Q1

To Ted Hastings, audit engagement partner

From: Audit manager

Subject: Audit planning of Mercurio Co

Date: 2 July 20X5

Mercurio Co is a listed company, which has been grown steadily for a long time. This year, the company has significant financial risks, and the going concern problem should be considered. The Compliance risk of selling unusual pets, Operational risks of unprofitable veterinary clinics services and the Operational risks of damaged inventory are also existed.

The material misstatements include fraud risk of recognisation of revenue, weak internal control, wrong classification of Property,and insufficient of disclosures.The materiality will be set as 1%, which will be 60\*1%=6millions. The planning also focus on the outsourcing and the holiday payment obligations.

1. Compliance risk of selling unusual pets

Selling unusual pets requires compliance with specific import restrictions and welfare standards, it will cost more when the company obey the laws, including training staffs about these rules and designing related internal control policies or procedures for preventing this company from breaking the laws. Once the company break these rules ,there may be penalty which cause reputation problems, even more these stores may be closed by regulations. At last, the revenue and profit will be decreased.

Operational risks of unprofitable veterinary clinics services

The veterinary clinics services need fully qualified vets within most of its stores, so the company should have many qualified vets and train them a lot every year. The management expense will be high and can not be reduced within operational activities. At the same time, the customers are price sensitive, low price causes low revenue. Both factors cause the services could be unprofitable, and the service is popular in customers which means the company will damage the reputation once if the services are closed. So the low profit or even loss problems can not be solved. Eventually it may causes cash flow problem.

The operational risks of inventory damaged

The 12million of inventory have been damaged, it will cause the company lack of inventory to sell. There is risk of damage reputation and loss customers. And the loss of inventory is material to the company, the company may have no money to purchase more before getting the insurance, and cause the going concern problem. Otherwise, the company may involve into a legal case with the transition company and the insurance company ,which wil increase the legal fees and further decrease the profit.

Financial risks of high gearing ratios and increasing Bank loans

The gearing ratio is 31%, increasing by (31%-11%)/11%=181.82%，the bank loan increased by 251-75=176 millions。The financial cost will be high, and causes the lower profit. And then the cash flow will be not sufficient. This year, the revenue is increasing by (803-745)/745=7.79%，but the cash is decreasing by -(36-81)/81=55.56%，the bank loan increased by 251-75=176 millions. Assuming the average profit before Tax will be 60 millions, it still takes the company at least 3 years to pay all loans back. There is a risk that the company can not pay the loan on time will may cause going concern problem.

unsufficient cash flows and going concern problems

Besides the risks of going concern caused by bank loans and high gearing ratios, the company need 9\*20=180millions to refit the stores purchased from Lakwell Co. the company can afford that much money to do this activity. it borrows more money, the financial cost will be more, and the company will have less cash flow to face expanding risks.

1. recognisation of revenue

the revenue should be recognized when the control of goods and services have been transferred according to IFRS15. The revenue is recognized over time when the customers control and consume the services at the same time. The healthcare plan may last for a long time and including several stages. While the healthcare is provided, the customers will control the services and consume the benefit from the service, so the company may recognize the revenue earlier than it should be. It should be recognized after every single stages of services have been finished. There is the risk of overstating the revenue and the profit. It also breaks the cut off assertion. The company is listed and is asking for more finance. A good performance will be needed. So there is management bias to overstate the revenue. There may be fraud risk in financial statement.

Wrong classification of PPE and held-for-sale

The assets may be classified into held-for-sale if it satisfied the criterias: the management plans to sell the assets in less one year, and the assets are probable sold in their present condition. the management plans should be approved and located to buyers. The assets should be identified and the market price should be identified, too.

The company has not decided how many of the stores will be sold, so there is not a plan yet. but there is a risk of Wrong classification of PPE and held-for-sale when the plans have been published.

Unsufficeint disclosure of events after the reporting dates

Events after the reporting dates includes adjust ones and non-adjust ones. non-adjust Events after the reporting dates should be disclosed and the nature and estimate amount of the events should be included. The stores will be refitted after the reporting dates and this are not related with the past events before the the reporting dates. It is a non-adjust Events after the reporting date. The amount is 9\*20=180 millions which is material to the company, there is a risk of unsufficeint disclosure of events after the reporting dates. Which may decrease the reliable for the users because of the misstatements

Weak internal control of credit risks

The credit control function has been provided from the third party. There is risks that the company can not know the credit control information and their customers directly. The forecast trade receivables may be wrong. There is risks of ovestating the trade receivables because the trade receivables have been received by the third party. And the risks of understating the trade receivables because trade receivables should have been impaired after the 60’s credit days.

Wrong holidays pay obligation

There is control risks of holidays pay obligation record system. Some employees are duplicated on the payroll system and the holidays recordings always are manual instead of the system. There is the risks that the holiday recordings have been missed and the employees take more holidays. There is risk that the staff cost may be overstated due to the data is wrong.The employees are increasing by (7000-6200)/6200=12.90%，and the holidays pay obligation increased by (21.1-11.6)/11.6=81.90%。 the trend does not match, there is risk that the holidays pay obligation is overstated and the profit has been understated.

Overstate the damaged inventory and understate the impairment

The inventory should be at the lower of cost and the net relieased value. The net relieased value should be the fair value less cost to sell. The 80% of inventory 12\*80%=9.6million have been damaged, should be written down to inventory and the loss should be recoganized. The 20% of inventory may be influenced, too. The customer may know the news and do not willing to buy these inventory. The price may be decrease and the cost to sell may increase, there may be risk that the impairment has been understated and the profit has been overstated.

Overstate the contingent assets

The contingent assets should be recoganized only when the receivables are highly probable obtained. The email from the insurance company is informal, it is not highly probable, there is a risk of overstating the contingent assets

1. understanding the service of the outsourcing

the credit control function is provided by third party, audit team should understand what procedures the third party performed, what information the third party got, what action the third party will take to solve the credit problem and so on. The understanding will influence the scope of the audit. if the control is not enough, the risk of credit will be high, the audit team should perform more audit procedures on Trade receivables.

understanding the relationship between the company and the outsourcing

if the company can control the function and get the information easily, the audit team may get sufficient evidence from the third party, otherwise, there may limitation of evidence. The audit team should assess whether the other procedures are enough, there may influence the opinion of report. It more likely is qualified opinion “except for”

Discuss with or ask for the audit team of third party

Discuss with management if there is an audit team of third party, discuss with the team when the management and third party approve. If it is possible, ask for Type 2 report to confirm the effectiveness of control in third party

Written representation from management

Clearifying the responsibility of management on outsourcing, it is still their responsibility to make sure the trade receivables are correct.

(d)

Asking for holidays pay obligation calculation memo from management

Reviewing the calculation memo and check the reasonableness of assumptions and the data.

Recalculating the holidays pay obligation

 According to the assumption made by management, recalculate the holidays pay obligation in case there are mathmetical misstatement.

Enquire with management and the related employees

Enquire with management about the policies and check if it is fit with the calculation. Enquire with related employees about how they collect the data used in calculation and check whether there are fraud or wrong.

Inspect the initial records of holidays pay obligation

Inspect the initial records in order to find whether there are any changes and unreasonableness.

Analysising procedures

Comparing with prior years, if the trend is significant, it may indicate there are misstatements. The holidays pay obligation are related the number of employees, check with the changes of employees, if the trend is different. The audit team should gain reasonable explains from management.

Checking the payment after the financial date.

Checking the payment after the financial date. If there are significant differences or turn back, the reasonable explains will be gained.

Best regards,

Audit manager

Q2

1. the deadine of report

the deadline is October but the acceptance is September, there are only 30 days to finish the job. It is emergency. The audit should discuss with the management about the deadline because the shorter time budgets will damage the quality of audit.

the qualitified staff

the capiture expenditure forecast audit should need qualified staff who have related experiences because the financial director have no experiences. There may be a lot of mistakes.

The fees

The qualified staff means more cost, the limited time budget mean more staff. Both factors will increase the fees. so it should discuss with the management.

The enthical problem

Although the company is not our client, the bankers and the competitors may be our client, there is risk of conflict of interest which means our firm need to disclose the information to all parties and get present before the acceptance.

the facility can not gain before issuing the report

there may be risks of obtianing insufficient audit evidence before issuing the report. Once there are legal cases, it will damage firm’s reputation and penalty will be paid

(b)

The consideration of calculation is not sufficient

The expenditure includes legel fees, site preparation and tree removal and so on. But the recover expense of the site should be considered. If the time value is significant, then the present value should be used in the calculation.

The financial cost should be included

The capital expenditure forecast is used to finance from bankers. It should assume the loans have been included, the finance cost should be capitalized in the calculation.

This cause the expenditure is lower than it actually is

Time value should be considered

Although the period is short, the amount is large, so the influence will be large. The cost of capital will be used correctly, If only the bank loan is used, the effective interest rate will be the loan rate.

The forecast is prepared and approved by same director

There is weak of internal control on the forecast. If should be preparede by other staff and check by director and approved by more senior managers

The facility is due for renewal in December 20x5, it should be given to the auditors, otherwise the assurance report should state the situation clearly.

Q3

(A)(I)

The lease is arranged on 1 April 20X4,which is after the financial date. The matter is a non-adjustment event after the reporting date. The disclosure should include the nature and the estimate amount. The audit team should obtain the contract and check the terms to make sure it meets the IFRE@16

The lease have been correctly recoganized. The audit team should obtain the lease calculation working paper from management, check the data with the contracts to make sure there is no wrong number used. Check the estimate interest rate and other assumptions to make sure there are nothing unreasonable. Recalculate the amount to make sure there is no mathmetical misstatement.

The right-of-use asset should be depreciated in 7 years including the rent-free period. Discuss with the management about the wrong policy and ask for correction. If necessary, talk with the governance.

Check the payment invoices after the financial date to confirm that the payment is fit with the contract. Or make an enquiry with the third party when the management present.

Obtain the written representation, the management should confirm that they give all the information on the lease events to the auditors.

(ii)

The company can return the inventory. They can not control the inventory, it should not included in fiannacial statement as inventory.the audit team should get the contract to confirm the terms, and check the journal ,give the audit adjustment credit inventory, DEBIT prepayment. Ask management for correction. If refused, audit team should discuss with the governance. ortherwise, the qualified opinion will be issued.

Obtain the purchased invoices and the bank returns. To make sure the 8.1million is correct.

Arrange an inventory count activities.checking the amount of inventory unsold.

(b)

The audit opinion should be unmodified opinion, with key audit matters about the inventory and other emhaiss matters below about the lease.