

Question 1

Trendy Clothings Ltd ('Trendy'), a company engaged in the manufacturing and sales of clothing for young people for the past two decades. Two years ago with its profit declining, Trendy appointed a new managing director Peter Graves who is known to be very autocratic in his management style. Nevertheless in spite of the decline in the clothing industry Graves was able to show good earnings and growth due to an increase in sales. He was credited for single-handedly turning the company around by not only successfully acquiring a number competitors sales outlet but also by hiring an aggressive group of sales executives using an unusually generous incentive plan based on volume of sales combined with a relatively low salaries.

In the current year Trendy have decided to terminate the services of its previous auditor and in its place have appointed your audit firm, with the approval of the Board, as the auditor for the first time. The reason for the termination of the previous auditor was not clearly made known to you by Trendy but the industry talk was that it was primarily due to a dispute over the valuation of stocks and the recognition of sales revenue. This is the first time that your firm has audited a company in the clothing industry.

Trendy have recently installed a sophisticated computer system but it caters only for inventory and sales. Most of the computer time is reserved for production and marketing because Graves believes these areas are more essential to operations than the record-keeping function. As such with the accounting operations not computerized. You, as the senior in charge of the audit, have noticed that the accounting records are kept manually and this has put a strain on the overworked, underpaid but competent accounting staff.

Trendy's profit for the current year is approximately 15% higher than the preceding year, due to the increase in sales volume and a much lower provisions for bad debts compared to last year. This is somewhat surprising, in view of the significant decline in the profits of the clothing industry as a whole.

During the year too there was an acquisition of a company in which one of the directors is deemed to have substantial interests.

You have been informed that due to the need for additional funds to finance its acquisitions Trendy's borrowings – both short and long term – increased significantly and thus putting a strain on the company's cash flow. The management is said to be reluctant to request a fresh injection of capital from its shareholders as the increased number of shares would decrease the earnings per share.

Instead, according to Peter Graves he is currently negotiating with several cash-rich companies in the hope of being able to merge with them as a means of overcoming the capital problems.

Required

In the audit of Trendy Clothings Ltd describe:

- a) the major concerns that you may come across; and
- b) for each concern, indicate the audit planning actions required.

Total - 20 marks

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Major Concern	Planning Action Required
1. This is the first audit for your firm of Trendy. This raises audit risk as your firm is not familiar with Trendy	Schedule familiarisation visits for key members of staff. Allow extra time for audit work generally as there may be unexpected problems.
2. This is the first time you are auditing a company in a clothing industry. This raises audit risk as your firm do not have staffs who are experienced in this particular field	Hire audit staffs who are experienced in the clothing industry. Schedule immediate training for existing staff.
3. Dispute with previous auditor may indicate that there were problems with management with the valuation and their accounting practices.	Contact the previous auditors to ascertain the nature of the dispute. Obtain details from management about the recognition of sales revenue, valuation of stocks and accounting practices to be followed in the current year. Ensure that you are satisfied with these. Plan to focus your audit work on these areas.
4. Autocratic management – control risk	This is an indication of a possible weakness in the control environment. Obtain and document an understanding of the company's accounting and control system to help you to plan your audit.
5. The company appears to be heavily dependent on the energies and expertise of Peter Graves	Ascertain the nature of management responsibilities within Trendy, Peter Graves character (integrity, expertise, knowledge), the abilities of other members of senior management

Major Concern	Planning Action Required
6. The use of a generous incentive sales plan based on sales volume to motivate young executives	As the executives remunerations are very much dependent on the sales volume, consider the risk or the possibility of manipulation of the sales forecast figures which after all were determined by the sales and production personnel. Plan audit work to take account of this risk i.e. allowing more time and allocate more experienced staff.
7. Lack of sophisticated accounting records and reliance on sales and production department data for forecasting. Accounting staff underpaid and overworked.	Assess the control risks within the accounting systems and particularly consider the possibility that forecasting data may be overly optimistic and insufficiently grounded in historical records. Ensure that sufficient work is carried out to ascertain the reliability of accounting system and of forecast data.
8. Installation of the new computer system and the priority being given to the production and marketing systems	Allow time for the ascertainment and evaluation of the computer system, taking into account that this will be the first full year of operation. Consider the need to book computer audit specialists. Consider how CAATs may be used.
9. There are several indications (above) that Peter Graves prioritises areas other than the accounting record systems.	This is an another indication of a weakness in the control environment. Take this into account in assessing risk.
10. The increase in the profit is rather unusual considering the setback in the clothing industry.	Conduct analytical review in order to assess the reasonableness of the accounting figures. Consider the possibility of management manipulation and allow audit time for the careful scrutiny of accounting estimates and the reasonableness of the provision of the bad debts.
11. The purchase of company in which one of the directors have substantial interests.	This is an issue of related party transaction. Review the valuation and the price paid and ascertain if it is reasonable and that it was an arms length transaction.
12. Significant increase in borrowings	Assess the going concern status of Trendy.

	Obtain cash flow and profit forecasts and the assumptions on which they are based. Allow audit time review indications of lack of going concern.
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