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Stage 1 (a) (ii)

From the background provided and the Financial Statements (F/S) for 2012 and 2013, the following ***major risk areas*** need to be addressed during audit of Laser Engineering Pty. Ltd. (LE).

1. **Fraud risk:** Accounts department is improperly staffed, and it seems that the internal control systems are not sufficiently strong to detect fraud or misappropriation. This is evident from the incident of forgery which went undetected for 12 months. The accounting software is not integrated with the general ledger systems and manual reconciliation is being done. This increases the risk of fraud and misstatements in the F/S.
2. **Business risk:** LE has invested heavily in R&D of a new lathe machine which has not received good response from the market. Failure of this product poses significant risks for the company.
3. **Related party transactions:** 12.3% of the sales in 2013 (5.96% in 2012) were made to the son of the Operations Director (Dave Chan). Such large dependence on one customer poses significant business risk. Further, the verifiability of the genuineness of the sale, and the propriety of the sales price is also difficult to ascertain.
4. **Discretion in accounting of significant R&D expenditure:** The entire amount of $31.60 million spent on R&D has been capitalized, and the amortization rate is only around 10%. Such technologies have a relatively short life, and there is significant risk of obsolescence.
5. **Risks of remaining a going concern, and consequent risk of misstatements and earnings management**:

The income statement does not show gross profit, selling, general and administrative, and unusual expenses. These figures had to be constructed by back calculations (Appendix C & D).

Current Assets: While the accounts receivable has increased substantially, the provision for doubtful debts has decreased. Further, while the turnover has declined by 3.5% (Appendix D), the inventory has increased by 9.5% (Appendix B) indicating reduced efficiency.

Non-current assets: The loan of 3 million has not been repaid by the debtor, even in part. It is possible that it is a related party transaction, and the quality / terms need to be examined.

Depreciation of tangibles: Land and building has been re-valued upwards significantly. The accumulated depreciation in Plant & Equipment has reduced from $61 million in 2012 to $42.20 million in 2013, posing operational risks.

Investment in other companies have declined significantly from $18.95 million to $300,000. The gain or loss related to this sale is not evident from the F/S.

Deferred tax asset: There has been a significant increase under this head, and needs to be examined from the angle of statutory compliance.

Liabilities: There is very little cash on books, the bank overdraft has increased substantially from $192.7 million to $360 million, and the OD is secured. This indicates severe deficiency of working capital and low creditworthiness of LE. Despite significant increase in net loss in 2013, the company has provided for a dividend of $20 million and increased provision for employee entitlements from $19.5 million to $26.5 million. Provision for maintenance has decreased from $36 million to $26.5 million. The company has defaulted on a loan repayment to its parent company confirming liquidity risk.

Sales trends: The quarterly pattern of sales for the past three years shows a trend of substantial rise in sales in October to December quarter. This needs to be examined to understand whether the sales have been manipulated to meet the targets.

Ratios: The current ratio, receivables turnover and the inventory turnover has declined significantly indicating reduced efficiency and pressure on liquidity. The erosion in net worth has led to significant increase in debt / equity ratio (Appendix E). As a % of Total Assets (TA), Current Liabilities (CL) have increased from 71% to 93%, and total liabilities are now 99% of the Total Assets (Appendix A). Further, CL increased by 41%, TL increased by 38%, and Net assets declined by 94% in 2013 (Appendix B). The gross profit decreased from 37% to 31%, and the net margins deteriorated from -12.7% to -33.22% during the period (Appendix C).

All the above observations indicate that management may be expecting that LE may cease to be a going concern. The covenants related to the loans require the company to maintain a net tangible asset ratio and positive current ratio. This is another “incentive” for the management to “manage earnings”.

Stage 1(b)

Prima-facie, it appears that the internal control (IC) systems of LE are not adequate. Therefore, the audit needs to be based primarily on substantive procedures / detailed analysis. Despite this, since this is the first audit of LE by the firm, details of the business, and internal and external environment of the company should be understood. Regarding the risks outlined above, the following main audit procedures will be followed:

1. **Fraud risk:** The internal manuals / policies will be studied to understand the level of checks being exercised for different transactions. To understand implementation, a percentage of the transactions will be traced from original documents to journal to ledger to financial statements for actual occurrence, completeness, accuracy, proper period and classification. The forgery case will also be examined.
2. **Business risk:** The external environment, competitors / market share trends / new products etc. will be examined to ascertain the competitive position of LE. Specifically, the reasons for low sales of the new lathe machine will be ascertained. For this, interview of key management personnel, sales persons, and customer feedback or other methods of independent inquiries (e.g through internet) will be used.
3. **Related party transactions:** The company policy will be examined to understand how it defines a related party, and details of such transactions in past three years will be obtained. Approvals related to this particular transaction (sale to Dave's son), and also the nature of business / financial position of his company will be examined. The genuineness of the sale will be examined by checking original documents like purchase order, delivery notes, bank reconciliation of payments etc. Suitable comparison checks for arm-length pricing will be made.
4. **Discretion in accounting of significant R&D expenditure:** The board approval for capitalizing the entire amount of the R&D, and also the 10% rate of amortization will be examined. Based on discussions with the management and also analysis of industry practice (studying balance sheet of competitors), a suitable rate will be recommended.
5. **Risks of remaining a going concern, and consequent risk of misstatements and earnings management**: Management will be asked to provide detailed income statement showing the gross profit, selling, GAD & unusual expenses clearly alongwith relevant detailed notes. Reason for reducing the provision for bad debts, and the details about the $3 million loan (relevant contract document) will be examined. The process followed for increasing the value of Land and

building, and previous practice and market conditions will be studied. Details related to reduced depreciation will ascertained to examine the financial preparedness of the company for future replacements. Details about sale of investment in shares will be ascertained from records**.** Most importantly, management will be asked a cash flow plan for funding operations in the coming quarters. Inquiries will be made from the bankers to check for defaults in payment of loans etc. Reason for proposing a dividend, and details of increase in provision for employee entitlements will be checked to see if these comprise of bonus payments. Sales during the October to December period will be checked for a majority of the transactions from original records like purchase orders, delivery notes, payments, receivables etc.

Appendix A

Balance sheets (Vertical Analysis)

LASER ENGINEERING PTY.LTD

Draft Balance Sheet as at 30th June, 2013

	2012	% of	2013	% of
Current assets	'000	**Total assets**	'000	**Total assets**
Cash	$900	0.14%	$1,000	0.14%
Accounts receivables	$98,400	15.42%	$120,280	17.35%
Inventories	$115,700	18.13%	$126,700	18.28%
Total current assets	**$215,000**	33.68%	**$247,980**	35.77%
Non-current assets		0.00%		0.00%
Receivables	$3,000	0.47%	$3,000	0.43%
Property, plant & equipment	$308,000	48.25%	$306,000	44.14%
Investments	$18,950	2.97%	$300	0.04%
Other	$93,350	14.62%	$136,000	19.62%
Total non-current assets	**$423,300**	66.32%	**$445,300**	64.23%
Total assets	**$638,300**	100.00%	**$693,280**	100.00%
Current liabilities				
Creditors & borrowings	$400,500	62.74%	$591,700	85.35%
Provisions	$55,500	8.69%	$53,100	7.66%
Total current liabilities	**$456,000**	71.44%	**$644,800**	93.01%
Non-current liabilities				
Creditors & borrowings	$24,000	3.76%	$24,000	3.46%
Provisions	$17,000	2.66%	$16,000	2.31%
Total non-current liabilities	**$41,000**	6.42%	**$40,000**	5.77%
Total liabilities	**$497,000**	77.86%	**$684,800**	98.78%
Net assets	**$141,300**	22.14%	**$8,480**	1.22%
Shareholders' equity				
Share capital	$100,000	15.67%	$100,000	14.42%
Reserves	$120,000	18.80%	$157,662	22.74%
Accumulated losses	-$78,700	-12.33%	-$249,182	-35.94%
Total Shareholders' equity	**$141,300**	22.14%	**$8,480**	1.22%

APPENDIX B

Balance Sheets (Horizontal analysis)

LASER ENGINEERING PTY.LTD

Draft Balance Sheet as at 30th June, 2013

	2012	2013	$ Change	% Change
Current assets	'000	'000		
Cash	$900	$1,000	$100	11.11%
Accounts receivables	$98,400	$120,280	$21,880	22.24%
Inventories	$115,700	$126,700	$11,000	9.51%
Total current assets	**$215,000**	**$247,980**	$32,980	15.34%
Non-current assets				
Receivables	$3,000	$3,000	$0	0.00%
Property, plant & equipment	$308,000	$306,000	-$2,000	-0.65%
Investments	$18,950	$300	-$18,650	-98.42%
Other	$93,350	$136,000	$42,650	45.69%
Total non-current assets	**$423,300**	**$445,300**	$22,000	5.20%
Total assets	**$638,300**	**$693,280**	$54,980	8.61%
Current liabilities				
Creditors & borrowings	$400,500	$591,700	$191,200	47.74%
Provisions	$55,500	$53,100	-$2,400	-4.32%
Total current liabilities	**$456,000**	**$644,800**	$188,800	41.40%
Non-current liabilities				
Creditors & borrowings	$24,000	$24,000	$0	0.00%
Provisions	$17,000	$16,000	-$1,000	-5.88%
Total non-current liabilities	**$41,000**	**$40,000**	-$1,000	-2.44%
Total liabilities	**$497,000**	**$684,800**	$187,800	37.79%
Net assets	**$141,300**	**$8,480**	-$132,820	-94.00%
Shareholders' equity				
Share capital	$100,000	$100,000	$0	0.00%
Reserves	$120,000	$157,662	$37,662	31.39%
Accumulated losses	-$78,700	-$249,182	-$170,482	216.62%
Total Shareholders' equity	**$141,300**	**$8,480**	-$132,820	-94.00%

APPENDIX C

Income statements (Vertical Analysis)

LASER ENGINEERING PTY. LTD.

Draft Income Statement for the year ended 30th June 2013

	2012	% of	2013	% of
	'000	Turnover	'000	Turnover
Turnover	$469,600	100.00%	$453,000	100.00%
Cost of Sales	**$295,848**	63.00%	**$312,570**	69.00%
Gross profit	**$173,752**	37.00%	**$140,430**	31.00%
Selling, General & Administrative expenses & unusual expenses	$238,772	50.85%	$316,542	69.88%
Operating profit/(loss) before tax	**-$65,020**	-13.85%	**-$176,112**	-38.88%
Income tax revenue	$5,320	1.13%	$25,630	5.66%
Operating profit/(loss) after tax	**-$59,700**	-12.71%	**-$150,482**	-33.22%
Retained profits (Accumulated losses) at the beginning of the financial year	-$19,000	-4.05%	-$78,700	-17.37%
Dividend proposed	$0	0.00%	-$20,000	-4.42%
Retained profits (Accumulated losses) at the end of the financial year	**-$78,700**	-16.76%	**-$249,182**	-55.01%

APPENDIX D

LASER ENGINEERING PTY. LTD.

Draft Income Statement for the year ended 30th June 2013

	2012	2013	$ Change	% change
	'000	'000		
Turnover	$469,600	$453,000	-$16,600	-3.53%
Cost of Sales	**$295,848**	**$312,570**	$16,722	5.65%
Gross profit	**$173,752**	**$140,430**	-$33,322	-19.18%
Selling, General & Administrative expenses & unusual expenses	$238,772	$316,542	$77,770	32.57%
Operating profit/(loss) before tax	**-$65,020**	**-$176,112**	-$111,092	170.86%
Income tax revenue	$5,320	$25,630	$20,310	381.77%
Operating profit/(loss) after tax	**-$59,700**	**-$150,482**	-$90,782	152.06%
Retained profits (Accumulated losses) at the beginning of the financial year	-$19,000	-$78,700	-$59,700	314.21%
Dividend proposed	$0	-$20,000	-$20,000	
Retained profits (Accumulated losses) at the end of the financial year	**-$78,700**	**-$249,182**	-$170,482	216.62%

Income statements (Horizontal Analysis)

APPENDIX E

Laser Engineering Pty. Ltd - Ratio analysis

Ratios	**2012**	**2013**
Current assets / Current liabilities	47.15%	38.46%
Turnover / Accounts receivables	4.77	3.77
COGS / Inventory	2.56	2.47
Total Debt / Equity	3.52	80.75