

SECTION A – answer ALL questions in this section

Question 1

Your firm has recently been appointed auditor of TraidInd Limited (“TraidInd”). The company operates a chain of 45 UK based retail stores, selling cotton batik clothing and accessories. The company owns a Milton Keynes-based warehouse from which it supplies all stores with inventory.

The company sources its inventory from a small number of workshops in India. Freelance UK designers work with these workshops in order to provide design support for the spring, summer, and winter seasons. TraidInd places its orders three times a year to coincide with the three seasons. All transactions are conducted in US\$ and payment is due in full on arrival of the goods in the UK.

The majority of the company’s sales are conducted by cash, cheque, or credit card. In order to remain competitive with other major high street retailers the company offers a returns policy to its customers that allows goods to be returned to the store for any reason with a full refund offered. Goods returned under this policy are then sold on in bulk through the trade, sometimes at less than their original cost to TraidInd.

The company’s employees include monthly paid head office staff and store managers and a weekly paid core number of other store staff. In addition the company employs a large number of casual staff during peak periods. Permanent staff are paid by weekly/monthly direct bank transfer and casual staff are paid in cash.

Charity Dawes is TraidInd’s managing director. Aged 30, she is also the company’s main shareholder. She adopts a very hands-on approach to the business and is involved in all major decisions and rarely delegates. Until recently she was advised by her mother who has a long experience of the retail trade. However, her mother recently retired as sales director and has not yet been replaced. The company has grown rapidly in recent years and is heavily reliant on loans from other family members and a bank overdraft. The company has recently acquired new offices adjacent to its central warehouse. Their purchase was financed by large bank borrowings under term loans, which call for annual capital repayments.

Requirements

- (a) Describe the different components that comprise audit risk.
(4 marks)
- (b) Explain why the auditor needs to consider risk when conducting an audit.
(4 marks)
- (c) Identify, from the circumstances outlined above, the factors which indicate high audit risk in respect of the audit of TraidInd Limited and, for each factor identified, explain why it contributes to high audit risk.
(12 marks)

Total: 20 marks

Question 1

(a) Describe the different components that comprise audit risk.

4 marks

(a) Components of audit risk

Inherent risk 1 mark

- risk of material error arising regardless of related internal controls/risks associated with the nature and characteristics of the business

Control risk 1 mark

- risk that internal controls fail to prevent or detect a material error

Detection risk 2 marks

- risk that auditor's substantive procedures will fail to detect a material error
- detection risk is split into sampling/non-sampling risk
- sampling risk is the risk that the sample is not representative of the population
- non-sampling risk is the risk that all other work by auditor fails to detect a material error

(b) Explain why the auditor needs to consider risk when conducting an audit.

4 marks

- Enables auditor to plan audit effectively
- Ensure audit attention is devoted to appropriate areas
- The higher the risk, the greater the amount of assurance work required
- Steps taken will affect the nature timing and extent of audit procedures

1 mark per point

(c) Identify, from the circumstances outlined above, the factors which indicate high audit risk in respect of the audit of TraidInd Limited and, for each factor identified, explain why it contributes to high audit risk.

(12 marks)

1 mark per point (but a why must be included)

1. New audit to your firm – not familiar with business
2. Fashion is a volatile/ seasonal business – vulnerable to stock obsolescence and variation in cash flow

3. Company sells goods sourced from relatively small no of suppliers – vulnerable supplies
4. Large number of cash transactions (sales/wages) - misappropriation
5. Company deals in foreign currency – vulnerable to fluctuations
6. Dominant/majority shareholder MD - over dependence on MD – if unable to work and no succession in place
7. Loss of expertise with retirement of mother as sales director – MD will be overstretched
8. Reliance on family loans – could be withdrawn? Not subject to formal agreement?
9. Company's customer returns policy - customer returns could give rise to misstated balances in accounts/Inventory at > NRV or may be obsolete
10. Large bank borrowings: can they meet repayments?
11. Casual staff employed – can lead to loss of control
12. Risk of obsolete inventory as company may be stuck with last year's trend (difficult to determine inventory values)
13. Large chain of stores with issues of control and retail outlets vulnerable to fraud
 - a. Inventory control issue with respect to number of stores/Inventory lost in transit or double counted
 - b. Risk of stock-outs/loss of supplier/large borrowings causing going concern problems
 - c. Risk of incomplete recording of sales
 - d. Risk of misappropriated cash
14. Exposure to foreign exchange risk resulting in misstated inventory/purchases
15. MD desire for profit may lead to manipulation of results
16. Casual staff resulting in misstated PAYE liabilities/fines/interest/misstated payroll figure