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Audit Risk – Tute 03 - Practice Questions & Answers

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Question 01

You are an audit supervisor of Cupid & Co, planning the final audit of a new client, Prancer Construction Co, for the year ending 30 September 2017. The company specialises in property construction and providing ongoing annual maintenance services for properties previously constructed. Forecast profit before tax is $13·8m and total assets are expected to be $22·3m, both of which are higher than for the year ended 30 September 2016.

You are required to produce the audit strategy document. The audit manager has met with Prancer Construction Co's finance director and has provided you with the following notes, a copy of the August management accounts and the prior year financial statements.

Meeting notes

The prior year financial statements recognise work in progress of $1·8m, which was comprised of property construction in progress as well as ongoing maintenance services for finished properties. The August 2017 management accounts recognise $2·1m inventory of completed properties compared to a balance of $1·4m in September 2016. A full year-end inventory count will be undertaken on 30 September at all of the 11 building sites where construction is in progress. There is not sufficient audit team resource to attend all inventory counts.

In line with industry practice, Prancer Construction Co offers its customers a five-year building warranty, which covers any construction defects. Customers are not required to pay any additional fees to obtain the warranty. The finance director anticipates this provision will be lower than last year as the company has improved its building practices and therefore the quality of the finished properties.

Customers who wish to purchase a property are required to place an order and pay a 5% non-refundable deposit prior to the completion of the building. When the building is complete, customers pay a further 92·5%, with the final 2·5% due to be paid six months later. The finance director has informed you that although an allowance for receivables has historically been maintained, it is anticipated that this can be significantly reduced.

Information from management accounts

Prancer Construction Co's prior year financial statements and August 2017 management accounts contain a material overdraft balance. The finance director has confirmed that there are minimum profit and net assets covenants attached to the overdraft.

A review of the management accounts shows the payables period was 56 days for August 2017, compared to 87 days for September 2016. The finance director anticipates that the September 20X7 payables days will be even lower than those in August 2017.

Required:

(a) Describe the process Cupid & Co should have undertaken to assess whether the PRECONDITIONS for an audit were present when accepting the audit of Prancer Construction Co. (3 marks)

(b) Identify THREE main areas, other than audit risks, which should be included within the audit strategy document for Prancer Construction Co, and for each area provide an example relevant to the audit. (3 marks)

(c) Using all the information provided describe SEVEN audit risks, and explain the auditor's response to each risk, in planning the audit of Prancer Construction Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (14 marks) (20 marks)

ANSWER

(a) Preconditions for the audit

To assess whether the preconditions for an audit are present, Cupid & Co should have determined whether the financial reporting framework to be applied in the preparation of Prancer Construction Co's financial statements is acceptable. In considering this, the auditor should have assessed the nature of the entity, the nature and purpose of the financial statements and whether law or regulation prescribes the applicable reporting framework.

In addition, the firm should have obtained the agreement of Prancer Construction Co's management that it acknowledges and understands its responsibility for the following:

- Preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- For such internal control as management determines is necessary to enable the preparation of financial statements which are free from material misstatement, whether due to fraud or error; and
- To provide Cupid & Co with access to all relevant information for the preparation of the financial statements, any additional information which the auditor may request from management and unrestricted access to personnel within Prancer Construction Co from whom the auditor determines it necessary to obtain audit evidence.

(b) Areas to be included in the audit strategy document Planning an Audit of Financial Statements sets out areas which should be considered and documented as part of the audit strategy document and are as follows:

Main characteristics of the engagement

The audit strategy should consider the main characteristics of the engagement, which define its scope. For Prancer Construction Co, the following are examples of things which should be included:

- Whether the financial information to be audited has been prepared in accordance with the relevant financial reporting framework.
- Whether computer-assisted audit techniques will be used and the effect of IT on audit procedures.
- The availability of key personnel at Prancer Construction Co.

Reporting objectives, timing and nature of communication

It should ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as:

- The audit timetable for reporting including the timing of interim and final stages.
- Organization of meetings with Prancer Construction Co's management to discuss any audit issues arising.
- Any discussions with management regarding the reports to be issued.
- The timings of the audit team meetings and review of work performed.

Significant factors affecting the audit

The strategy should consider the factors which, in the auditor's professional judgement, are significant in directing Prancer Construction Co's audit team's efforts, such as:

- The determination of materiality for the audit.
- The need to maintain a questioning mind and to exercise professional scepticism in gathering and evaluating audit evidence.

Preliminary engagement activities and knowledge from previous engagements

It should consider the results of preliminary audit planning activities and, where applicable, whether knowledge gained on other engagements for Prancer Construction Co is relevant, such as:

- Results of any tests over the effectiveness of internal controls.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal controls.
- Volume of transactions, which may determine whether it is more efficient for the audit team to rely on internal controls.
- Significant business developments affecting Prancer Construction Co, such as the improvement in building practices and construction quality.

Nature, timing and extent of resources

The audit strategy should ascertain the nature, timing and extent of resources necessary to perform the audit, such as:

- The selection of the audit team with experience of this type of industry.
- Assignment of audit work to the team members.
- Setting the audit budget.

(c)

Audit risks	Auditor's response
Prancer Construction Co is a new client for Cupid & Co. As the team is not familiar with the accounting policies, transactions and balances of the company, there will be an increased detection risk on the audit.	Cupid & Co should ensure they have a suitably experienced team. In addition, adequate time should be allocated for team members to obtain an understanding of the company and the risks of material misstatement including a detailed team briefing to cover the key areas of risk.
Prancer Construction Co is likely to have a material level of work in progress at the year end, being construction work in progress as well as ongoing maintenance services, as Prancer Construction Co has annual contracts for many of the buildings constructed.	The auditor should discuss with management the process they will undertake to assess the percentage completion for work in progress at the year end. This process should be reviewed by the auditor while attending the year-end inventory counts.

The level of work in progress will need to be assessed at the year end. Assessing the percentage completion for partially constructed buildings is likely to be quite subjective, and the team should consider if they have the required expertise to undertake this. If the percentage completion is not correctly calculated, the inventory valuation may be under or overstated.	In addition, consideration should be given as to whether an independent expert is required to value the work in progress or if a management expert has been used. If the work of an expert is to be used, then the audit team will need to assess the competence, capabilities and objectivity of the expert.
The August 2017 management accounts contain \$2·1 million of completed properties; this balance was \$1·4 million in September 2016. The increase in inventory may be due to an increased level of pre year-end orders. Alternatively, it may be that Prancer Construction Co is struggling to sell completed properties, which may indicate that they are overvalued. IAS 2 Inventories requires that inventory should be stated at the lower of cost and NRV.	Detailed cost and net realisable value (NRV) testing to be performed at the year end and the aged inventory report to be reviewed to assess whether inventory requires to be written down.
At the year end there will be inventory counts undertaken at all 11 of the building sites in progress.	The auditor should assess for which of the building sites they will attend the counts. This will be those with the most material inventory
It is unlikely that the auditor will be able to attend all of these inventory counts, increasing detection risk, and therefore they need to ensure that they obtain sufficient evidence over the inventory counting controls, and completeness and existence of inventory for any sites not visited.	or which according to management have the most significant risk of misstatement. For those not visited, the auditor will need to review the level of exceptions noted during the count and discuss with management any issues, which arose during the count.
Prancer Construction Co offers its customers a building warranty of five years, which covers any construction defects. A warranty provision will be required under IAS 37 Provisions, Contingent Liabilities and Contingent Assets. Calculating warranty provisions requires judgement as it is an uncertain amount. The finance director anticipates this provision will be lower than last year as the company has improved its building	Discuss with management the basis of the provision calculation, and compare this to the level of post year-end claims, if any, made by customers. In particular, discuss the rationale behind reducing the level of provision this year. Compare the prior year provision with the actual level of claims in the year, to assess the reasonableness of the judgements made by management.

practices and the quality of its finished properties. However, there is a risk that this provision could be understated, especially in light of the overdraft covenant relating to a minimum level of net assets and is being used as a mechanism to manipulate profit and asset levels.	
Customers who wish to purchase a property are required to place an order and a 5% non-refundable deposit prior to the completion of the building. These deposits should not be recognized as revenue in the statement of profit or loss until the performance obligations as per the contracts have been satisfied, which is likely to be when the building is finished and the sale process is complete. Instead, they should be recognized as deferred income within current liabilities. Management may have incorrectly treated the deferred income as revenue, resulting in overstated revenue and understated liabilities.	Discuss with management the treatment of deposits received in advance, to ensure it is appropriate. During the final audit, undertake increased testing over the cut-off of revenue and completeness of deferred income.
An allowance for receivables has historically been maintained, but it is anticipated that this will be reduced. There is a risk that receivables will be overvalued; some balances may not be recoverable and so will be overstated if not provided for. In addition, reducing the allowance for receivables will increase asset values and would improve the covenant compliance, which increases the manipulation risk further.	Review and test the controls surrounding how the finance director identifies old or potentially irrecoverable receivables balances and credit control to ensure that they are operating effectively. Discuss with the director the rationale for reducing the allowance for receivables. Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.
Prancer Construction Co has a material overdraft which has minimum profit and net assets covenants attached to it. If these covenants were to be breached, the overdraft balance would become instantly repayable.	Review the covenant calculations prepared by the company at the year end and identify whether any defaults have occurred; if so, determine the effect on the company. The team should maintain their professional skepticism and be alert to the risk that profit and/or net assets have been

If the company does not have sufficient cash to meet this repayment, then there could be going concern implications. In addition, there is a risk of manipulation of profit and net assets to ensure that covenants are met.	overstated to ensure compliance with the covenants.
Preliminary analytical review of the August management accounts shows payable days of 56 for August 2017, compared to 87 days for September 2016. It is anticipated that the year-end payable days will be even lower. The forecast profit is higher than last year, indicating an increase in trade, also the company's cash position has continued to deteriorate and therefore, it is unusual for payable days to have decreased. There is an increased risk of errors within trade payables and the year-end payables may be understated.	The audit team should increase their testing on trade payables at the year end, with a particular focus on completeness of payables. A payables circularisation or review of supplier statement reconciliations should be undertaken.

Question 02

You are an audit supervisor of Caving & Co and you are planning the audit of Hurling Co, a listed company, for the year ending 31 March 20X7. The company manufactures computer components and forecast profit before tax is $33·6m and total assets are $79·3m.

Hurling Co distributes its products through wholesalers as well as via its own website. The website was upgraded during the year at a cost of $1·1m. Additionally, the company entered into a transaction in February to purchase a new warehouse which will cost $3·2m. Hurling Co's legal advisers are working to ensure that the legal process will be completed by the year end. The company issued $5m of irredeemable preference shares to finance the warehouse purchase.

During the year the finance director has increased the useful economic lives of fixtures and fittings from three to four years as he felt this was a more appropriate period. The finance director has informed the engagement partner that a revised credit period has been agreed with one of its wholesale customers, as they have been experiencing difficulties with repaying the balance of $1·2m owing to Hurling Co. In January 20X7, Hurling Co introduced a new bonus based on sales targets for its sales staff. This has resulted in a significant number of new wholesale customer accounts being opened by sales staff. The new customers have been given favorable credit terms as an introductory offer, provided goods are purchased within a two-month period. As a result, revenue has increased by 5% on the prior year.

The company has launched several new products this year and all but one of these new launches have been successful. Feedback on product Luge, launched four months ago, has been mixed, and the company has just received notice from one of their customers, Petanque Co, of intended legal action. They are alleging the product sold to them was faulty, resulting in a significant loss of information and an ongoing detrimental impact on profits. As a precaution, sales of the Luge product have been halted and a product recall has been initiated for any Luge products sold in the last four months.

The finance director is keen to announce the company's financial results to the stock market earlier than last year and in order to facilitate this, he has asked if the audit could be completed in a shorter timescale. In addition, the company is intending to propose a final dividend once the financial statements are finalized.

Hurling Co's finance director has informed the audit engagement partner that one of the company's non-executive directors (NEDs) has just resigned, and he has enquired if the partners at Caving & Co can help Hurling Co in recruiting a new NED. Specifically he has requested the engagement quality control reviewer, who was until last year the audit engagement partner on Hurling Co, assist the company in this recruitment. Caving & Co also provides taxation services for Hurling Co in the form of tax return preparation along with some tax planning advice. The finance director has recommended to the audit committee of Hurling Co that this year's audit fee should be based on the company's profit before tax. At today's date, 20% of last year's audit fee is still outstanding and was due to be paid three months ago.

Required:

(a) Describe EIGHT audit risks, and explain the auditor's response to each risk, in planning the audit of Hurling Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (16 marks)

ANSWER

Audit Risk	Response
Hurling Co upgraded their website during the year at a cost of $1·1m. The costs incurred should be correctly allocated between revenue and capital expenditure. As the website has been upgraded, there is a possibility that the new processes and systems may not record data reliably and accurately. This may lead to a risk over completeness and accuracy of data in the underlying accounting records	Review a breakdown of the costs and agree to invoices to assess the nature of the expenditure and if capital, agree to inclusion within the asset register or agree to the statement of profit or loss. The audit team should document the revised system and undertake tests over the completeness and accuracy of data recorded from the website to the accounting records.
Hurling Co has entered into a transaction to purchase a new warehouse for $3·2m and it is anticipated that the legal process will be completed by the year end. Only assets which physically exist at the year end should be included in property, plant and equipment. If the transaction has not been completed by the year end, there is a risk that assets are overstated if the company incorrectly includes the warehouse at the year end.	Discuss with management as to whether the warehouse purchase was completed by the year end. If so, inspect legal documents of ownership, such as title deeds ensuring these are dated prior to 1 April 20X7 and are in the company name
Significant finance has been obtained in the year, as the company has issued $5m of irredeemable preference shares. This finance needs to be accounted for correctly, with adequate disclosure made. As the preference shares are irredeemable, they should be classified as equity rather than non-current liabilities. Failing to correctly classify the shares could result in understated equity and overstated non-current liabilities.	Review share issue documentation to confirm that the preference shares are irredeemable. Confirm that they have been correctly classified as equity within the accounting records and that total financing proceeds of $5m were received. In addition, the disclosures for this share issue should be reviewed in detail to ensure compliance with relevant accounting standards.
The finance director has extended the useful lives of fixtures and fittings from three to four years, resulting in the depreciation charge reducing. Under IAS 16 Property, Plant and Equipment, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable. However, there is a risk that this reduction has occurred in order to boost profits. If this is the case, then fixtures and fittings are overvalued and profit overstated.	Discuss with the directors the rationale for any extensions of asset lives and reduction of depreciation rates. Also, the four-year life should be compared to how often these assets are replaced, to assess the useful life of assets.

A customer of Hurling Co has been encountering difficulties paying their outstanding balance of $1·2m and Hurling Co has agreed to a revised credit period. If the customer is experiencing difficulties, there is an increased risk that the receivable is not recoverable and hence is overvalued.	Review the revised credit terms and identify if any after date cash receipts for this customer have been made. Discuss with the finance director whether he intends to make an allowance for this receivable. If not, review whether any existing allowance for uncollectable accounts is sufficient to cover the amount of this receivable.
A sales-related bonus scheme has been introduced in the year for sales staff, with a significant number of new customer accounts on favorable credit terms being opened pre year end. This has resulted in a 5% increase in revenue. Sales staff seeking to maximize their current year bonus may result in new accounts being opened from poor credit risks leading to irrecoverable receivables. In addition, there is a risk of sales cut-off errors as new customers could place orders within the two-month introductory period and subsequently return these goods post year end.	Increased sales cut-off testing will be performed along with a review of any post year-end returns as they may indicate cut-off errors. In addition, increased after date cash receipts testing to be undertaken for new customer account receivables.
Hurling Co has halted further sales of its new product Luge and a product recall has been initiated for any goods sold in the last four months. If there are issues with the quality of the Luge product, inventory may be overvalued as its NRV may be below its cost. Additionally, products of Luge sold within the last four months are being recalled, this will result in Hurling Co paying customer refunds. The sale will need to be removed; a refund liability should be recognized along with the reinstatement of inventory, although the NRV of this inventory could be of a minimal value. Failing to account for this correctly could result in overstated revenue and understated liabilities and inventory.	Discuss with the finance director whether any write downs will be made to this product, and what, if any, modifications may be required with regards the quality. Testing should be undertaken to confirm cost and NRV of the Luge products in inventory and that on a line-by-line basis the goods are valued correctly. Review the list of sales made of product Luge prior to the recall, agree that the sale has been removed from revenue and the inventory included. If the refund has not been paid pre year end, agree it is included within current liabilities.
Petanque Co, a customer of Hurling Co, has announced that they intend to commence legal action for a loss of information and profits as a result of the Luge product sold to them. If it is probable that the company will	Caving & Co should write to the company's lawyers to enquire of the existence and likelihood of success of any claim from Petanque Co.

make payment to the customer, a legal provision is required. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If Hurling Co has not done this, there is a risk over the completeness of any provisions or the necessary disclosure of contingent liabilities.	The results of this should be used to assess the level of provision or disclosure included in the financial statements.
The finance director has requested that the audit completes one week earlier than normal as he wishes to report results earlier. A reduction in the audit timetable will increase detection risk and place additional pressure on the team in obtaining sufficient and appropriate evidence. In addition, the finance team of Hurling Co will have less time to prepare the financial information leading to an increased risk of errors arising in the financial statements	The timetable should be confirmed with the finance director. If it is to be reduced, then consideration should be given to performing an interim audit in late March or early April; this would then reduce the pressure on the final audit. The team needs to maintain professional skepticism and be alert to the increased risk of errors occurring.
The company is intending to propose a final dividend once the financial statements are finalized. This amount should not be provided for in the 2017 financial statements, as the obligation only arises once the dividend is announced, which is post year end. In line with IAS 10 Events after the Reporting Date the dividend should only be disclosed. If the dividend is included, this will result in an overstatement of liabilities and understatement of equity	Discuss the issue with management and confirm that the dividend will not be included within liabilities in the 20X7 financial statements. The financial statements need to be reviewed to ensure that adequate disclosure of the proposed dividend is included.

Question 03

You are an audit supervisor of Chania & Co and are planning the audit of your client, Sitia Sparkle Co which manufactures cleaning products. Its year end was 31 July 20X6 and the draft profit before tax is $33·6 million. You are supervising a large audit team for the first time and will have specific responsibility for supervising and reviewing the work of the audit assistants in your team.

Sitia Sparkle Co purchases most of its raw materials from suppliers in Africa and these goods are shipped directly to the company's warehouse and the goods are usually in transit for up to three weeks. The company has incurred $1·3 million of expenditure on developing a new range of cleaning products which are due to be launched into the market place in November 20X6. In September 20X5, Sitia Sparkle Co also invested $0·9 million in a complex piece of plant and machinery as part of the development process. The full amount has been capitalized and this cost includes the purchase price, installation costs and training costs.

This year, the bonus scheme for senior management and directors has been changed so that rather than focusing on profits, it is instead based on the value of year-end total assets. In previous years an allowance for receivables, made up of specific balances, which equalled almost 1% of trade receivables was maintained. However, the finance director feels that this is excessive and unnecessary and has therefore not included it for 20X6 and has credited the opening balance to the profit or loss account.

A new general ledger system was introduced in May 2016; the finance director has stated that the data was transferred and the old and new systems were run in parallel until the end of August 2016. As a result of the additional workload on the finance team, a number of control account reconciliations were not completed as at 31 July 2016, including the bank reconciliation. The finance director is comfortable with this as these reconciliations were completed successfully for both June and August 2016. In addition, the year-end close down of the purchase ledger was undertaken on 8 August 2016.

Required:

Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Sitia Sparkle Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (12 marks)

ANSWER

Audit Risk	Response
Sitia Sparkle Co purchases their goods from suppliers in Africa and the goods are in transit for up to three weeks. At the year end, there is a risk that the cut-off of inventory, purchases and payables may not be accurate and may be under/overstated.	The audit team should undertake detailed cut-off testing of purchases of goods at the year end and the sample of GRNs from before and after the year end relating to goods from suppliers in Africa should be increased to ensure that cut-off is complete and accurate.
Sitia Sparkle Co has incurred expenditure of \$1·3 million in developing a new range of cleaning products. This expenditure is classed as research and development under IAS 38 Intangible Assets. The standard requires research costs to be expensed to profit or loss and development costs to be capitalized as an intangible asset. If the company has incorrectly classified research costs as development expenditure, there is a risk the intangible asset could be overstated and expenses understated. In addition, as the senior management bonus is based on year-end asset values, this increases this risk further as management may have a reason to overstate assets at the year end.	Obtain a breakdown of the expenditure and verify that it relates to the development of the new products. Undertake testing to determine whether the costs relate to the research or development stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.
In September 2015, the company invested \$0·9 million in a complex piece of plant and machinery. The costs include purchase price, installation and training costs. As per IAS 16 Property, Plant and Equipment, the cost of an asset incudes its purchase price and directly attributable costs only. Training costs are not permitted under IAS 16 to be capitalized as part of the cost and therefore plant and machinery and profits are overstated.	Obtain a breakdown of the \$0·9 million expenditure and undertake testing to confirm the level of training costs which have been included within non-current assets. Discuss the accounting treatment with the finance director and the level of any necessary adjustment to ensure treatment is in accordance with IAS 16.
The bonus scheme for senior management and directors of Sitia Sparkle Co has been changed; it is now based on the value of year-end total assets. There is a risk that management might be motivated to overstate the value of assets through the judgements taken or through the use of releasing provisions or capitalization policy.	Throughout the audit, the team will need to be alert to this risk and maintain professional skepticism. Detailed review and testing on judgmental decisions, including treatment of provisions, and compare treatment against prior years. Any manual journal adjustments affecting assets should be tested in detail.

	In addition, a written representation should be obtained from management confirming the basis of any significant judgements.
The finance director of Sitia Sparkle Co believes that an allowance for receivables is excessive and unnecessary and therefore has not provided for it at the year end and has credited the opening balance to profit or loss. There is a risk that receivables will be overvalued; some balances may be irrecoverable and so will be overstated if not provided for.	Review and test the controls surrounding how Sitia Sparkle Co identifies receivables balances which may require a provision to ensure that they are operating effectively in the current year. Discuss with the finance director the rationale for not maintaining an allowance for receivables and releasing the opening provision.
In addition, releasing the allowance for receivables will increase asset values and hence the senior management bonus which increases the risk further.	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.
A new general ledger system was introduced in May 20X6 and the old and new systems were run in parallel until August 2016.	The auditor should undertake detailed testing to confirm that all of the balances at the transfer date have been correctly recorded in the new general ledger system.
There is a risk of the balances in May being misstated and loss of data if they have not been transferred from the old system completely and accurately. If this is not done, this could result in the auditor not identifying a significant control risk. In addition, the new general ledger system will require documenting and the controls over this will need to be tested.	The auditor should document and test the new system. They should review any management reports run comparing the old and new system during the parallel run to identify any issues with the processing of accounting information.
A number of reconciliations, including the bank reconciliation, were not performed at the year end, however, they were undertaken in June and August. Control account reconciliations provide comfort that accounting records are being maintained completely and accurately. At the year end, it is important to confirm that balances including bank balances are not under or overstated. This is an example of a control procedure being overridden by management and raises concerns over the overall emphasis placed on internal control.	Discuss this issue with the finance director and request that the July control account reconciliations are undertaken. All reconciling items should be tested in detail and agreed to supporting documentation.

The purchase ledger of Sitia Sparkle Co was closed down on 8 August, rather than at the year end 31 July. There is a risk that the cut-off may be incorrect with purchases and payables over or understated.	The audit team should undertake testing of transactions posted to the purchase ledger between 1 and 8 August to identify whether any transactions relating to the 2017 year end have been included or any 2016 balances removed.

Question 04

You are an audit supervisor of Amethyst & Co and are currently planning the audit of your client, Aquamarine Co (Aquamarine) which manufactures elevators. Its year end is 31 July 2016 and the forecast profit before tax is $15·2 million.

The company undertakes continuous production in its factory, therefore at the year end it is anticipated that work in progress will be approximately $950,000. In order to improve the manufacturing process, Aquamarine placed an order in April for $720,000 of new plant and machinery; one third of this order was received in May with the remainder expected to be delivered by the supplier in late July or early August.

At the beginning of the year, Aquamarine purchased a patent for $1·3 million which gives them the exclusive right to manufacture specialized elevator equipment for five years. In order to finance this purchase, Aquamarine borrowed $1·2 million from the bank which is repayable over five years.

In January 2016 Aquamarine outsourced its payroll processing to an external service organization, Coral Payrolls Co (Coral). Coral handles all elements of the payroll cycle and sends monthly reports to Aquamarine detailing the payroll costs. Aquamarine ran its own payroll until 31 December 2015, at which point the records were transferred over to Coral.

The company has a policy of revaluing land and buildings and the finance director has announced that all land and buildings will be revalued at the year end. During a review of the management accounts for the month of May 2016, you have noticed that receivables have increased significantly on the previous year end and against May 2015.

The finance director has informed you that the company is planning to make approximately 65 employees redundant after the year end. No decision has been made as to when this will be announced, but it is likely to be prior to the year end.

Required:

(a) Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Aquamarine Co. (12 marks)

ANSWER

Audit Risk	Response
Aquamarine Co (Aquamarine) undertakes continuous production and the work in progress balance at the year end is likely to be material. As production will not cease, the exact cut-off of the work in progress will need to be assessed. If the cut-off is not correctly calculated, the inventory valuation may be under or over stated.	The auditor should discuss with management the process they will undertake to assess the cut-off point for work in progress at the year end. This process should be reviewed by the auditor while attending the year-end inventory count. In addition, consideration should be given as to whether an independent expert is required to value the work in progress. If so, this will need to be arranged with consent from management and in time for the year-end count.
Aquamarine has ordered $720,000 of plant and machinery, two-thirds of which may not have been received by the year end. Only assets which physically exist at the year end should be included in property, plant and equipment. If items not yet delivered have been capitalised, PPE will be overstated. Consideration will also need to be given to depreciation and when this should commence. If depreciation is not appropriately charged when the asset is available for use, this may result in assets and profit being over or understated.	Discuss with management as to whether the remaining plant and machinery ordered have arrived; if so, physically verify a sample of these assets to ensure existence and ensure only appropriate assets are recorded in the non-current asset register at the year end. Determine if the asset received is in use at the year end by physical observation and if so, if depreciation has commenced at an appropriate point.
A patent has been purchased for $1·3 million, and this enables Aquamarine to manufacture specialised elevator equipment for the next five years. In accordance with IAS 38	The audit team will need to agree the purchase price to supporting documentation and to confirm the useful life is five years.
Intangible Assets, this should be included as an intangible asset and amortised over its five-year life. If management has not correctly accounted for the patent, intangible assets and profits could be overstated.	The amortization charge should be recalculated in order to ensure the accuracy of the charge and that the intangible is correctly valued at the year end.
The company has borrowed $1·2 million from the bank via a five-year loan. This loan needs to be correctly split between current and non-current liabilities in order to ensure correct disclosure.	During the audit, the team would need to confirm that the $1·2 million loan finance was received. In addition, the split between current and non-current liabilities and the disclosures for this loan should be reviewed in detail to ensure compliance with

	relevant accounting standards. Details of security should be agreed to the bank confirmation letter.
Also, as the level of debt has increased, there should be additional finance costs. There is a risk that this has been omitted from the statement of profit or loss leading to understated finance costs and overstated profit.	The finance costs should be recalculated and any increase agreed to the loan documentation for confirmation of interest rates. Interest payments should be agreed to the cash book and bank statements to confirm the amount was paid and is not therefore a year-end payable
During the year Aquamarine outsourced its payroll processing to an external service organization. A detection risk arises as to whether sufficient and appropriate evidence is available at Aquamarine to confirm the completeness and accuracy of controls over payroll. If not, another auditor may be required to undertake testing at the service organization	Discuss with management the extent of records maintained at Aquamarine and any monitoring of controls undertaken by management over the payroll charge. Consideration should be given to contacting the service organization's auditor to confirm the level of controls in place.
The payroll processing transferred to Coral Payrolls Co from 1 January. If any errors occurred during the transfer process, these could result in the payroll charge and related employment tax liabilities being under/overstated.	Discuss with management the transfer process undertaken and any controls put in place to ensure the completeness and accuracy of the data. Where possible, undertake tests of controls to confirm the effectiveness of the transfer controls. In addition, perform substantive testing on the transfer of information from the old to the new system.
The land and buildings are to be revalued at the year end; it is likely that the revaluation surplus/deficit will be material. The revaluation needs to be carried out and recorded in accordance with IAS 16 Property, Plant and Equipment, otherwise non-current assets may be incorrectly valued.	Discuss with management the process adopted for undertaking the valuation, including whether the whole class of assets was revalued and if the valuation was undertaken by an expert. This process should be reviewed for compliance with IAS 16.
Receivables for the year to date are considerably higher than the prior year. If this continues to the year end, there is a risk that some receivables may be overvalued as they are not recoverable	Discuss with management the reasons for the increase in receivables and management's process for identifying potential irrecoverable debt. Test controls surrounding management's credit control processes. Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation.

	Also consider the adequacy of any allowance for receivables.
Aquamarine is planning to make approximately 65 employees redundant after the year end. The timing of this announcement has not been confirmed; if it is announced to the staff before the year end, then under IAS 37 Provisions, Contingent Liabilities and Contingent Assets a redundancy provision will be required at the year end. Failure to provide will result in an understatement of provisions and expenses.	Discuss with management the status of the redundancy announcement; if before the year end, review supporting documentation to confirm the timing. In addition, review the basis of and recalculate the redundancy provision.

Question 05

You are an audit supervisor of Pluto & Co and are currently planning the audit of your client, Venus Magnets Co (Venus) which manufactures decorative magnets. Its year end is 31 December 2015 and the forecast profit before tax is $9·6 million.

During the year, the directors reviewed the useful lives and depreciation rates of all classes of plant and machinery. This resulted in an overall increase in the asset lives and a reduction in the depreciation charge for the year.

Inventory is held in five warehouses and on 28 and 29 December a full inventory count will be held with adjustments for movements to the year end. This is due to a lack of available staff on 31 December. In October, there was a fire in one of the warehouses; inventory of $0·9 million was damaged and this has been written down to its scrap value of $0·2 million. An insurance claim has been submitted for the difference of $0·7 million. Venus is still waiting to hear from the insurance company with regards to this claim, but has included the insurance proceeds within the statement of profit or loss and the statement of financial position.

The finance director has informed the audit manager that the October and November bank reconciliations each contained unreconciled differences; however, he considers the overall differences involved to be immaterial.

A directors' bonus scheme was introduced during the year which is based on achieving a target profit before tax. In order to finalise the bonus figures, the finance director of Venus would like the audit to commence earlier so that the final results are available earlier this year.

Required:

Describe FIVE audit risks, and explain the auditor's response to each risk, in planning the audit of Venus Magnets Co.

Audit Risk	Response
The directors have reviewed the asset lives and depreciation rates of plant and machinery, resulting in the depreciation charge reducing. Under IAS 16 Property, Plant and Equipment, asset lives should be reviewed annually, and if the asset lives have increased as a result of this review such that the depreciation decreases, then this change may be reasonable. However, there is a risk that this reduction has occurred in order to achieve profit targets, due to the introduction of the bonus system. If this is the case, then plant and machinery is overvalued and profit overstated.	Discuss with the directors the rationale for any extensions of asset lives and reduction of depreciation rates. The revised useful life of a sample of assets should be compared to how often these assets are replaced, as this provides evidence of the useful life of assets.

Due to staff availability, the company is planning to undertake a full year-end inventory count days before the year end and then adjust for movements to the year end. If the adjustments are not completed accurately, then the year-end inventory could be under or overstated.	During the final audit the year-end inventory adjustments schedule should be reviewed in detail and supporting documentation obtained for all adjusting items. The audit team should increase the extent of inventory cut-off testing at the year end.
In October, a fire damaged inventory such that it has been written down from \$0·9m to \$0·2m which is its scrap value. This write down should have been charged to profit or loss. If the goods remain unsold after the year end, there is the risk that the scrap value is overstated and inventory overvalued.	Discuss with management the basis of the \$0·2m scrap value attributed. Review whether any of the goods were sold pre or post year end and at what value; this should assess whether the attributed scrap value is reasonable. If none have been sold, discuss with management the possibility of further write downs.
An insurance claim for \$0·7m has been submitted and the proceeds included within profit or loss. However, the company has not received a reply from the insurance company and this would therefore represent a possible contingent asset. To comply with IAS 37 Provisions, Contingent Liabilities and Contingent Assets, this should not be recognized until the receipt is virtually certain. With no response to date, the inclusion of this sum overstates profit and receivables.	Discuss with management whether any response has been received from the insurance company and review the related correspondence. If virtually certain, the treatment adopted is correct. If not, management should be requested to remove it from profit and receivables. If the receipt is probable, the auditor should request management include a contingent asset disclosure note.
The bank reconciliations for October and November both contain unreconciled amounts, and the finance director believes the overall differences to be immaterial. Errors in bank reconciliations could actually represent large errors which net off to a small amount. If the differences are not fully reconciled, it could result in bank balances being under or overstated. In addition, unreconciled amounts in the bank could have arisen due to fraud.	Discuss this issue with the finance director and request that the December reconciliation is fully reconciled. The reconciling items should be tested in detail and agreed to supporting documentation. Throughout the audit, the team should be alert to the risk of fraud and maintain professional skepticism.
A directors' bonus scheme was introduced which is based on achieving a target profit before tax. There is a risk the directors might feel under pressure to manipulate	Throughout the audit, the team will need to be alert to this risk and maintain professional skepticism. Detailed review and testing on judgmental decisions, including treatment of

the results through the judgements taken or through the use of provisions.	provisions, and compare treatment against prior years. Any journal adjustments affecting profit should be tested in detail. In addition, a written representation should be obtained from management confirming the basis of any significant judgements.
The finance director has requested that the audit commence earlier than normal as he wishes to report results earlier. A reduction in the audit timetable will increase detection risk and place additional pressure on the team in obtaining sufficient and appropriate evidence. In addition, the finance team will have less time to prepare the financial information leading to an increased risk of errors arising in the financial statements.	The timetable should be confirmed with the finance director. If it is to be reduced, then consideration should be given to performing an interim audit in late December or early January; this would then reduce the pressure on the final audit. The team needs to maintain professional skepticism and be alert to the increased risk of errors occurring.

Question 06

You are the audit supervisor of Maple & Co and are currently planning the audit of an existing client, Sycamore Science Co (Sycamore), whose year-end was 30 April 2015. Sycamore is a pharmaceutical company, which manufactures and supplies a wide range of medical supplies. The draft financial statements show revenue of $35·6 million and profit before tax of $5·9 million.

Sycamore's previous finance director left the company in December 2014 after it was discovered that he had been claiming fraudulent expenses from the company for a significant period of time. A new finance director was appointed in January 2015 who was previously a financial controller of a bank, and she has expressed surprise that Maple & Co had not uncovered the fraud during last year's audit.

During the year Sycamore has spent $1·8 million on developing several new products. These projects are at different stages of development and the draft financial statements show the full amount of $1·8 million within intangible assets. In order to fund this development, $2·0 million was borrowed from the bank and is due for repayment over a ten-year period. The bank has attached minimum profit targets as part of the loan covenants

The new finance director has informed the audit partner that since the year end there has been an increased number of sales returns and that in the month of May over $0·5 million of goods sold in April were returned. Maple & Co attended the year-end inventory count at Sycamore's warehouse. The auditor present raised concerns that during the count there were movements of goods in and out the warehouse and this process did not seem well controlled. During the year, a review of plant and equipment in the factory was undertaken and surplus plant was sold, resulting in a profit on disposal of $210,000.

Required:

Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Sycamore Science Co. (12 marks)

ANSWER

Audit Risk	Response
Sycamore's previous finance director left in December after it was discovered that he had been committing fraud with regards to expenses claimed. There is a risk that he may have undertaken other fraudulent transactions; these would need to be written off in the statement of profit or loss. If these have not been uncovered, the financial statements could include errors	Discuss with the new finance director what procedures they have adopted to identify any further frauds by the previous finance director. In addition, the team should maintain their professional skepticism and be alert to the risk of further fraud and errors.
The new finance director was appointed in January 2015 and was previously a financial controller of a bank. Sycamore is a pharmaceutical company which is very different to a bank; there is a risk that the new finance director is not sufficiently competent to prepare the financial statements, leading to errors.	During the audit, careful attention should be applied to any changes in accounting policies and in particular any key judgmental decisions made by the finance director
During the year, Sycamore has spent $1·8 million on developing new products; these are at different stages and the total amount has been capitalized as an intangible asset. However, in order to be capitalized it must meet all of the criteria under IAS 38 Intangible Assets. There is a risk that some projects may not reach final development stage and hence should be expensed rather than capitalized. Intangible assets and profit could be overstated.	A breakdown of the development expenditure should be reviewed and tested in detail to ensure that only projects which meet the capitalization criteria are included as an intangible asset, with the balance being expensed.
Sycamore has borrowed $2·0 million from the bank via a ten-year loan. This loan needs to be correctly split between current and non-current liabilities in order to ensure correct disclosure	During the audit, the team would need to confirm that the $2·0 million loan finance was received. In addition, the split between current and non-current liabilities and the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards.
Also as the level of debt has increased, there should be additional finance costs. There is a risk that this has been omitted from the statement of profit or loss, leading to understated finance costs and overstated profit.	The finance costs should be recalculated and any increase agreed to the loan documentation for confirmation of interest rates and cashbook and bank statements to confirm the amount was paid and is not therefore a year-end payable.

The loan has a minimum profit target covenant. If this is breached, the loan would be instantly repayable and would be classified as a current liability. If the company does not have sufficient cash flow to meet this loan repayment, then there could be going concern implications. In addition, there is a risk of manipulation of profit to ensure that covenants are met.	Review the covenant calculations prepared by Sycamore and identify whether any defaults have occurred; if so, determine the effect on the company. The team should maintain their professional skepticism and be alert to the risk that profit has been overstated to ensure compliance with the covenant.
There have been a significant number of sales returns made subsequent to the year end. As these relate to pre year-end sales, they should be removed from revenue in the draft financial statements and the inventory reinstated. If the sales returns have not been correctly recorded, then revenue will be overstated and inventory understated.	Review a sample of the post year-end sales returns and confirm if they relate to pre year-end sales, that the revenue has been reversed and the inventory included in the year-end ledgers. In addition, the reason for the increased level of returns should be discussed with management. This will help to assess if there are underlying issues with the net realizable value of inventory.
During Sycamore's year-end inventory count there were movements of goods in and out. If these goods in transit were not carefully controlled, then goods could have been omitted or counted twice. This would result in inventory being under or overstated.	During the final audit, the goods received notes and goods dispatched notes received during the inventory count should be reviewed and followed through into the inventory count records as correctly included or not.
Surplus plant and equipment was sold during the year, resulting in a profit on disposal of $210,000. As there is a minimum profit loan covenant, there is a risk that this profit on disposal may not have been correctly calculated, resulting in overstated profits.	Recalculate the profit and loss on disposal calculations and agree all items to supporting documentation
In addition, significant profits or losses on disposal are an indication that the depreciation policy of plant and equipment may not be appropriate. Therefore, depreciation may be overstated.	Discuss the depreciation policy for plant and equipment with the finance director to assess its reasonableness.

Question 07

You are the audit senior of Rhino & Co and you are planning the audit of Kangaroo Construction Co (Kangaroo) for the year ended 31 March 2013. Kangaroo specializes in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts: Kangaroo has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge. The directors need to meet a target profit before interest and taxation of $0·5 million in order to be paid their annual bonus. In addition, to try and improve profits, Kangaroo changed their main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To help with operating cash flow, the directors borrowed $1 million from the bank during the year. This is due for repayment at the end of 2013.

Financial statement extracts for year ended 31 March	
	DRAFT
	2013
	$
Revenue	12.5
Cost of sales	(7.0)
Gross profit	5.5
Operating expenses	(5.0)
Profit before interest and taxation	0.5
Inventory	1.9
Receivables	3.1
Cash	0.8
Trade payables	1.6
Lone	1.0

Required:

Using the information above:

(i) Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit; and (5 marks)

(ii) Using the information provided and the ratios calculated, identify and describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Kangaroo Construction Co.(10 marks)

ANSWER

(i) Ratios Ratios to assist the audit supervisor in planning the audit:

	2013	2012
Gross margin	5·5/12·5 = 44%	7/15 = 46·7%
Operating margin	0·5/12·5 = 4%	1·9/15 = 12·7%
Inventory days	1·9/7 * 365 = 99 days	1·4/8 * 365 = 64 days
Inventory turnover	7/1·9 = 3·7	8/1·4 = 5·7
Receivable days	3·1/12·5 * 365 = 91 days	2·0/15 * 365 = 49 days
Payable days	1·6/7 * 365 = 83 days	1·2/8 * 365 = 55 days
Current ratio	5·8/2·6 = 2·2	5·3/1·2 = 4·4
Quick ratio	(5·8 – 1·9)/2·6 = 1·5	(5·3 – 1·4)/1·2 = 3·3

(ii) Audit risks and responses

Audit Risk	Response
Receivable days have increased from 49 to 91 days and management has significantly extended the credit terms given to customers. This leads to an increased risk of recoverability of receivables as they may be overvalued.	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation.
Due to the fall in demand for Kangaroo Construction Co's (Kangaroo) houses, there are some houses where the selling price may be below cost. IAS 2 Inventories requires that inventory should be stated at the lower of cost and NRV. In addition, inventory days have increased from 64 to 99 days and inventory turnover has fallen from 5·7 in 2012 to 3·7 in the current year. There is a risk that inventory is overvalued.	Detailed cost and net realizable value (NVR) testing to be performed and the aged inventory report to be reviewed to assess whether inventory requires writing down.
The directors have extended the useful lives of plant and machinery from three to five years, resulting in the depreciation charge reducing. Under FRS 16 Property, Plant and Equipment, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable. However, there is a risk that this reduction has occurred in order to achieve profit	Discuss with the directors the rationale for extending the useful lives. Also, the five year life should be compared to how often these assets are replaced, as this provides evidence of the useful life of assets.

targets. If this is the case, then plant and machinery is overvalued and profit overstated.	
The directors need to reach a profit level of $0·5 million in order to receive their annual bonus. There is a risk that they might feel under pressure to manipulate the results through the judgements taken or through the use of provisions	Throughout the audit, the team will need to be alert to this risk and maintain professional skepticism. They will need to carefully review judgmental decisions and compare treatment against prior years. In addition, a written representation should be obtained from management confirming the basis of any significant judgements.
Due to a change in material supplier, the quality of products used has deteriorated and this has led to customers claiming on their five-year building warranty. If the overall number of people claiming on the warranty is likely to increase, then the warranty provision should possibly be higher. If the directors have not increased the level of the provision, then there is a risk the provision is understated.	Review the level of the warranty provision in light of the increased level of claims to confirm completeness of the provision.
Kangaroo has borrowed $1·0m from the bank via a short-term loan. This loan needs to be repaid in 2013 and so should be disclosed as a current liability. In addition, Kangaroo may have given the bank a charge over its assets as security for the loan. There is a risk that the disclosure of any security given is not complete.	During the audit, the team would need to check that the $1·0m loan finance was received. In addition, the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards and legislation. The loan correspondence should be reviewed to ascertain whether any security has been given, and this bank should be circularized as part of the bank confirmation process.
The current and quick ratios have decreased from 4·4 to 2·2 and 3·3 to 1·5 respectively. In addition, the cash balances have decreased over the year, there is a fall in demand and Kangaroo have taken out a short-term loan of $1 million, which needs to be repaid in 2013. Although all ratios are above the minimum levels, this is still a significant decrease and along with the fall in both operating and gross profit margins, as well as the significant increase in payable	Detailed going concern testing to be performed during the audit and discussed with the directors to ensure that the going concern basis is reasonable. The team should discuss with the directors how the short-term loan of $1·0 million will be repaid later in 2013.

days could be evidence of going concern difficulties.	