Lecture 11- Revision

Question 1

Sola Drink Ltd. (Sola) manufactures fizzy drinks such as cola and lemonade and its year end is 31 December 2017. You are the audit manager of Steven & Partners and are currently planning the audit of Sola. You attended the planning meeting with the engagement partner and finance director last week. The minutes of the meeting are presented below. You are reviewing these as part of the process of preparing the audit strategy.

Minutes of the Planning Meeting for Sola

Sola's trading results have been strong this year and the company is forecasting revenue of $85 million, which is an increase from the previous year. The company has invested significantly into the fizzy drinks production process at the factory. This resulted in an expenditure of $5 million on updating, repairing and replacing a significant amount of the machinery used in the production process.

As the level of production has increased, the company has expanded the number of warehouses it uses to store inventory. It now utilises 15 warehouses; Sola owns some of these while some are rented from third parties. There will be inventory counts taking place at all 15 of these sites at year end.

A new accounting general ledger has been introduced at the beginning of the year, with the old and new systems being run in parallel for two months.

Because of the increase in revenue, Sola has recently recruited a new credit controller to chase outstanding receivables. The finance director thinks it is not necessary to continue to maintain an allowance for receivables and so has released the opening allowance of $1.5 million.

Sola also incurred an expenditure of $4.5 million on developing a new brand of fizzy soft drinks. The company started this process in April 2017 and is close to launching their new product into the market place.

The finance director stated that there was a problem in November in the mixing of raw materials within the production process which resulted in a large batch of cola products tasting different. A number of these products were sold; however, due to complaints by customers about the flavour, no further sales of these goods have been made. No adjustment has been made to the valuation of the damaged inventory, which will still be held at the cost of $1 million at year end.

As in previous years, the management of Sola is due to be paid a significant annual bonus based on the value of total year end assets.

Required:

(a) Explain the THREE (3) components of audit risk in general.

(6 marks)

(b) Using the minutes provided, identify and describe FIVE (5) audit risks, and explain the auditor's response to each risk, in planning the audit of Sola Drink Ltd.

(15 marks)

(c) Identify TWO (2) main areas, other than audit risks, that should be included in the audit strategy document for Sola Drink Ltd, and for each area provide an example relevant to the audit.

(6 marks)

(d) Describe TWO (2) substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidence relating to the following three matters:

(i) The treatment of the $5 million expenditure incurred on improving the factory production process;

(6 marks)

(ii) The release of the $1.5 million allowances for receivables; and

(6 marks)

(iii) The damaged batch of cola inventory.

(6 marks)

(Total = 6 + 15 + 6 + 6+ 6 + 6= 45)

Question 2

You are the audit manager of Edward & Partners and you are currently reviewing the audit files for several of your clients for which the audit fieldwork is complete. The audit seniors have raised the following issues for two clients described in Part A and B:

Part A

Max Designs Ltd. (Max)

Max's year end is 30 September, however, subsequent to the year end the company's sales ledger was corrupted by a computer virus. Max's finance director was able to produce the financial statements before this occurred; however, the audit team has been unable to access the sales ledger to undertake detailed testing of revenue or year-end receivables. All other accounting records are unaffected and there are no backups available for the sales ledger. Max's revenue is $15.6 million, its receivables are $3.4 million and profit before tax is $2 million.

Required:

(i) Discuss the issue described above, including an assessment of whether it is material in nature to completing your audit.

(4 marks)

(ii) Recommend TWO (2) procedures the audit team should undertake at the completion stage to try to resolve the issue in (i).

(4 marks)

(iii) If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Max Designs Ltd.

(4 marks)

Part B

Sky Enterprises Ltd. (Sky)

Sky has experienced difficult trading conditions and as a result it has lost significant market share. The cash flow forecast has been reviewed during the audit fieldwork and it shows a significant net cash outflow. The management of Sky are confident that further funding can be obtained, so they have prepared the financial statements on a going concern basis with no additional disclosures; the audit senior is highly sceptical about this. The prior year financial statements showed a profit before tax of $1.2 million; however, the current year loss before tax is $4.4 million and the forecast net cash outflow for the next 12 months is $3.2 million.

Required:

(i) Discuss the issue described above, including an assessment of whether it is material.

(4 marks)

(ii) Recommend TWO (2) procedures the audit team should undertake at the completion stage to try to resolve the issue.

(4 marks)

(iii) If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Sky Enterprises Ltd.

(4 marks)

(Total = 6 x 4 = 24 marks)

Question 3

(a) Identify and explain TWO (2) factors that influence the sample size for substantive tests.

(5 Marks)

(b) The auditor needs to gather sufficient and appropriate audit evidence to form their audit opinion. Explain what you understand by the terms 'sufficient' and 'appropriate'.

(5 Marks)

(c) What are the THREE (3) audit assertions that are important to ensuring that the auditor has gained sufficient and appropriate audit evidence for sales account? Explain.

(5 Marks)

[Total = 5 + 5 + 5 = 15 marks]