

QUESTION TWO

(a)

Explain the components of audit risk and, for each component, state an example of a factor which can result in increased audit risk

(5 marks)

(b)

Richey Communications Ltd (Richey) is a large mobile phone company which operates a network of stores in countries across Europe. The company's year end is 30 June 2014. You are the audit senior of Piano & Co. Richey is a new client and you are currently planning the audit with the audit manager. You have been provided with the following planning notes from the audit partner following his meeting with the finance director.

Richey purchases goods from a supplier in South Asia and these goods are shipped to the company's central warehouse. The goods are usually in transit for two weeks and the company correctly records the goods when received. Richey does not undertake a year-end stock count, but it carries out monthly continuous (perpetual) stock counts and any errors identified are adjusted in the stock system for that month.

During the year the company introduced a bonus based on sales for its sales persons. The bonus target was based on increasing the number of customers signing up for 24-month phone line contracts. This has been successful and revenue has increased by 15%, especially in the last few months of the year. The level of debtors is considerably higher than last year and there are concerns about the creditworthiness of some customers.

Richey has a policy of revaluing its land and buildings and this year has updated the valuations of all land and buildings.

During the year the directors have each been paid a significant bonus, and they have included this within wages and salaries. Separate disclosure of directors' remuneration, which includes the bonus, is required by the Companies Act 2006.

Requirement:

Describe the audit risks, and explain the auditor's response to each risk, in planning the audit of Richey Communications Ltd.

QUESTION TWO

Components of audit risk

Inherent risk

The susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Inherent risk is affected by the nature of an entity and factors which can result in an increase include:

- Changes in the industry it operates in.
- Operations that are subject to a high degree of regulation.
- Going concern and liquidity issues including loss of significant customers.
- Developing or offering new products or services, or moving into new lines of business.
- Expanding into new locations.
- Application of new accounting standards.
- Accounting measurements that involve complex processes.
- Events or transactions that involve significant accounting estimates.
- Pending litigation and contingent liabilities.

Control risk

The risk that a misstatement that could occur in an assertion about a class of transaction, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

The following factors can result in an increase in control risk:

- Lack of personnel with appropriate accounting and financial reporting skills.
- Changes in key personnel including departure of key management.
- Deficiencies in internal control, especially those not addressed by management.
- Changes in the information technology (IT) environment.
- Installation of significant new IT systems related to financial reporting.

Detection risk

The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Detection risk is affected by sampling and non-sampling risk and factors which can result in an increase include:

- Inadequate planning.
- Inappropriate assignment of personnel to the engagement team.
- Failing to apply professional scepticism.
- Inadequate supervision and review of the audit work performed.
- Incorrect sampling techniques performed.
- Incorrect sample sizes

(1) Audit Risk

Richey Communications Ltd (Richey) is a new client for Piano & Co. As the team is not so familiar with the accounting policies, transactions and balances of Richey, there will be an increased detection risk on the audit.

Response

Piano & Co should ensure they have a suitably experienced team. Also, adequate time should be allocated for team members to obtain an understanding of the company and the risks of material misstatement.

(2) Audit Risk

Richey purchases their goods from South Asia and the goods are in transit for two weeks. At the year end there is a risk that the cut-off of stock, purchases and creditors may not be accurate. The company correctly accounts for goods when they receive them. Therefore at the year end only goods which have been received into the warehouse should be included in the stock balance and a respective payables balance recognised.

Response

The audit team should undertake detailed cut-off testing of goods in transit from the suppliers in South Asia to ensure that the cut-off is complete and accurate.

Additionally, the auditor should ensure that any transactions undertaken in a foreign currency are accounted for in accordance with FRS 23.

(3) Audit Risk

The company undertakes continuous (perpetual) stock counts at its central warehouse. Under such a system all stock must be counted at least once a year with adjustments made to the stock records. Stock could be under or overstated if the continuous (perpetual) stock counts are not complete and the stock records accurately updated for adjustments.

Response

The completeness of the continuous (perpetual) stock counts should be reviewed. In addition, the level of adjustments made to stock should be considered to assess whether reliance on the stock records at the year end will be acceptable.

The audit team should attend at least one of the continuous (perpetual) stock counts to review whether the controls over the stock count are adequate.

The audit team should confirm that all of the stock lines have been counted or are due to be counted at least once a year by reviewing the schedules of counts undertaken/due to be undertaken.

Discuss with management how they will ensure that year-end stock will not be under or overstated.

Consider attending the stock count at the year end to undertake test counts of stock from records to floor and from floor to records in order to confirm the existence and completeness of stock.

(4) Audit Risk

A sales-related bonus scheme has been introduced in the year; this may lead to sales cut-off errors with employees aiming to maximise their current year bonus.

Response

Increased sales cut-off testing will be performed along with a review of any post year-end cancellations of contracts as they may indicate cut-off errors.

(5) Audit Risk

Debtors are considerably higher than the prior year and there are concerns about the creditworthiness of some customers. There is a risk that some debtors may be overvalued as they are not recoverable. In addition, debtors could be overstated as a result of the bonus scheme; some of the customers signed up for contracts may not actually exist.

Response

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

External confirmation of debtors to confirm that customers exist and represent valid amounts due.

(6) Audit Risk

Richey has a policy of revaluing its land and buildings and these valuations have been updated during the year. Property, plant and equipment could be under or overvalued if the recent valuation has not been carried out in accordance with FRS 15 and adequate disclosures may not have been made in the financial statements.

Response

Discuss with management the process adopted for undertaking the valuation, including whether the whole class of assets was revalued and if the valuation was undertaken by an expert. This process should be reviewed for compliance with FRS 15.

Review the disclosures of the revaluation in the financial statements for compliance with FRS 15.

(7) Audit Risk

The directors have each been paid a significant bonus and disclosure of this as part of directors' remuneration is required in the financial statements by Companies Act 2006.

The directors' remuneration disclosure will not be complete and accurate if the bonus paid is not included within the remuneration disclosed in accordance with Companies Act 2006.

Response

Discuss this matter with management and review the disclosure in the financial statements to ensure compliance with Companies Act 2006.