

SECTION A

QUESTION ONE

(a)

Explain why the external auditor needs to consider risk when conducting an audit. (5 marks)

(b)

Maxi Cola Ltd (Maxi) manufactures fizzy drinks such as cola and lemonade as well as other soft drinks and its year end is 31 December 2013. You are the audit manager of Pepper & Co and are currently planning the audit of Maxi. You attended the planning meeting with the engagement partner and finance director last week and recorded the minutes from the meeting shown below. You are reviewing these as part of the process of preparing the audit strategy.

Minutes of planning meeting for Maxi:

Maxi'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 in the cola and fizzy drinks production process at the factory. This resulted in 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 stock. It now utilises 15 warehouses; some are owned by Maxi and some are rented from third parties. There will be stock counts taking place at all 15 of these sites at the 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 a period of two months.

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

In addition, Maxi has incurred expenditure of £4.5 million on developing a new brand of fizzy soft drinks. The company started this process in January 2013 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 stock, which will still be held at cost of £1 million at the year end.

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

Required:

Using the minutes provided, identify and describe the audit risks, and explain the auditor's response to each risk, in planning the audit of Maxi Cola Ltd.

(20 marks)

QUESTION ONE

(a)

- Enables auditor to plan audit effectively
- Ensure audit attention is devoted to appropriate areas
- The higher the risk, the greater the amount of assurance work required
- Steps taken will affect the nature timing and extent of audit procedures
- An audit plan and detailed audit programme should result from the planning and risk assessment process

(b)

Audit risks and responses

(1) Audit Risk

Maxi has incurred £5m on updating, repairing and replacing a significant amount of the production process machinery.

If this expenditure is of a capital nature, it should be capitalised as part of property, plant and equipment (PPE) in line with FRS 15. However, if it relates more to repairs, then it should be expensed to the profit and loss account. If the expenditure is not correctly classified, profit and PPE could be under or overstated.

Response

The auditor should review a breakdown of these costs to ascertain the split of capital and revenue expenditure, and further testing should be undertaken to ensure that the classification in the financial statements is correct.

(2) Audit Risk

At the year end there will be stock counts undertaken in all 15 warehouses.

It is unlikely that the auditor will be able to attend all 15 stock counts and therefore they need to ensure that they obtain sufficient evidence over the stock counting controls, and completeness

Response

The auditor should assess which of the stock sites they will attend the counts for. This will be any with material stock or which have a history of significant errors.

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.

(3) Audit Risk

Stock is stored within 15 warehouses; some are owned by Maxi and some rented from third parties. Only warehouses owned by Maxi should be included within PPE. There is a risk of overstatement of PPE and understatement of rental expenses if Maxi has capitalised all 15 warehouses.

Response

The auditor should review supporting documentation for all warehouses included within PPE to confirm ownership by Maxi and to ensure non-current assets are not overstated.

(4) Audit Risk

A new accounting general ledger system has been introduced at the beginning of the year and the old system was run in parallel for two months.

There is a risk of opening balances being misstated and loss of data if they have not been transferred from the old system correctly. In addition, the new general ledger system will require documenting and the controls over this will need to be tested.

Response

The auditor should undertake detailed testing to confirm that all opening balances have been correctly recorded in the new general ledger system.

They 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.

(5) Audit Risk

The finance director of Maxi has decided to release the opening provision of £1.5 million for allowance for debtors as he feels it is unnecessary. There is a risk that debtors will be overvalued, as despite having a credit controller, some balances will be irrecoverable and so will be overstated if not provided against. In addition, due to the damaged stock there is an increased risk of customers refusing to make payments in full.

Response

Extended post year-end cash receipts testing and a review of the aged debtors ledger to be performed to assess valuation and the need for an allowance for debtors.

(6) Audit Risk

Maxi has incurred expenditure of £4.5 million on developing a new brand of fizzy drink. This expenditure is research and development under FRS 10.

The standard requires research costs to be expensed and development costs to be capitalised as an intangible asset. If Maxi has incorrectly classified research costs as development expenditure, there is a risk the intangible asset could be overstated and expenses understated.

Response

Obtain a breakdown of the expenditure and 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 FRS10.

(7) Audit Risk

A large batch of cola products has been damaged in the production process and will be in Stock at the year end. No adjustment has been made by management. The valuation of stock as per SSAP 9 should be at the lower of cost and net realisable value. Hence it is likely that this Stock is overvalued.

Response

Detailed cost and net realisable value testing to be performed to assess how much the Stock requires writing down by.

(8) Audit Risk

Due to the damaged cola products, a number of customers have complained. It is likely that for any of the damaged goods sold, Maxi will need to refund these customers. Revenue is possibly overstated if the sales returns are not completely and accurately recorded.

Response

Review the breakdown of sales of damaged goods, and ensure that they have been accurately removed from revenue.

(9) Audit Risk

The management of Maxi receives a significant annual bonus based on the value of year end total assets. There is a risk that management might feel under pressure to overstate the value of assets through the judgements taken or through the use of releasing provisions.

Response

Throughout the audit the team will need to be alert to this risk. They will need to maintain professional scepticism and carefully review judgemental decisions and compare treatment against prior years.