Your client, Island Co, is a manufacturer of machinery used in the coal extraction industry. You are currently planning the audit of the financial statements for the year ended 30 November 2007. The draft financial statements show revenue of $125 million (2006 — $103 million), profit before tax of $5.6 million (2006 — $5.1 million) and total assets of $95 million (2006 — $90 million). Your firm was appointed as auditor to Island Co for the first time in June 2007.

Island Co designs, constructs and installs machinery for five key customers. Payment is due in three instalments: 50% is due when the order is confirmed (stage one), 25% on delivery of the machinery (stage two), and 25% on successful installation in the customer's coal mine (stage three). Generally it takes six months from the order being finalised until the final installation.

At 30 November, there is an amount outstanding of $2.85 million from Jacks Mine Co. The amount is a disputed stage three payment. Jacks Mine Co is refusing to pay until the machinery, which was installed in August 2007, is running at 100% efficiency.

One customer, Sawyer Co, communicated in November 2007, via its lawyers with Island Co, claiming damages for injuries suffered by a drilling machine operator whose arm was severely injured when a machine malfunctioned. Kate Shannon, the chief executive officer of Island Co, has told you that the claim is being ignored as it is generally known that Sawyer Co has a poor health and safety record, and thus the accident was their fault. Two orders which were placed by Sawyer Co in October 2007 have been cancelled.

Work in progress is valued at $85 million at 30 November 2007. A physical inventory count was held on 17 November 2007. The chief engineer estimated the stage of completion of each machine at that date. One of the major components included in the coal extracting machinery is now being sourced from overseas. The new supplier,Locke Co, is located in Spain and invoices Island Co in euros. There is a trade payable of $15 million owing to Locke Co recorded within current liabilities.

All machines are supplied carrying a one year warranty. A warranty provision is recognised on the balance sheet at $2.5 million (2006 — $2.4 million). Kate Shannon estimates the cost of repairing defective machinery reported by customers, and this estimate forms the basis of the provision.

Kate Shannon owns 60% of the shares in Island 00. She also owns 55% of Pacific Co, which leases a head office to Island Co. Kate is considering selling some of her shares in Island Co in late January 2008, and would like the audit to be finished by that time.

Required:

(3) Using the information provided, identify and explain the principal audit risks, and any other matters to be considered when planning the final audit for Island Co for the year ended 30 November 2007.

Note: your answer should be presented in the format of briefing notes to be used at a planning meeting.

Requirement (a) includes 2 professional marks. (13 marks)