Strategic Professional – Options

Advanced Audit and Assurance – United Kingdom

Monday 3 September 2018

AAA UK ACCA

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.

Paper 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 Bison & Co, a firm of Chartered Certified Accountants, responsible for the audit of the Eagle Group (the Group), which has a financial year ending 31 December 20X8. Your firm is appointed to audit the parent company, Eagle plc, and all of its subsidiaries, with the exception of Lynx Co, a newly acquired subsidiary located in a foreign country which is audited by a local firm of auditors, Vulture Associates.

All companies in the Group report using IFRS® Standards as the applicable financial reporting framework and have the same financial year end.

You are provided with the following exhibits:

1. An email which you have received from Maya Crag, the audit engagement partner.
2. Background information about the Group including a request from the Group finance director in respect of a non-audit engagement.
3. Extracts from the Group financial statements projected to 31 December 20X8 and comparatives, extracted from the management accounts, and accompanying explanatory notes.
4. Management's determination of the goodwill arising on the acquisition of Lynx Co.
5. An extract from the audit strategy document prepared by Vulture Associates relating to Lynx Co.

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 audit engagement partner

To: Audit manager

From: Maya Crag, Audit engagement partner

Subject: Audit planning for the Eagle Group

Hello

I have provided you with some information in the form of a number of exhibits which you should use in planning the audit of the Eagle Group (the Group). I held a meeting yesterday with the Group finance director and representatives from the Group audit committee, and we discussed a number of issues which will impact on the audit planning.

Using the information provided, I require you to prepare briefing notes for my use in which you evaluate the audit risks to be considered in planning the Group audit. You should use analytical procedures to assist in identifying audit risks.

You are **not required** to consider audit risks relating to disclosure, as these will be planned for later in the audit process.

You should also design the principal audit procedures to be used in the audit of the goodwill arising on the acquisition of Lynx Co. Management's calculation of the goodwill is shown in Exhibit 4. You **do not need to consider** the procedures relating to impairment testing, or to foreign currency retranslation, as these will be planned later in the audit.

In addition, using the information provided in Exhibit 5, evaluate the extract of the audit strategy prepared by Vulture Associates in respect of their audit of Lynx Co, and discuss any implications for the Group audit.

Finally, Exhibit 2 includes a request from the Group finance director in respect of our firm providing advice on the Group's integrated report. Discuss the ethical and professional implications of this request, recommending any further actions which should be taken by our firm.

Thank you.

Exhibit 2 – Background information about the Group and request from Group finance director

Group operational activities

The Group, which is FTSE 350 listed, operates in distribution, supply chain and logistics management. Its headquarters are in Leeds, and its operations are worldwide, spanning more than 200 countries. The Group's strategy is to strengthen its market share and grow revenue in a sustainable manner by expansion into emerging markets. There are over 50 subsidiaries in the Group, many of which are international. There are three main business divisions: post and parcel delivery, commercial freight and supply chain management, each of which historically has provided approximately one-third of the Group's revenue.

A fourth business division which focuses purely on providing distribution channels for the oil and coal sector was established two years ago, and in 20X8 began to grow quite rapidly. It is forecast to provide 12% of the Group's revenue this year, growing to 15% in 20X9. This division is performing particularly well in developing economies.

In recent years, revenue has grown steadily, based mainly on growth in some locations where e-commerce is rapidly developing. This year, revenue is projected to decline slightly, which the Group attributes to increased competition, as a new distribution company has taken some of the Group's market share in a number of countries. However, the Group management team is confident that this is a short-term drop in revenue, and forecasts a return to growth in 20X9.

Innovation

The Group has invested in automating its warehousing facilities, and while it still employs more than 250,000 staff, many manual warehouse jobs are now performed by robots. Approximately 5,000 staff were made redundant early in this financial year due to automation of their work. Other innovations include increased use of automated loading and unloading of vehicles, and improvements in the technology used to monitor and manage inventory levels.

Integrated reporting

The Group is proud of this innovation and is keen to highlight these technological developments in its integrated report. The Group finance director has been asked to lead a project tasked with producing the Group's first integrated report. The finance director has sent the following request to the audit engagement partner:

'We would like your firm to assist us in developing our integrated report, and to provide assurance on it, as we believe this will enhance the credibility of the information it contains. Specifically, we would like your input into the choice of key performance indicators which should be presented, how to present them, and how they should be reconciled, where relevant, to financial information from the audited financial statements.'

The publication of an integrated report is not a requirement in the UK, but there is a growing pressure from stakeholders for the Group to publish an integrated report.

If Bison & Co accepts the engagement in relation to the Group's integrated report, the work would be performed by a team separate from the audit team.

Exhibit 3 – Extracts from consolidated financial statements

Statement of financial position

	Note	As at 31 December 20X8 Projected £ million	As at 31 December 20X7 Actual £ million
Non-current assets			
Goodwill	1	1,100	970
Other intangible assets	2	200	170
Property, plant and equipment		657	600
Other investments		85	100
Total non-current assets		2,042	1,840
Current assets		1,450	1,420
Total assets		3,492	3,260
Equity and liabilities			
Equity			
Share capital	3	1,250	1,150
Retained earnings		840	780
Other components of equity		130	140
Non-controlling interests		25	23
Total equity		2,245	2,093
Non-current liabilities	4	650	620
Current liabilities		597	547
Total equity and liabilities		3,492	3,260

Statement of profit or loss

	Note	Year to 31 December 20X8 Projected £ million	Year to 31 December 20X7 Actual £ million
Revenue	5	5,770	5,990
Other operating income	6	120	80
Operating expenses	7	(5,540)	(5,800)
Operating profit		350	270
Finance charges		(28)	(30)
Profit before tax		322	240
Tax expense		(64)	(60)
Profit for the year		258	180

Notes to the extracts from financial statements

Goodwill

1. Goodwill relates to the Group's subsidiaries, and is tested for impairment on an annual basis. Management will conduct the annual impairment review in December 20X8, but it is anticipated that no impairment will need to be recognised this year due to anticipated growth in revenue which is forecast for the next two years.

   In March 20X8, the Group acquired an 80% controlling shareholding in Lynx Co, a listed company located in a foreign country, for consideration of £351 million. Management's determination of the goodwill arising on this acquisition is shown in Exhibit 4.

Other intangible assets

2. Other intangible assets relates mostly to software and other technological development costs. During the year £35 million was spent on developing a new IT system for dealing with customer enquiries and processing customer orders. A further £20 million was spent on research and development into robots being used in warehouses, and £5 million on developing new accounting software. These costs have been capitalised as intangible assets and are all being amortised over a 15-year useful life.

Equity and non-current liabilities

3. A share issue in July 20X8 raised cash of £100 million, which was used to fund capital expenditure.

4. Non-current liabilities includes borrowings of £539 million (20X7 – £500 million), pension plan deficit, which relates only to the acquired subsidiary Lynx Co, of £11 million (20X7 – no comparative as acquired in the year), and provisions of £100 million (20X7 – £120 million). Changes in financing during the year have impacted on the Group's weighted average cost of capital. Information from the Group's treasury management team suggests that the weighted average cost of capital is currently 10%.

Financial performance

5. Revenue has decreased by 3·7% over the year, due to a new competitor in the market taking some of the Group's market share.

6. Other operating income comprises the following items:

	20X8 £ million	20X7 £ million
Reversal of provisions	60	40
Reversal of impairment losses on receivables and other assets	30	20
Foreign currency gains	28	23
Profit/(loss) on disposal of non-current assets	2	(3)
Total	120	80

7. Operating expenses includes the following items:

	20X8 £ million	20X7 £ million
Staff costs	3,650	3,610
Cost of raw materials, consumables and supplies	1,725	1,780
Depreciation, amortisation and impairment	145	140
Other operating expenses	20	270
Total	5,540	5,800

Exhibit 4 – Determination of goodwill on the acquisition of Lynx Co

	Note	£ million
Cash consideration – paid 1 March 20X8		80
Contingent consideration	1	271
Total consideration		351
Fair value of non-controlling interest	2	49
		400
Less: Fair value of identifiable net assets	3	(300)
Goodwill		100

Notes:

1. The contingent consideration will be payable four years after the initial acquisition date and is calculated based on a payment of £525 million, only payable if Lynx Co reaches revenue and profit targets outlined in the purchase documentation. The amount included in the goodwill calculation has been discounted to present value using a discount factor based on an 18% interest rate.
2. The non-controlling interest is measured at fair value, the amount being based on Lynx Co's share price on 1 March 20X8.
3. The assets and liabilities acquired and their fair values were determined by an independent firm of Chartered Certified Accountants, Sidewinder & Co, who was engaged by the Group to perform due diligence on Lynx Co's prior to the acquisition taking place. A fair value uplift of £12 million was made in relation to property, plant and equipment.

Exhibit 5 – Extract from audit strategy – prepared by Vulture Associates in respect of the audit of Lynx Co

The two points below are an extract from the audit strategy. Other sections of the audit strategy, including the audit risk assessment, have been reviewed by the Group audit team and are considered to be satisfactory. Lynx Co is projected to be loss making this year, and the Group audit team is confident that sufficient procedures on going concern have been planned for.

Controls effectiveness

We will place reliance on internal controls, which will reduce the amount of substantive testing which needs to be performed. This is justified on the grounds that in the previous year's audit, controls were tested and found to be highly effective. We do not plan to re-test the controls, as according to management there have been no changes in systems or the control environment during the year.

Valuation of pension plan

Lynx Co has a defined benefit pension plan in place for its employees. The draft financial statements recognise a net non-current liability of £11 million in relation to plan assets with a value of £38 million, and plan liabilities valued at £49 million. In previous years the pension plan has been valued by an external valuer, and in 20X7 a net deficit of £3 million was recognised in non-current liabilities. However, this year the valuation has been performed by one of Vulture Associates' partners, who is a qualified actuary. The fee for providing this valuation was £35,000. It is expected that the audit fee will be £600,000 and fees for other audit-related services will be in the region of £100,000.

Section B – BOTH questions are compulsory and MUST be attempted

2 (a) You are an audit manager in Coram & Co, a firm of Chartered Certified Accountants. The audit of one of your clients, Clark Ltd, for the year ended 31 May 20X8 is nearly complete and the auditor's report is due to be issued next week. Clark Ltd is an unlisted, family owned business which specialises in the service and repair of both commercial and privately owned motor vehicles. The company operates from seven geographically distinct sites, each of which is considered a separate cash generating unit for impairment review purposes. The draft financial statements recognise profit before taxation for the year of £2·3 million and total assets of £22 million.

The schedule of uncorrected misstatements included in Clark Ltd's audit working papers and prepared by the audit supervisor is shown below. You are due to attend a meeting with the finance director of Clark Ltd tomorrow, at which the uncorrected misstatements will be discussed.

	Statement of profit or loss		Statement of financial position	
Schedule of uncorrected misstatements	Debit	Credit	Debit	Credit
	£	£	£	£
(i) Lease of testing equipment				
– lease assets			475,000	
– lease liabilities				475,000
(ii) Legal claim				
– contingent assets			1,200,000	
– provision for liabilities				1,200,000
(iii) Asset impairment				
– assets				85,000
– expenses	85,000			
Totals	85,000	–	1,675,000	1,760,000

(i) Lease of testing equipment

According to UK legislation, all motor vehicles over three years old are required to undergo an annual test of vehicle safety and roadworthiness. The annual test requires specialist testing equipment which is inspected by government officials on a regular basis. Following inspection visits in May 20X8, the government inspection report required Clark Ltd to replace the testing equipment at three of its sites. In order to comply with this requirement, Clark Ltd has agreed to lease new testing equipment from a leasing company on six-month leases. Under the terms of the leases, the company has no option to purchase the equipment. The testing equipment was made available for use by Clark Ltd at each of the three sites on 31 May 20X8. The client has capitalised leases with a total carrying amount of £625,000 at two of the sites but has elected to take advantage of the IFRS® 16 *Leases* exemption not to capitalise short-term leases at the largest of the three sites. As a result, the present value of the lease payments of £475,000 relating to this site has not been recognised on the company's statement of financial position.

(ii) Legal claim

A customer of Clark Ltd successfully sued the company for negligence in April 20X8 after suffering a personal injury at one of its sites. The court awarded the customer £1·2 million in damages and this had not yet been paid as at 31 May 20X8. The audit working papers include a copy of a verified letter dated 25 May 20X8 from an insurance company confirming that the claim is fully covered under Clark Ltd's public liability insurance policy. On the basis that the company has no net liability as a result of the claim, the finance director has not recognised any amounts in the financial statements and has not made any disclosures in relation to the matter.

(iii) Asset impairment

During the year, a significant new competitor entered the market place at one of Clark Ltd's seven sites. As a result, the site has experienced a decline in market share and revenue. The company has therefore conducted an impairment test on the site's assets. The company's working papers for the impairment test have been audited and the following figures have been agreed by the audit team:

	Site assets £
Carrying amount on statement of financial position as at 31 May 20X8	3·6 million
Value in use	2·9 million
Fair value	3·9 million

Related costs of selling the assets:

– legal costs	126,000
– transaction taxes	174,000
– costs of removing the assets	85,000
– costs of reorganising the business following the asset disposals	96,000

On the basis of the results of these figures, the client has calculated the recoverable amount of the assets as £3·6 million and concluded that the site has not suffered an impairment. No adjustments have therefore been made to the financial statements in this regard.

Required:

Recommend and explain the matters which should be discussed with management in relation to each of the proposed adjustments, including an assessment of their individual impact on the financial statements and on the auditor's opinion if management does not make the proposed adjustments. (17 marks)

(b) Your client portfolio as an audit manager at Coram & Co also includes Turner plc which is a listed financial institution offering loans and credit facilities to both commercial and retail customers. You have received an email from the audit supervisor who is currently supervising interim testing on systems and controls in relation to the audit for the year ending 31 October 20X8. The email gives the following details for your consideration:

One of the audit team members, Janette Stott, has provisionally agreed to take out a loan with Turner plc to finance the purchase of a domestic residence. The loan will be secured on the property and the client's business manager has promised Janette that he will ensure that she gets 'the very best deal which the bank can offer.'

The payroll manager at Turner plc has asked the audit supervisor if it would be possible for Coram & Co to provide a member of staff on secondment to work in the payroll department. The payroll manager has struggled to recruit a new supervisor for the organisation's main payroll system and wants to assign a qualified member of the audit firm's staff for an initial period of six months.

Required:

Comment on the ethical and professional issues raised in respect of the audit of Turner plc and recommend any actions to be taken by the audit firm. (8 marks)

(25 marks)

3 (a) You are an audit manager in Jansen & Co which offers a range of audit and other assurance services to its clients. One of your audit clients is Narley Ltd, which operates a commercial haulage company. Narley Ltd has been an audit client for the last five years. The company is UK-based but is currently planning a significant expansion of its operations into Europe. In order to finance the planned expansion, Narley Ltd needs funds to purchase additional heavy goods vehicles, expand its warehousing facilities and recruit more drivers. The company is also planning a major advertising and marketing campaign targeted at potential customers in Europe.

Narley Ltd's finance director, Suzanne Seddon, has approached you to ask if your firm will provide a report on the prospective financial information which has been prepared in support of a loan application. The application is for a new long-term loan of £22 million from the company's current lender which it intends to use exclusively to finance the planned expansion. The company currently has an existing long-term loan of £31 million from the same bank which is redeemable in five years' time.

Suzanne Seddon has provided you with the following extract from the prospective financial information which will form part of the company's loan application:

Forecast statements of profit or loss

	Note	Year ended 31 August 20X8 Unaudited £'000	Year ending 31 August 20X9 Forecast £'000	Year ending 31 August 20Y0 Forecast £'000
Revenue	1	138,861	174,965	225,705
Cost of sales	2	(104,862)	(124,786)	(157,230)
Administrative expenses	3	(22,936)	(21,984)	(20,743)
Operating profit		11,063	28,195	47,732
Finance costs	4	(1,450)	(1,638)	(1,597)
Profit before tax		9,613	26,557	46,135

Notes:

1. Revenue represents the amounts derived from the provision of haulage services to commercial customers operating principally in the retail sector. Narley Ltd's board of directors believes that trade in both its existing and new markets will experience significant growth over the next two years.
2. Cost of sales comprises the costs of warehousing and distribution including relevant staff costs, maintenance and repair of vehicles and depreciation of property, equipment and vehicles.
3. Administrative expenses are mainly the costs of running Narley Ltd's central head office facility.
4. Finance costs represent the cost of servicing long-term finance from Narley Ltd's bankers.

Required:

(i) Explain the matters which should be considered by Jansen & Co before accepting the engagement to review and report on Narley Ltd's prospective financial information. (6 marks)

(ii) Assuming Jansen & Co accepts the engagement, recommend the examination procedures to be performed in respect of Narley Ltd's forecast statements of profit or loss. (9 marks)

(b) Krupt Ltd is a family owned business which has been an audit client of Jansen & Co for many years and on which you have been the audit manager for the last two years. The audit for the year ended 30 June 20X8 is approaching completion and the audit supervisor has asked for your advice in relation to recent developments at the client.

Krupt Ltd is a wholesaler of electronic goods and is owned by Mr and Mrs Krupt who are both 50% shareholders and directors of the company. The company's principal source of finance is a loan from Hongclays Bank of £1·2 million which is secured by a floating charge over the company's inventory. The bank has also taken out personal guarantees on the domestic residence owned jointly by Mr and Mrs Krupt under the terms of which the bank has the right to take possession of the property in the event that it cannot recover its debts from the company.

As part of the going concern review, the audit supervisor, Jemma Jones, has scrutinised the management accounts for the first four months of the current reporting period and has identified that the company is making significant losses which she believes to be unsustainable. She has also inspected correspondence between the company and Hongclays Bank which indicates that the company has already breached key loan covenants.

Jemma has been informed by the company's procurement manager that Krupt Ltd has recently taken delivery of a large quantity of a new inventory line with a value of £0·75 million which it has purchased on credit from one of its suppliers. At present the company also has other inventory with a total value of approximately £0·5 million. Based on a review of the company's bank statements and cash flow forecasts, Jemma does not believe that there is any realistic prospect that the company will be able to pay this supplier for the foreseeable future and is concerned about the possible implications of this transaction for the directors of the company. Jemma has not come across these issues before. She has a clear sense that something is wrong and she has asked you to:

(i) explain the concepts of fraudulent and wrongful trading and;

(ii) evaluate the possible implications of the circumstances and transactions noted during the going concern review for the directors of Krupt Ltd.

Required:

Respond to Jemma's request. (10 marks)

(25 marks)

End of Question Paper