Q1

to: ted hastings

from: audit manager

date: 1 July 20x5

subject: audit planning -Mercurio co

introduction

the brief note has been perpared to assess in audit planning for the year end 30 september 20x5. the business risks and risk of material misstatement are evaluated in the note.the note then go on th discuss and conclude on the impact which outsourcing the credit control funstion will have on our audit planning. and finally design the principal audit procedures of the holiday pay obligation.

(a)business risk

1. unusual pets

some stores of M sell unusual pets, and required compliance withe specific import restrictions and welfare standard. the staff shoudl be trained to learn those specific regulations, if not do so, and caused breach some regulation.

there is business risk of ruin the M co’s reputation and cased bad publicity. further profit and sales would be reduced.

1. vaccinations and health check

the cost of vaccinations and health check has increased over recent years, but the price can’t increased due to customer price sensitivity. it is a operating problems , which would caused a risk of profit suffered. if it more serious, it would case drain cash flow.

1. expanding into new location

M purchase the stores which cost $171m and used their cash reserves to expand in a new location. M co is lack of the staff who have the local law and policy knowledge, which have a risk of non-compliance. and the expansion may not successful, so there is a risk of reducing return of investment and further drain cash flow.

1. bank loan

there is a financing pressure for M to get additiaonl bank loan.

as the increasing gearing ratio and current ratio, M may breach the covenants of the bank.

bank recall the loan if the covenants are breached. and M unlikely to be able to repay. it would cause a cash flow problem.

(b)materiality

the overall following materiality is used to assess the significance of identified risks and based on the PBT.

benchmarks

5%-10% of PBT=a range of $3M-$6M

the materiality is just a starting point during audit planning and professional judgement need to be applied.

M is a listed company and have a expanision plan , which shows a higher level of risk of material misstatement, so the lower materiality level($6m) should be chosen.

1. revenue recognise

revnue of vaccinations and health check accountes for 10% of the co’s revenue, so it is material.

revenue should be recognsied when the professional obligation is satisfied. if the contract is satisfied overtime, revenue should be recognised as the progress .if the contract is satisfied overtime, revenue should be recognised as control is transfered.

M co’s accountign policy is to recognsie the revenue when the plan commences, but at that time the performace obligation hasn’t be satisfied.

there is a risk of overstated revenue understated liability.

there is a mgt bias which is try to overstated the revenue to show a good profitability to bank, and then get the additiaonal bank loan

1. unusual trend

the increasng rate of revenue is 7.78%, and the increasing rate of operaing profit is 56.36%.

it is an unusual trend becasue normally, the increasing rate of revenue and operating profit almost the same. there is a risk of overstated operating profit and understated expense.

M try to have additional bank loan, but current gearing ratio is increased to 31%. so try to get a bank loan, mgt may have the motivation of overstated profit. and take some earning management.

1. TR

the tr is $42m, so the trade receivable is material.

if there is probable the TR not be recovered, allowance should be recognised.

the TR increased significantly, the increasing rate is 91%. it caused a higher risk of the TR can’t be recovered at full amount. so M need to recognsied allowance for TR, but there isn’t information of allowance. there is a risk of overstated TR and understated allowance.

1. valuation of goods

the $12m of pet food is material to the financial statement

the inventory’s recoverable amount less than the carrying amount in the financial statement. the impairment loss should be recognsied at profit or loss.

the goods was involved in an accident and was destoryed the entire supply of goods.

it is an impairment indicator, so the value of the goods should be impaired and the impairment loss should be recognised, because the ownership of the goods has transfered

there is a risk of overstated profit and overstated inventory.

1. insurance

the value of 80% of the destroyed goods (0.8\*12=9.6m)is material

if the insurance is probable received and the amount can be estimated reliably, contingent asset can be recognised and it required a adequately disclosure in the note.

tje insurance company has just provided an informal email, so insurance is not probable to be received, so the insurance can’t recognised in a financial statemetn.

there is a risk of overstated contingent asset and inadequate disclosure.

1. holiday

the holiday obligation is 21.1m and material to the financial statement.

the annual salary is 21.1m/7000=3014$ per day, so there is a risk of overstated the expense and the holiday pay obligation.

conclusion:

the risk has been prioritised in respect of the magnitude and likelihood of the issue.

the revenue recognsied of the health plan is the most significant risk becasue of its is the 10% of the total revenue.

(c)

outsourcing is when certain functions within a business are contracted out to service organisations.

if the client use the services of a service organisation, including following matters

the nature of the service procided by the service organisation and the significance of those services to teh audited entity.

teh nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation

the degree of interaction between the activities of the services organisation and those of the audit entity

the nature of the relationshop between the audited entity and the service organisation.

bacause and risk of material misstatement creased by the use of the service organisation can identified and and appropriate response planned.

auditor is required to evaluate the design and implementation of relevant controls .

information should be available from the audited entity to enable to understand the competence and independence of the service organisation

auditor decide to contract the service organisation to request specific information, to visit the service organistion and perform procedures.

(d)

obtain the contract with employees to confirm the number of carry forward paid absence days

discuss with management to ensure the reason of why the recording holidays taken by staff.

recalculate the holiday pay obligation to agree the amount to the financial statement.

review the list of employees from human resources department to agree the number of staff changed in the payroll system.

discuss with management after merging the full-time and part-time staff recording, how to treat and calculate different salary to them to agree with the amount in financial statement.

Q2

(a)

**integrity**

G will required to perform customer due diligence(cdd) to understand the identify and business reputation of K’s principle owners, key management and TCWG.

G should also consider whether there are any indicator of money laundering.

G should consider the reason why K didn’t use its audit firm to make the assurance report and the potential management bias

in order to provide an assurance report, G should understand the K co and its business is required which the current audit firm will usually have.

the different firm may be difficult to challenge the assumption in the capital expenditure forecast.

G should be given permission by K to contract its auditors. if permission is not give, the appointment should not be accepted.

the forecast is prepared to get a bank loan, so the management of K may have a incentive to overstated the performance.

**competence**

before accepting engagement, G should consider whether the staff have enough experience and skills to make an assurance for K co.

there are time pressure, due to K want to get the report as soon as possible and before october 20x5. and G should consider whether other resources are available and sufficient.

**ethical issue**

because K co is a new client for G, so the independence hasn’t be considered previously. and the objectivity is the important principle to be assessed.

whether there are any conflict of interest between K co and any existing companies. if the conflicts exist, G should notify both clients and the safeguards.

**PFI**

G should consider the intended users and distribution of the assurance report. if the report is distributed generally, there is more risk to be assessed.

**conclusion**

if there are no specific issue with respect to the objectiviey and incentive of money laundering, the engagement should be accepted.

(b)

obtain the legal documentation to confirm the legal fee agreed to the amount in the capital expenditure forecast.

review the cash book to agree with the amount of building work payment.

discuss with the management to understand the assumption of the forecast, including the price and cost arised from the building work.

recalculate the total amount of the 2 years forecast to confirm the mathematical accuracy.

obtain the written representation from management to ensure the assumption and all the information is reliable.

review the board minutes to understand situation of the construction of planned distribution center subject

obtain the breakdown of the total cost relating to interior fittings and refurbishment, to confirm the capitaled and expensed cost is correctly recorded.

Q3

(a)

i lease

matters

the depreciation should be charged as 28.9/7=4.1m, more than the materiality $1.1m, so the misstatement is material to the financial statement.

depreciation of RUA should be charged over the full rent periods, even free-rental period.

the depreciation error cause the RUA overstated and expense understated.

there may be management bias on the incorrect depreciation charging method due to a desire to manipulate profit.

evidence

written representation from managment to confirm the determination of the effective implicit interest rate is reasonable.

copy of the lease contract to agree the lease period, free-rental terms and the rental payment to support the amounts calculation of lease liability and RUA

recalculation the lease liability and RUA provided by management to confirm the accuracy of the fingers

evidence of physical inspection and the title deeds to confirm the existence of the new property and the ownership of the property

ii inventory

matters

M should return of the product when suppliers required at any time, so M didn’t have the control of products. as a result, the value of $8.1m should be included in inventory. the transaction is consignment.

the misstatement of $8.1m is more than materiality $1.1m, so it is a material misstatement.

it cause overstated inventory and understated liability.

evidence

copy of the contract with suppliers to confirm the terms of return products to support the transaction is consignment goods.

the evidence of physical inspection to ensure the existence of the products and agree with the received goods record.

review the cash book to agree the value of the products recorded.

(b)

the lease and inventory misstatement are all more than the materiality level, so the misstatements are material.

if the misstatement related more than one element of financial statement or the amount is a substantial proportation of financial statement, the misstatements are pervasive.

in the case, neither of the criteria are met, so the misstatement is not pervasive.

the aggregate misstatements are material but not pervasive to financial statement.

a qualified opinion on the basis of material misstatement should be given

the report should include a heading “qualified opinion”, states that expect the matter described in the basis for qualified opinion paragraph, the financial statement is true and fair view.

the basis for qualified opinion paragraph, which should be placed after the qualified opinion, should describe the material misstatement relating to lease and inventory.