

SECTION A

QUESTION ONE

(a)

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

(10 marks)

(b)

Arnold Ltd develops, manufactures and sells a range of pharmaceuticals and has a wide customer base across Europe and Asia. You are the audit manager of Norton & Co and you are planning the audit of Arnold Ltd whose financial year end is 31 January. You attended a planning meeting with the finance director and engagement partner and are now reviewing the meeting notes in order to produce the audit strategy and plan. Revenue for the year is forecast at £25 million.

During the year the company has spent £2.2 million on developing several new products. Some of these are in the early stages of development whilst others are nearing completion. The finance director has confirmed that all projects are likely to be successful and so he is intending to capitalise the full £2.2 million. Once products have completed the development stage, Arnold begins manufacturing them. At the year end it is anticipated that there will be significant levels of work in progress. In addition the company uses a standard costing method to value stock; the standard costs are set when a product is first manufactured and are not usually updated. In order to fulfil customer orders promptly, Arnold Ltd has warehouses for finished goods located across Europe and Asia; approximately one third of these are third party warehouses where Arnold just rents space.

In September a new accounting package was introduced. This is a bespoke system developed by the information technology (IT) manager. The old and new packages were not run in parallel as it was felt that this would be too onerous for the accounting team. Two months after the system changeover the IT manager left the company; a new manager has been recruited but is not due to start work until January.

In order to fund the development of new products, Arnold has restructured its finance and raised £1 million through issuing shares at a premium and £2.5 million through a long-term loan. There are bank covenants attached to the loan, the main one relating to a minimum level of total assets. If these covenants are breached then the loan becomes immediately repayable. The company has a policy of revaluing land and buildings, and the finance director has announced that all land and buildings will be revalued as at the year end.

The reporting timetable for audit completion of Arnold Ltd is quite short, and the finance director would like to report results even earlier this year.

Requirement:

Using the information provided, identify and describe the audit risks and explain the auditor's response to each risk in planning the audit of Arnold Ltd.

(25 marks)

(TOTAL 35 MARKS)

QUESTION ONE

(a)

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.

Audit risks and responses

Audit risk and response

The finance director of Arnold is planning to capitalise the full £2.2 million of development expenditure incurred. However in order to be capitalised it must meet all of the criteria under IAS 38 *Intangible Assets*.

There is a risk that some projects may not reach final development stage and hence should be expensed rather than capitalised. Intangible assets could be overstated and this risk is increased due to the loan covenant requirements to maintain a minimum level of assets.

A breakdown of the development expenditure should be reviewed and tested in detail to ensure that only projects which meet the capitalisation criteria are included as an intangible asset, with the balance being expensed.

Audit risk and response

The stock valuation method used by Arnold is standard costing. This method is acceptable under SSAP 9; however, only if standard cost is a close approximation to actual cost. Arnold has not updated their standard costs from when the product was first developed and hence there is a risk that the standard costs could be out of date, resulting in over or undervalued stock.

The standard costs used for the stock valuation should be tested in detail and compared to actual cost. If there are significant variations this should be discussed with management, to ensure that the valuation is appropriate.

Audit risk and response

The work in progress balance at the year end is likely to be material; however there is a risk that due to the nature of the production process the audit team may not be sufficiently qualified to assess the quantity and value of work in progress leading to misstated work in progress.

Consideration should be given as to whether an independent expert is required to value the work in progress. If so this will need to be arranged with consent from management and in time for the year-end count.

Audit risk and response

Over one-third of the warehouses of Arnold belong to third parties. Sufficient and appropriate evidence will need to be obtained to confirm the quantities of stock held in these locations in order to verify completeness and existence.

Additional procedures will be required to ensure that stock quantities have been confirmed for both third party and company owned locations.

Audit risk and response

In September Arnold Ltd introduced a new accounting system. This is a critical system for the accounts preparation and if there were any errors that occurred during the changeover process, these could impact on the final amounts in the trial balance.

The new system will need to be documented in full and testing should be performed over the transfer of data from the old to the new system.

Audit risk and response

The new accounting system is bespoke and the IT manager who developed it has left the company already and his replacement is not due to start work until just before the year end. The accounting personnel who are using the system may have encountered problems and without the IT manager's support, errors could be occurring in the system due to a lack of knowledge and experience. This could result in significant errors arising in the financial statements.

This issue should be discussed with the finance director to understand how he is addressing this risk of misstatement. In addition, the team should remain alert throughout the audit for evidence of such errors.

Audit risk and response

Significant finance has been obtained in the year, £1 million of equity finance and £2.5 million of long-term loans. This finance needs to be accounted for correctly, with adequate disclosure made. The equity finance needs to be allocated correctly between share capital and share premium, and the loan should be presented as a non-current liability.

Check that the split of the equity finance is correct and that total financing proceeds of £3.5 million were received. In addition, the disclosures for this finance should be reviewed in detail to ensure compliance with relevant accounting standards.

Audit risk and response

The loan has a number of covenants attached to it. If these are breached then the loan would be instantly repayable and would be classified as a current liability. This could result in the company being in a net current liability position. If the company did not have sufficient cash flow to meet this loan repayment then there could be going concern implications.

Review the covenant calculations prepared by Arnold Ltd and identify whether any defaults have occurred; if so then determine the effect on the company.

The team should maintain their professional scepticism and be alert to the risk that assets have been overstated to ensure compliance with covenants.

Audit risk and response

The land and buildings are to be revalued at the year end, it is likely that the revaluation surplus/deficit will be material. The revaluation needs to be carried out and recorded in accordance with IAS 16 *Property, Plant and Equipment*; otherwise non-current assets may be incorrectly valued.

Review the reasonableness of the valuation and recalculate the revaluation surplus/deficit to ensure that land and buildings are correctly valued.

Audit risk and response

The reporting timetable for Arnold Ltd is likely to be reduced. The previous timetable was already quite short; any further reductions will increase detection risk and place additional pressure on the team in obtaining sufficient and appropriate evidence.

The timetable should be confirmed with the finance director. If it is to be reduced then consideration should be given to performing an interim audit in late December or early January, this would then reduce the pressure on the final audit.