Section B

16. Firebird

(a) Purpose and importance of an audit engagement letter

An engagement letter provides a written agreement of the terms and conditions of the audit engagement between the auditor and management or those charged with governance.

It defines the scope of the audit and sets out respective responsibilities. It is important because confirming that there is a common understanding between the auditor and management, or those charged with governance, of the terms of the audit engagement helps to avoid misunderstanding with respect to the audit.

(b) Audit risks and auditor's response

Audit Risk	**Auditor's response**
The receivables collection has increased from 38 to 71 days and management has granted an extended payment period to a major new customer, Moon Co. While the increase in the collection may be due to the favourable credit terms offered to Moon Co, it could also indicate an increased risk over recoverability of receivables. If this is the case, trade receivables may be overvalued, and expenses understated.	Review and test the controls implemented by Firebird Co to identify trade receivables balances which may not be recoverable and the procedures around credit control to ensure that they are operating affectively. 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.
The finance director has made a change to the inventory valuation in the year with additional overheads being included. In addition, the inventory holding period has increased from 42 to 55 days. There is a risk that inventory is overvalued due to the inclusion of inappropriate costs.	The change in the inventory policy will be discussed with management and a review performed of the additional overheads included to ensure that these are of a production nature. Detailed cost and net realisable value testing to be performed and the aged inventory report to be reviewed to assess whether inventory requires writing down to net realisable value.
The company is planning to undertake the full year end inventory counts on 29 and 30 December and then adjust post year end for movements on the last day of the year. If the adjustments are not made accurately and cut-off is not correctly applied, then the year-end inventory could be under or overstated	The auditor should attend the inventory counts held prior to the year end to test the controls over the count and request details of goods received and dispatched on 31 December, in order to agree to the reconciliation. During the final audit, the year-end inventory adjustment schedule should be reviewed in detail and agreed to supporting documentation of goods received and dispatched, using third party documents where possible, which were requested during the inventory count.

	The audit team should increase the extent of inventory cut-off testing at the year-end date 31st December.

Audit risk	Auditor's response
Firebird Co offers its customers a two-year product warranty which covers any defects. This represents an assurance type warranty provision which 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 based on prior years' experience. However, there is a risk that this provision could be understated and is being used as a mechanism to manipulate profit, especially in the light of the difficult trading conditions.	Discuss with management the basis of the provision calculation and compare this to the basis used in previous years and 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 and reliability of the judgements made by management
Firebird Co receives as annual trade discount from its main supplier, Marrina Co, and a trade discount receivable of $0.9m is expected to be recognised at the year end. The receivable should only be recognised if the company has purchased the required volume levels. If the annual volumes are over or understated, then the receivable recognised and cost of sales may be over or understated.	Discuss with management the basis of the discount calculation and agree the calculations back to supporting documentation, including the supplier contract. Review post year-end correspondence with Marrina Co for evidence of the discount being applied or post year-end bank statements for evidence of receipt.
Surplus plant and machinery was sold during the year, resulting in a loss on disposal of $380,000. The assets may not have been correctly removed from the non-current assets register and the loss on disposal not correctly adjusted for. This would result in overstated assets and profits.	Review the non-current assets register to confirm the removal of the disposed assets. Recalculate the loss on disposal calculations and agree all items to supporting documentation.
Significant profits or losses on disposal are an indication that the depreciation policy of plant and machinery may not be appropriate. Therefore, depreciation may be understated, and profit and assets overstated.	Discuss the depreciation policy for plan and machinery with the finance director to assess its reasonableness.

Firebird Bo placed an order in November 20X8 for a significant item of plant. The asset is due to be delivered in February 20X9. A non-refundable deposit of $0.4m was paid pre year-end. There is a risk that this expenditure may be incorrectly classified as part of non-current assets at the year end. The deposit paid represents a prepayment and should be recognised with current assets. If this has not been correctly recorded, non-current assets may be overstated and current assets understated.	Discuss with management how the deposit of $0.4m has been accounted for. Agree the pre year-end payment of $0.4m to cash book and bank statements. Review the order documentation to confirm the delivery date for the plant and machinery to assess whether the purchase was completed by the year end.
In November 20X8, Firebird Co raised new finance through issuing $1.1m of shares at a premium. The equity finance needs to be allocated correctly between share capital and share premium with adequate disclosure made. If this is not done, then the financial statements may be misstated due to a lack of disclosure or share capital and share premium may be misstated.	The Audit team should confirm that proceeds of $1.1m were received and that the split of share capital and share premium is correct and appropriately recorded. In addition, the disclosures for this finance should be reviewed in detail to ensure compliance with relevant accounting standards and local legislation.
The company has experienced difficult trading conditions, the current ratio has decreased from 1.62 to 0.98 and the bank overdraft has increased from $0.2m to £1.7m despite the new finance raised. These factors indicate that the company is experiencing a reduction in cash flow which could result in going concern difficulties or uncertainties. These uncertainties may not be adequately disclosed in the financial statements.	Detailed going concern testing to be performed during the audit, including the review of cash flow forecasts and the underlying assumptions. These should be discussed with management to ensure that the going concern basis is reasonable.
The report to management issued after the prior year audit highlighted significant deficiencies relating to the purchases cycle. If these deficiencies have not been rectified, the controls over purchase and payables may continue to be weak leading to an increased risk of misstatements arising. Cost of sales, expense and trade payables may not be complete or accurate.	Discuss with management whether the purchase cycle recommendations suggest by Mockingbird & Co were implemented successfully this year. If so, undertake tests of these controls to assess if they are operating efficiently. If the controls are not in place or operating efficiently, adopt a full substantive approach for confirming the completeness and accuracy of cost of sales and other expenses and trade payables.

(c) Going concern procedures

- Obtain the company's cash flow forecast and review the cash inflows and outflows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows to meet its liabilities as they fall due.

- Perform a sensitivity analysis on the cash flows to understand the margin of safety the company has in terms of its net cash in/outflow.

- Evaluate management's plan for future actions, including their contingency plans in relation to ongoing financing and plans for generating revenue, and consider the feasibility of these plans.

- Review the company's post year-end sales and order book to assess if the levels of trade are likely to increase and if the revenue figures in the cash flow forecast are reasonable taking into account the impact of the new customer, Moon Co.

- Obtain the contract with Moon Co to assess the payment terms in relations to Firebird Co's cash position and whether Firebird Co is able to manage these increased terms.

- Review any agreements with the bank to determine whether there are any covenants in relation to the overdraft and whether any have been breached.

- Review post year-end correspondence with suppliers to identify if any have threatened legal action.

- With the client's permission, enquire of the lawyers of Firebird Co as to the existence of any litigation and if so, the likely outcome of any litigation.

- Perform audit procedures in relations to subsequent events to identify any items which might indicate or mitigate the risk of the going concern basis not being appropriate.

- Examine warranty claims post year end to assess if significant refunds have been given or if there are any likely problems over the quality of products, leading to high returns; if so, confirm this has been adjusted for in the cash flow forecast.

- Examine if the final payment has been made for the asset in February 20X9, as if it has not, Firebird Co may not be able to continue without the increased plant.

- Review the post year-end board minutes to identify any other issues which might indicate further financial difficulties for the company.

- Review post year-end management accounts to assess if in line with cash flow forecast.

- Obtain a written representation confirming the directors' view that Firebird Co is a going concern.

(d) Trade discount receivable

- Obtain a schedule analysing the $0.9m trade discount receivable, cast and agree to inclusion in the trial balance.

- Agree to supplier contract/correspondence that Firebird Co does qualify for an annual trade discount, noting the % discounts to be applied and the required levels of volumes to be achieved.

- Review any correspondence received from Marrina Co which confirms the amount receivable.

- Review the level of purchases as per the purchase ledger and agree to the supplier the contract with Marrina Co to confirm the Firebird Co has purchased the minimum required volumes to qualify for a trade discount.

- Recalculate the expected discount, agreeing the % discount to supplier correspondence and the level of purchases to date per supplier to the purchase daybook.

- Agree that the trade discount has been correctly allocated to cost of sales.

- Review inventory records to confirm whether any goods purchased from Marrina Co remain in inventory at the year end.

- Agree the trade discount receivable to post year-end payments/credit notes or supplier statements to confirm adjustment by supplier

- Compare the level of discounts receivable to the previous year and discuss with management any significant fluctuations.

17 Turbo Co

(a) Direct controls and tests of control

Direct control	**Test of control**
On a quarterly basis, Turbo Co reviews standard costs and variance reports of action Versus standard costs or produced for the production director. For significant differences, the production director investigates the reasons for the variance and if required, revises the standard costs. IAS 2 *Inventories* Allows standard costs as a method for valuing inventory, providing it is a close approximation to actual cost. Regularly reviewing standard costs ensures that any necessary adjustments are made promptly, and inventory valuation is appropriate and in line with the requirements of the standard.	Obtain variance reports to confirm they have been prepared quarterly and discuss the latest variance report with the production director to assess the level of differences arising and inquire whether any adjustments have been made to standard costs. Review the inventory records for details of changes to the standard costs, selected sample and agree to the documentation and review performed by the production director. Confirm that the changes made are appropriate in line with the current costs.
The IA Department is responsible for supervising each of the inventory counts and ensuring that the counting teams are following their instructions. This increases the level of independence associated with account, making the results more reliable. if warehouse staff were supervising the counts, they may wish to hide inefficiencies and inventory discrepancies so that their Department is not criticised.	The auditor should attend at least one of the perpetual (continuous) inventory counts and they should observe who is responsible for supervising the count.

Inventory is counted on a monthly basis and at each of the six locations twice a year, ensuring that all product lines are counted at least twice a year. Where perpetual (continuous) inventory counting is used, management is required to ensure that all product lines are counted at least once a year. This ensures that the records used to measure inventory quantities at the year-end have been compared to actual levels at least once and any necessary adjustments made to the records.	Review the file for completed inventory count to date to assess whether all locations have been visited this year. Discuss with IA the schedule of inventory count dates for the remainder of the year to confirm all inventory lines will be counted at least once a year.
On a monthly basis, IA undertakes a reconciliation of goods stored in a third-party warehouse per Turbo Co's records, with the monthly count records submitted by the third-party warehouse. Any variances or investigated by IA. This ensures that inventory records used by the company when confirming sales orders are complete and accurate with regards to goods held by third parties.	Select a sample of reconciliations undertaken by a of goods held by third parties to the company records. For those differences, discussed with a member of IA any actions undertaken to resolve the discrepancies.
The inventory count sheets are sequentially numbered and at the end of the count, they are given to the count supervisor who checks the sequence of the sheets. This ensures that if sheets are missing, it is promptly identified so that the inventory record adjustments are complete and accurate.	For a sample of inventory counts, review the sequence of the inventory sheet for any gaps in the sequence and evidence of review from the count supervisor. Obtain an explanation from the account supervisor for any gaps.
The count sheets are sent to the finance Department where any differences within the inventory records are promptly identified and investigated. This will ensure that any issues arising as a result of control deficiencies in accounting procedures, deficiencies in recording of received and dispatch goods or due to fraud by warehouse employees are swiftly identified and then mitigated.	For a sample of monthly inventory counts, obtained details from the finance Department of the differences identified between the count and the inventory records and review for evidence of investigation of the cause of the differences. In addition, discuss with management the steps taken to reduce the risk of such differences arising in the future.

(b) Control deficiencies and recommendations

Control deficiency	Control recommendation
	it is not practical to stop all inventory movements as production needs to continue.

Movements of raw materials and goods continued during each inventory count as production does not cease. Inventory records could be under/overstated Is good so missed or double counted due to movements in the warehouses.	However, in relation to the raw materials warehouse, materials required for production on the day of the count should be estimated and put to one side. These will not be included as raw materials and instead will be work in progress. any goods transferred from the manufacturing site to the warehouse on the day of the count should be kept to a minimum. They should be stored to one side, and at the end of the count should be counted and included in finished goods.
The raw materials warehouse manager has estimated the quantities of raw materials for the first time. In the past, a specialist has undertaken this role and the warehouse manager may not be suitably qualified to undertake the estimation. If he makes a mistake, then inventory could be incorrectly updated. In addition, he may wish to hide inefficiencies and inventory discrepancies so that his Department is not criticised.	A specialist should be utilised on the two inventory counts held at the raw materials warehouse to assess quantities. for the counts undertaken in the current year, the warehouse manager could estimate the raw materials and the specialist could cheque it. This would give an indication as to whether he is able to accurately assess the quantities for subsequent inventory counts.
Each area of the warehouse is counted once only. If inventory is only checked once, then counting errors may arise resulting in under or overstated inventory being recorded in the accounting records.	Once all inventories have been counted once, each area should be recounted by a different team. Any differences on the 1st count should be promptly notified to the count supervisor and a third count undertaken if necessary. If a second count at each warehouse would be too time consuming, then sample checks should be undertaken by a different counting team or members of IA.
If the accounting team encounters any product lines not listed on the inventory count sheets, this is entered onto a surplus inventory sheet, which is not sequentially numbered. Therefore, the supervisor will be able to ensure the completeness of all such inventory sheets and hence of inventory.	Each team should be given a blank surplus inventory sheet for entering any inventory which is not on their count sheets. The circus inventory sheet should be sequentially numbered, any unused sheet should be returned at the end of the count, and the supervisor should check that the sequence of sheet is complete at the end of the count.
Damaged goods are not being clearly identified as such as the counter is not noting the level of damage on the inventory sheets.	Damaged goods should be clearly flagged by the counting teams and should be moved to a designated central location. This will avoid the risk of selling these goods.

If these goods are left in the aisles, they could be inadvertently sold to customers resulting in a loss of customer goodwill. The counters are those who make an assessment of the level of damage, it will be difficult for the finance team to decide on an appropriate level of write down if they are not able to see the damaged goods, resulting in overvalued inventory. inventory count differences identified and investigated by the finance team are only updated into inventory records in the following two weeks. If the differences are not promptly updated in the inventory records, this will reduce their completeness and accuracy. Orders may be taken for goods which are showing as available in the record but are not, resulting in a loss of revenue and customer goodwill.	A senior member of the finance team should attend each of the perpetual/continuous inventory counts and inspect the damaged goods to assess the level of any written down or allowance. After the monthly inventory count discrepancies have been investigated to identify possible causes, the inventory record should immediately be updated. Upon completion of the investigation of account discrepancies, ace senior member of the finance team should review for evidence of the revised figures being promptly updated into the inventory records.

(c) Preventing and detecting fraud

The internal audit Department can help the directors by assessing the main areas of fraud risk, assessing the adequacy and effectiveness of control systems and making recommendations regarding controls to mitigate key risks.

Once the controls have been implemented by the company, the internal audit Department can undertake regular reviews of compliance by each warehouse of these controls. When non-compliance is identified, they can instigate further training if necessary, make additional control recommendations and report suspect fraud to senior management.

When fraud is suspected, the internal audit Department can undertake a detailed fraud investigation to identify who is involved, how much was stolen and gather evidence for any subsequent police investigation.

In addition, the presence of any internal audit Department can itself act as a fraud deterrent, as the risk of being discovered means individuals or less likely to undertake fraudulent activities.

18 IRONMAN CO

(a) Depreciation [1 mark per procedure]

- Enquire of management why they have not charged appreciation on assets and discuss the requirement to follow accounting standards.
- If buildings have been valued recently, inspect the valuation report to assess whether the cost is significantly higher than the valuation.

- Research market values of similar properties on the Internet to assess the market value and compare this with the cost recorded in the financial statements.

- Physically inspect the assets for signs of damage which may indicate impairment.

- Review profits / losses on disposals in previous years to determine whether the finance directors' claims are valid.

- Calculate the recoverable amount of the assets and compare with carrying amount to determine whether the assets are impaired and should be written down.

- Using an appropriate depreciation rate, calculate the estimated misstatement for the current year and prior years.

- Review the financial statement disclosure on accounting policies to confirm that the company's policy for not depreciation assets is disclosed and explained.

(b) Company restructure [1 mark per procedure]

- Review board minutes you confirm the decision was made before the year-end.

- Inspect a copy of the announcement made to staff to confirm this occurred after the year-end.

- Review the financial statements to ensure that the restructure is accounted for as a material non-adjusting event. The financial statements should include disclosure of the event but should not include a provision for the restructuring costs as there was no obligation at the year-end.

- Obtain a breakdown of the restructuring costs, cast and agree to the disclosure not relating to the non-adjusting event

- Review the breakdown of costs for any obvious emissions to ensure completeness.

- Review subsequent events to obtain further evidence regarding the accuracy of the costs which should be included in the disclosure note.

- For costs such as redundancies, calculate the estimated cost and compare with management's estimate to ensure reasonableness.

- For other restructuring costs, inspect quotations or draft agreements to ensure reasonableness.

(c) Inventory [1 mark per procedure]

- Enquire of management whether the previous auditor attended the count. If so, contact the previous auditor and review their working papers.

- Perform counts on a sample of items of inventory at the current date and perform a rollback to the year-end inventory count to evaluate the accuracy of the year-end account.

- If the company has an internal audit Department which was involved in overseeing the count, review their working papers to assess the reliability of the County records.

(d) Auditor's report

Discussion of issue

IAS 16 *Property, Plant and Equipment* Requires depreciation to be charged which reflects the usage of the asset. **[½ mark]** By not charging depreciation, non-current assets and profits are overstated in the financial statements. **[½ mark]**

Materiality calculation

The estimated depreciation charge for the year of $0.5 million represents 3.3% of the assets and 16.7% of the profit before tax. **[½ mark].** This Is material to the years of financial statements.
[½ mark]

The total depreciation of $2.5 million represents 16.7% of total assets **[½ mark]** which is material.

Audit opinion

The audit opinion will be modified **[½ mark]** due to material misstatement. **[½ mark]**

The misstatement is material but not pervasive **[½ mark]** as it is isolated and does not represent a substantial proportion of assets. **[½ mark]**

The opinion will be qualified **[½ mark]** which states that 'except for' the misstatement, the financial statements give a true and fair view. **[½ mark]**

Auditor's report

The basis for opinion section within the auditor's report will change to a basis for qualified opinion.
[½ mark]

The basis for qualified opinion will explain the issue **[½ mark]** and quantify the effects of the misstatement on the financial statement figures for the current year and accumulated reserves. **[½ mark]**

Applied Skills, AA
Audit and Assurance (AA) — **Marking Scheme**

Section A

Questions 1-15 – each worth 2 marks	**30**

Section B — *Marks*

16	**(a)**	**Purpose of engagement Letter**	
		Written agreement of terms	1
		Defines scope of terms	1
		Sets out responsibilities	1
		Helps to avoid misunderstandings	1

	Restricted to	**3**
(b)	**Audit risks and responses** (only 8 risks required)	
	Receivables collection period	2
	Change in inventory valuation	2
	Inventory count pre year end	2
	Warranty provision	2
	Accounting for trade discount	2
	Significant loss on disposal	2
	new plant and machinery	2
	Issue of shares at a premium	2
	Cash flow difficulties	2
	Prior year purchase cycle deficiencies	2
	Max 8 issues, 2 marks each	**16**
(c)	**Going concern procedures**	
	Review cash flow forecasts and assumptions	1
	Perform sensitivity analysis on cash flow forecast	1
	Evaluate management plan for future actions	1
	Review post year end orderbook to assess levels of trade	1
	Review agreements with the bank to determine whether any covenants breached	1
	Review correspondence with suppliers for dispute/legal action	1
	Obtaining confirmation from company lawyers about any legal action	1
	Review post year end board minutes for any indications of financial difficulties or uncertainties	1
	Review management accounts to assess if in line with cash flow	1
	Review financial statement disclosure	1
	Obtain a written representation	1
	Restricted to	**6**
(d)	**Substantive procedures - trade discount receivable**	
	Obtain schedule, cast and agree to trial balance	1
	Agree trade discount his supplier contract	1
	Review supplier correspondence for confirmation to discount	1
	Review purchase levels to confirm discount allowed	1
	Recalculate discount based on purchases	1
	Agree to post year end bank statements	1
	Compare two prior discount and investigate differences	1
	Restricted to	**5**
Total marks		**30**

17 **(a)** **Direct control and test of controls** (only 4 required)

Variances of standard v actual cost investigated	2
IA supervises inventory count	2
Inventory counts twice a year	2
IA reconciles and investigate inventories held by third parties	2
Sequentially numbered count sheets and sequence checks	2
Finance Department investigates all account discrepancies	2
Max 4 issues, 2 marks each	**8**

(b) **Control deficiencies and recommendations** (only 4 issues required)

Ongoing movements during count	2
Raw materials counted by estimation	2
Areas only counted once	2
Extra non sequentially numbered sheets	2
Damaged goods not segregated	2
Difference is not updated promptly	2
Max 4 issues, 2 marks each	**8**

(c) **IA - Preventing and detecting fraud**

IA can assess fraud risk and recommend improvements	1
Test controls on a regular basis	1
Undertake detailed fraud investigation	1
IA acts as a fraud deterrent	1
	4
Total marks	**20**

18.

	Marks
(a) Depreciation	
• Enquire of management	1
• Inspect valuation report	1
• Market value	1
• Physically inspect for signs of impairment	1
• Review profits/losses on disposal	1
• Calculate recoverable amount and compare with carrying amount	1
• Calculate misstatement	1
• Review financial statement disclosure	**6**
Maximum	
(b) Company restructure	1
	1

- Review board minutes 1
- Inspect copy of announcement 1
- Review financial statement accounting treatment 1
- Obtain breakdown of costs and cast 1
- Review costs for omissions 1
- Review subsequent events 1
- Calculate estimated redundancy costs **6**
- Review supporting documentation for other costs

Maximum

1

(c) Inventory

1

- Review previous auditors' working papers 1
- Perform test counts and roll back **3**
- Review internal audit working papers

Maximum

½

(d) Auditor's report ½

Discussion of issue

- IAS 16 requires depreciation to reflect usage
- Profit and assets overstated ½

Materiality calculation ½

- Materiality calculation
- Conclusion on materiality ½

Audit Opinion ½

- Modified Opinion ½
- Material misstatement ½
- Material but not pervasive ½
- Does no represent a substantial proportion of the FS ½
- Qualified opinion
- Except for…… FS give a true and fair view ½

Auditor's report ½

- Basis for opinion becomes basis for qualified opinion **5**
- basis for qualified opinion explains the misstatement and quantifies the effect **20**

Maximum Total