Answers

Section B

Scarlet Co

(a) Engagement letters

Purpose of an engagement letter

The letter of engagement outlines the responsibilities of both the audit firm and the audit client. Its purpose is to:

- minimise the risk of any misunderstanding between the auditor and the client;
- confirm acceptance of the engagement; and
- forms the basis of the contract by outlining the terms and conditions of the engagement.

Items to be included in an engagement letter

- the objective and scope of the audit;
- the responsibilities of the auditor;
- responsibilities of management;
- identification of the financial reporting framework used in the preparation of the financial statements;
- expected form and content of any reports to be issued;
- elaboration of the scope of the audit with reference to legislation;
- the form of any other communication of the results of the audit;
- the fact that some material misstatements may not be discovered;
- arrangements concerning the planning and performance of the audit, including the composition of the audit team;
- the expectation that management will provide written representations;
- the basis on which the audit firm will calculate its fees;
- a request for management to agree to the terms of the audit engagement and acknowledge receipt of the letter of engagement;
- arrangements concerning the involvement of internal audit and other staff employed at the company;
- any obligations to provide audit working papers to third parties;
- any restrictions on the auditor's liability; and
- arrangements to make available draft financial statements and any other information.

(b) Factors to consider prior to accepting Scarlet Co as a new audit client

The outgoing auditor's response

Prior to accepting an audit engagement, the auditor is required to contact the previous auditors, after obtaining permission from Scarlet Co, to ask for all information relevant to the decision as to whether or not the firm should accept appointment. The auditor should consider the outgoing auditor's response to assess whether there are any ethical or professional reasons why the firm should not accept appointment.

Management integrity
If Orange & Co's audit engagement partner has reason to believe that Scarlet Co's management lack integrity, there is a greater risk of fraud and intimidation. Orange & Co need to consider management integrity because if there are serious concerns regarding this, Orange & Co must not accept the audit engagement.

Pre-conditions for an audit
Orange & Co can only accept an audit engagement if the preconditions are present. The preconditions confirm that management will use an acceptable financial reporting framework under which they will prepare the financial statements and confirms that management acknowledges and understands its responsibilities for:

- Preparing the financial statements in accordance with the applicable financial reporting framework;
- Internal control necessary for the preparation of the financial statements to be free from material misstatement; and
- Providing the auditor with access to information relevant for the audit and access to staff within the entity to obtain audit evidence.

If the preconditions are not present, Orange & Co cannot accept the audit engagement.

Independence and objectivity
The auditor must consider whether there are any threats to independence and objectivity which cannot be reduced to an acceptably low level by the use of appropriate safeguards, such as if any of Orange & Co's staff have shares in Scarlet Co or are related to staff employed at Scarlet Co. If such threats are present and cannot be sufficiently mitigated, Orange & Co must not accept the audit engagement.

Resources available at the time of the audit
Orange & Co must have adequate resources with the relevant experience available at the time the audit of Scarlet Co is likely to be carried out. All audit staff deployed to the audit of Scarlet Co must be capable of carrying out the audit in accordance with International Standards on Auditing (ISAs). If adequate resources will not be available, Orange & Co must not accept the audit engagement.

(c) Audit risks and auditor's responses

Audit risk	Auditor's response
Scarlet Co is a new audit client of the firm. The audit engagement team will be unfamiliar with the accounting policies, transactions and balances of the client, hence there will be increased detection risk on the audit.	Orange & Co should ensure that it has a suitably experienced team deployed on the audit. In addition, sufficient time must be set aside so that the team members can familiarise themselves with the new client, document its systems and controls and understand the risks of material misstatement.

In addition, there is less assurance over opening balances as Orange & Co did not perform last year's audit.	Increased audit procedures should be performed on the opening balances to confirm their reasonableness.
The company's financial accountant was taken ill suddenly in May 20X5 and a temporary accountant has been drafted in to help prepare the financial statements. There is an increased risk of errors in the financial statements as the temporary financial accountant may not be familiar with the company's activities and so errors/omissions may go unnoticed.	Discuss with management the technical competency and experience of the temporary financial accountant. In addition, the audit engagement team should ensure that increased substantive procedures are undertaken on the material areas of the financial statements to reduce audit risk, particularly those requiring judgement.
The year-end financial statements have to be prepared by the end of September 20X5 in order to secure bank finance and management wish to report strong results. This increases the risk that the directors may manipulate the financial statements, by overstating profits and assets and understating liabilities.	The audit engagement team should maintain professional scepticism throughout the course of the audit. Detailed cut-off testing on areas such as revenue, inventory and payables should be performed to ensure that cut-off has been correctly applied and substantive procedures performed on estimates and judgements to ensure accuracy.
A specialised machine was acquired and staff members had to be trained in the machine's use at a cost of $15,000 which has been capitalised as part of the cost of the machine. IAS® 16 Property, Plant and Equipment prohibits training costs from being capitalised and therefore profits and property, plant and equipment will be overstated, and expenses understated if the training costs are not written off to the statement of profit or loss.	Discuss the accounting treatment with the directors and request that an adjustment is made to ensure appropriate treatment of the training costs. Obtain a breakdown of the remaining capitalised costs and agree to supporting documentation to ensure that they meet the recognition criteria in IAS 16.
The delivery time of three weeks from the company's international supplier is likely to result in goods in transit at the year end. The company has advised that the contract with the supplier means that Scarlet Co will be responsible for goods from dispatch and therefore inventory should be recorded when the products are sent by the supplier. There is a risk that inventory is not recorded on dispatch and therefore inventory and liabilities are understated at the year end.	Discuss with management the point at which inventory is recorded and review the contract with the supplier to verify the requirements in place. Review the controls the company has in place to ensure that inventory is recorded from the point of dispatch. Extend cut-off testing by reviewing pre and post year-end GRNs and supplier dispatch notes to verify that inventory is recorded at the correct point.

Preliminary analytical procedures indicate that the receivables collection period has increased from 38 days to 52 days due to customers taking longer to pay. There is a risk that some receivables may not be recoverable and an allowance for receivables is required, hence receivables may be overstated and the allowance for receivables understated.	Extend post year-end cash receipts testing and perform a review of the aged receivables listing to assess the valuation of receivables. Discuss with management the adequacy of any allowance for receivables.
On 29 May 20X5, the directors announced that a brand was being discontinued resulting in four members of staff being made redundant. The costs of redundancy are being included in the July 20X5 payroll run. As there is a present obligation for which the costs can be reliably measured, and which will result in an outflow of funds, IAS 37 Provisions, Contingent Assets and Contingent Liabilities would require this provision to be recognised in the financial statements. If a provision is not recognised profit would be overstated and liabilities and payables would be understated.	Obtain the calculation of the redundancy payments and agree that a provision has been included as a liability in the year-end financial statements. Agree the redundancy payments have been paid post year end.
The directors have each been paid a significant bonus at the year end and separate disclosure of this is required in the financial statements by local legislation. The directors' remuneration disclosure will be incomplete and inaccurate if the bonus paid is included in the payroll charge for the year and not separately disclosed in accordance with the local legislation.	Discuss this matter with management and review the disclosure in the financial statements to ensure it complies with local legislation.
A customer has returned $120,000 of faulty goods to the company prior to the year-end but a credit note is yet to be issued. As this sale occurred pre year end there is a risk that revenue and receivables are overstated if the credit note is not correctly recorded prior to the year end.	Inspect a copy of the credit note and confirm an adjustment to revenue and receivables has been recorded pre-year end.
The company's suppliers have been paid on 1 June 20X5 and the payment has been	Request that the bank reconciliation is amended to remove the supplier payments at

included as an unpresented item in the year-end bank reconciliation. This is possible evidence of window dressing which results in understated payables and bank balances.	the year-end as these should be accounted for in the 31 May 20X6 financial statements. Review the journal entry correcting the payables and bank balances at the year end.

(d) Substantive procedures for the redundancy costs

- Review the board minutes for evidence of the decision to discontinue the brand of chemicals prior to the year-end.
- Review supporting documentation to confirm that the decision to discontinue the brand was notified to the four members of staff prior to the year end.
- Obtain details of the redundancy calculated by employee, cast the schedule and agree to the trial balance/financial statements.
- Recalculate the redundancy provision to confirm completeness and agree components of the cost to supporting documentation such as employee contracts.
- Agree the redundancy payments made in July 20X5 to the cash book/payroll records and compare these to the provision in the financial statements.
- Obtain a written representation from management confirming the completeness of the costs.
- Review the disclosures included in the financial statements to verify they are in compliance with requirements of IAS 37 Provisions, Contingent Assets and Contingent Liabilities.

Snowdon Co

(a) Significant deficiencies

Examples of matters the external auditor may consider in determining whether a deficiency in internal controls is significant include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process.
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.

– The interaction of the deficiency with other deficiencies in internal control.

(b) Key controls and tests of control

Key control	Test of control
Capital expenditure purchase orders are classified by the finance department between capital and revenue using guidelines established by the finance director, this is noted on the purchase order. The finance director also sample checks the classification is correctly applied. The use of finance department guidelines and sample checks by the finance director should reduce the risk of an incorrect assessment and of understated/overstated profits, assets and incorrect depreciation charges.	Select a sample of capital expenditure purchase orders and review evidence of the classification being noted. For a sample of orders compare the classification noted with the finance director's guidelines to assess whether the classification was correctly undertaken. Review purchase orders for evidence of the finance director's sample checks for example, by signature.
Snowdon Co has a separate human resources (HR) department, which is responsible for setting up all new employees. Having a segregation of roles between HR and payroll departments reduces the risk of fictitious employees being set up and also being paid.	Review the job descriptions of payroll and HR to confirm the split of responsibilities with regards to setting up new joiners. Discuss with members of the payroll department the process for setting up new joiners and agree new joiners to documentation initiated by HR.
Pre-printed forms are completed by HR for new employees, and includes assignment of a unique employee number, and once verified a copy is sent to the payroll department. The payroll system is unable to process new joiners without the inclusion of the employee's unique number. As payroll is unable to set up new joiners without the forms and employee number it reduces the risk of fictitious employees being set up by payroll.	Select a sample of new employees added to the payroll during the year, review the joiner forms for evidence of completion and the allocation of a unique employee number which was received by payroll prior to being added to the system. Select a sample of edit reports for changes to payroll during the year; agree a sample of new employees added to payroll to the joiner's forms. Attempt to add a new joiner to the payroll system without a unique

	employee number, the system should reject this addition.
The cashier reconciles the bank statements to the cash book monthly and this reconciliation is reviewed and investigated by the financial controller, who evidences his review by way of signature on the bank reconciliation. The bank reconciliation is a key control which reduces the risk of fraud. Monthly review and investigation ensure that fraud and errors are identified on a timely basis.	Review the file of bank reconciliations to confirm that there is one for each month. Inspect a sample of monthly bank reconciliations for evidence of investigation and review by the financial controller. For a sample of months reperform the bank reconciliation and where differences have occurred discuss and investigate these with the financial controller.

(c) Control deficiencies and recommendations

Control deficiency	Control recommendation
Snowdon Co has experienced significant staff shortages within its internal audit (IA) department, and the department is currently under-resourced. This has resulted in a reduction in their programme of work for the year. Maintaining an IA department is an important control as it enables senior management to test whether controls are operating effectively within the company. If the team has staff shortages, this reduces the effectiveness of this monitoring control.	Senior management should consider recruiting additional employees to join the IA department or outsourcing the IA function. In the interim, employees from other departments, such as finance, could be seconded to IA to assist them with audits. It must be ensured that these reviews do not cover controls operating in the department in which the employees normally work.
Some departments have already significantly exceeded their annual capital expenditure budgets. It appears that purchase orders for capital expenditure are being placed without being agreed back to annual capital budgets, resulting in overspends. The increased expenditure may be due to increased levels of services being provided, or it could be due to a lack of control over the capital expenditure	The company's monthly management accounts should include an analysis of capital expenditure against budget and prior year per department. Each department head should include narrative which explains the significant variances to date. Capital purchase orders should be compared to the annual department budgets as part of the authorisation process. Any spend in excess of the budget should be referred for authorisation to the finance director.

process, resulting in increased costs and reduced profits.	
The IA department undertakes physical verification of assets each year for the four largest centres as well as five of the other centres, randomly selected. The company has 45 centres as well as a head office and warehouse, hence if each year the four largest sites are visited this can result in the other sites only being visited every eight years. If the non-current assets register is not physically verified on a regular basis, there is an increased risk of assets being misappropriated as there is no check that the assets still exist in their correct location. In addition, obsolete assets will not be identified on a timely basis.	IA should review its programme of visits to assess if additional resources could be devoted to ensuring that all sites are visited over a shorter period, for example, five years. This would ensure that physical verification of all assets could be completed more regularly. For sites visited any assets which cannot be located should be investigated fully. If it cannot be located, then it should be written off. Each centre should submit a list of assets with serial numbers to IA, who should compare these to the PPE register. Those sites with significant variations should be prioritised for a site visit by IA.
All members of the payroll department can amend employees' standing data in the payroll system as they have access to the password. As all members of payroll can amend standing data this may result in errors or unauthorised changes being made, leading to incorrect payment of wages and increased risk of fraud.	The password to amend standing data should be changed and only communicated to senior members of the payroll department. If all members of payroll need the ability to amend standing data, the system should be changed to require authorisation of all changes by a senior member of payroll. Edit reports should be generated for all standing data changes with clear reference to who made the change and who authorised it. These edit reports should be regularly reviewed by a responsible official and they should evidence this review with a signature.
The senior payroll manager reviews the bank transfer listing prior to authorising the payments and if any discrepancies are noted, always makes the adjustment in the payroll records for any changes required.	The senior payroll manager should not be able to process changes to the payroll system as well as authorise payments. Discrepancies should be thoroughly investigated, and

Discrepancies may arise due to the payroll records or the bank transfer listing being incorrect. Assuming the discrepancies are always in the payroll records may result in incorrect amendments being made to payroll or incorrect amounts paid to employees. In addition, there is a lack of segregation of duties as it is the payroll team which processes the amounts and the senior payroll manager who authorises payments. The senior manager could fraudulently increase or incorrectly amend the amounts to be paid to certain employees, process this payment as well as amend the records.	adjustments made in the relevant record as required. The authorisation of the bank transfer listing should be undertaken by an individual outside the payroll department, such as the finance director.
After passing a credit check a credit limit is set for all new customers by the sales director, but these credit limits are not reviewed after this unless a review is requested by the customer. If credit limits are not reviewed regularly, they could be out of date, resulting in limits being too high and sales being made to poor credit risks or too low and Snowdon Co losing potential revenue.	Credit limits should continue to be set by the sales director; however, these limits should be reviewed and amended as appropriate on a regular basis by a responsible official.
Client services managers are given responsibility to chase customers directly for payment once an invoice is outstanding for 90 days. This is considerably in excess of the company's credit terms of 30 days which will lead to poor cash flow. Further, client services managers are more likely to focus on customer relationships and generating further revenues rather than chasing payments. This could result in an increase in irrecoverable balances and reduced profit and cash flows.	A credit controller should be appointed, and it should be their role, rather than the client services managers, to chase any outstanding sales invoices which are more than 30 days old.

Encore Co

(a) Vehicles additions and disposals

- Cast the schedule of additions to vehicles, cast it and agree the total to the disclosure note for property, plant and equipment. Agree the cost of the vehicles given in part-exchange to the disclosure note to confirm that they have been removed from cost carried forward.
- For a sample of new vehicles on the schedule of additions agree the cost to the purchase invoice, ensuring that the recorded cost includes the cash amount paid plus the trade-in allowance for the old vehicle. Confirm that the invoice is made out to Encore Co.
- Physically inspect a sample of additions, confirming that the registration number of the vehicle agrees to that on the non-current assets register.
- Review the non-current assets register to confirm that the 20 old vehicles were removed and that the 20 new vehicles were included.
- Recalculate the loss on disposal of $1.1m ($1.8 - ($4.6m - $3.9m) and agree to the trial balance and statement of profit or loss.
- Agree the cash payment of $3.9m to the cash book and bank statement.
- Recalculate the depreciation expense, confirming that the depreciation expense was based on the old vehicles until 1 February and on the cost of the new vehicles after that date.
- Recalculate accumulated depreciation on the vehicles disposed of and confirm that this has been removed from accumulated depreciation carried forward.
- In light of the loss on disposal, review depreciation rates on existing vehicles to establish if the carrying amount of other vehicles may be overstated.
- Discuss with management Encore Co's history of vehicle replacement to establish if vehicles are being used for the entire period of their estimated useful life.
- Discuss with management why trade-in allowances were so much lower than the carrying amounts of the vehicles to provide further evidence as to whether depreciation policies are reasonable.
- Review the notes to the financial statements to ensure that disclosure of the additions and disposals is in accordance with IAS 16 Property, Plant and Equipment.

(b) Valuation of trade receivables

- Review the aged receivables listing to identify slow moving or old balances. Discuss the status of these balances with the credit controller to assess whether the customers are likely to pay or if an allowance for receivables is required.
- Review whether there are any after-date cash receipts for slow moving/old receivable balances.
- Review correspondence with customers in order to identify any balances which are in dispute or unlikely to be paid and discuss with management whether any allowance is required.

- Review board minutes to identify whether there are any significant concerns in relation to outstanding receivables balances and assess whether the allowance is reasonable.
- Obtain a breakdown of the allowance for trade receivables. Recalculate it and compare it to any potentially irrecoverable balances to assess if the allowance is adequate.
- Review the payment history for evidence of slow paying by any customers who were granted credit in the period when there was no credit controller and who may not, therefore, have been properly scrutinised.
- Discuss with the finance director the rationale for maintaining the allowance at the same level in light of the increase in the receivables collection period and the absence of a credit controller.
- Inspect post year-end sales returns/credit notes and consider whether an additional allowance against receivables is required.

(c) Potential breach of regulations

- Review correspondence with the transport authority to establish details of the complaint and the number of times the breach has allegedly occurred.
- Enquire of the directors why they are unwilling to provide or make disclosure, whether they accept that any breaches took place but believe that the effect is immaterial or whether they dispute their occurrence.
- Review Encore Co's policies and procedures to record driving hours and rest periods and compare to the regulations to determine the likelihood that breaches have occurred and how frequently.
- Review correspondence with the transport authority to establish if there have been discussions about other instances of potential non-compliance.
- Review correspondence with Encore Co's legal advisers or, with the client's permission, contact the lawyers to establish their assessment of the likelihood of the breach being proven and any fines that would be payable.
- Review the board minutes to ascertain management's view as to the likelihood of payment to the transport authority.
- Obtain a written representation to the effect that the directors are not aware of any other breaches of laws or regulations that would require a provision or disclosure in the financial statements.
- Inspect the post year-end cash book and bank statements to identify whether any fines have been paid.

(d) Auditor's report

The breaches in regulations and the initial investigation into the breaches occurred before the year end. The announcement by the authorities that they are taking legal action provides further evidence regarding these conditions which existed at the year-end date therefore IAS 10 Events after the Reporting Period would classify this as an adjusting subsequent event. As it seems probable that the fine will be payable, a provision must be included rather than merely the disclosure. Failure to make such a provision will cause profits to be overstated and provisions to be understated.

The potential fine of $850,000 (17 x $50,000) is 16% ($850k/$5.3m) of profit before tax and 2.1% ($850k/$40.1m) of total assets. It is therefore material.

If the directors refuse to make a provision, then Velo & Co should issue a modified opinion on the grounds that there is a material misstatement of profit and liabilities. As this is material but not pervasive a qualified opinion would be appropriate.

A basis for qualified opinion paragraph would be included after the opinion paragraph. This would explain the material misstatement in relation to the non-recognition of the provision and the effect on the financial statements. The opinion paragraph would be qualified ‘except for’.

	Marks	Marks

Marking Scheme

Scarlet Co

(a) Purpose and contents of engagement letter

Purpose	2	
Four examples of items to be included (1/2 mark each)	2	
		4

(b) Factors to consider prior to acceptance

Outgoing auditor's response	1	
Management integrity	1	
Pre-conditions	1	
Independence and objectivity	1	
Resources	1	
		5

(c) Audit risk and response (only 8 risks required)

New client	2	
Temporary accountant	2	
FS preparation deadline for bank loan application	2	
Training costs capitalised	2	
Goods in transit	2	
Increase in receivables days	2	
Redundancy provision	2	

		Marks	*Marks*
	Directors' bonus disclosure	2	
	Credit note for faulty goods	2	
	Late supplier payment run	2	
	Max 8 issues, 2 marks each		**16**
(d)	**Substantive procedures for redundancy costs**		
	1 mark per well-described procedure		
	Restricted to		**5**
Total marks			**30**

	Marks	Marks
Snowdon Co		
(a) Significant deficiencies		
Likelihood of leading to material misstatement	1	
Susceptibility to loss or fraud	1	
Subjectivity and complexity of amounts	1	
Amount exposed to deficiency	1	
Volume of activity	1	
Importance to financial reporting process	1	
Cause and frequency of exceptions	1	
Interaction with other deficiencies	1	
Restricted to		4
(b) Key controls and tests of control (only 3 required)		
Capital expenditure classification	2	
HR department/payroll department	2	
Processing new joiners	2	
Bank reconciliations	2	
Max 3 issues, 2 marks each		6
(c) Control deficiencies and recommendations (only 5 required)		
IA staff shortages	2	
Capital expenditure over budget	2	
Physical verification of assets	2	
Amendment of standing data	2	

	Marks	Marks
Changes made in payroll records	2	
Credit limits not reviewed	2	
Invoices only chased after 90 days	2	
Max 5 issues, 2 marks each		**10**
Total marks		**20**

		Marks	*Marks*
Encore Co			
(a)	**Substantive procedures for vehicle additions and disposals**		
	1 mark per well-described procedure		
	Restricted to		**6**
(b)	**Substantive procedures for valuation of trade receivables**		
	1 mark per well-described procedure		
	Restricted to		**5**
(c)	**Substantive procedures for breach of regulations**		
	1 mark per well-described procedure		
	Restricted to		**4**
(d)	**Impact on auditor's report**		
	Discussion of issue	1	
	Materiality calculation and assessment	1	
	Type of modification required	2	
	Impact on auditor's report	1	
			5
Total marks			**20**