at depreciated historic cost.

The audit supervisor's review of Taylor plc's board minutes identified that the company has renovated car parking facilities at 17 of its stores which has resulted in a significant increase in customer numbers and revenue at each of these locations. The total cost of the renovation work was £13.2 million and has been included in operating expenses for the current year. The audit file includes a working paper recording discussions with management which confirms that capital expenditure authorisation forms had not been completed for this expenditure.

You are aware that your firm had intended to replace the current engagement partner, Bryony Robertson, with Philip Campbell who is Eddie & Co's other specialist in food retail. Unfortunately, Mr Campbell was taken ill earlier in the year and will not now be available until next year's audit engagement. As a result, 20X9 is the sixth consecutive year in which Bryony Robertson has acted as engagement partner.

**Required:**

**From the information provided above, recommend the matters which should be included in Eddie & Co's report to those charged with governance, and explain the reason for their inclusion.** (15 marks)

**(25 marks)**

- 3 (a) The IAASB has published the Exposure Draft, *Proposed ISA 540 (Revised) Auditing Accounting Estimates and Related Disclosures* (ED-540) stating 'The objective of ED-540 is for the auditor to obtain sufficient appropriate audit evidence to evaluate whether accounting estimates and related disclosures are reasonable in the context of the applicable financial reporting framework, or are misstated. ED-540 includes enhanced requirements for risk assessment procedures and the auditor's work effort in responding to the assessed risks of material misstatement to support this evaluation.'

**Required:**

**Explain why accounting estimates are considered to be a source of high audit risk and discuss the reasons for the development of ED-540, commenting on its proposals for an enhanced risk assessment in relation to the audit of accounting estimates.** (8 marks)

- (b) You are the manager responsible for the audit of Awdry plc, a listed entity whose principal activity is the operation of a regional railway network. The audit for the year ended 28 February 20X9 is the first year your firm has audited Awdry plc. The draft financial statements recognise total assets of £58 million and profit before tax of £7.4 million. The detailed audit fieldwork has started and the audit supervisor has brought the following matters to your attention in relation to the testing of key accounting estimates:

**(i) Cash-settled share-based payment scheme**

On 1 March 20X8, Awdry plc granted 550,000 share appreciation rights to 55 executives and senior employees of the company with each eligible member of staff receiving 10,000 of the rights. The fair value of the rights was estimated on 28 February 20X9 by an external expert using an options pricing model at £4.50 each. Awdry plc prides itself on good employee relations and the senior management team has estimated that all 55 staff will qualify for the rights when they vest three years after the granting of the rights on 1 March 20X8. The company has recognised a straight line expense in this year's draft accounts of £825,000.

(6 marks)

**(ii) Regulatory penalties**

Awdry plc has been subject to a review by the national railways regulator following a complaint from a member of staff with safety concerns. The regulator identified breaches in safety regulations and issued a penalty notice on 30 September 20X8. Awdry plc has appealed against the initial penalty payable. Negotiations with the regulator are still ongoing and the amount payable has not yet been finalised. Awdry plc currently estimates that the total penalty payable as a result of the breach will be £1.3 million which it expects to repay in equal annual instalments over the next ten years with the first payment falling due on 1 March 20X9. The company's draft statement of profit or loss for the current year recognises an expense of £1.3 million and the draft statement of financial position includes a liability for the same amount.

(6 marks)

**(iii) Property development**

Awdry plc owns an industrial property which it has historically used as a maintenance depot for its engines and carriages. The company has an accounting policy of revaluing its properties to fair value and at the interim audit it was noted that the depot was recorded at a carrying amount of £2.5 million in the non-current asset register. During the first week of the audit fieldwork, the audit supervisor identified a year-end journal which uplifted the depot to a fair value of £4.9 million in this year's statement of financial position as at 28 February 20X9. Management has advised that this represents the estimated sales value of the building following Awdry plc's plan to develop the building as a residential property. The client has confirmed that the property is suitable for conversion into residential apartments at an estimated cost of £1.2 million and has negotiated secured finance for the development with their bank. The development will be subject to the payment of fees to the local council's building regulator of £173,000.

(5 marks)

**Required:**

- (i) Evaluate the client's accounting treatments and the difficulties which you might encounter when auditing each of the accounting estimates described above; and
- (ii) Design the audit procedures which should now be performed to gather sufficient and appropriate audit evidence.

Note: The split of the mark allocation is shown against each of the issues above.

**(25 marks)**

**End of Question Paper**