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Audit Risk-Practice Questions

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Question 01

You are an audit supervisor of Cupid & Co, planning the final audit of a new client, Prance Construction Co, for the year ending 30 September 20X7. The company specializes in property construction and providing ongoing annual maintenance services for properties previously constructed. Forecast profit before tax is $13.8m and total assets are expected to be $22.3m, both of which are higher than for the year ended 30 September 20X6.

You are required to produce the audit strategy document. The audit manager has met with Prance Construction Co's finance director and has provided you with the following notes, a copy of the August management accounts and the prior year financial statements.

Meeting notes

The prior year financial statements recognize work in progress of $1.8m, which was comprised of property construction in progress as well as ongoing maintenance services for finished properties. The August 20X7 management accounts recognize $2.1m inventory of completed properties compared to a balance of $1.4m in September 20X6. A full year-end inventory count will be undertaken on 30 September at all of the 11 building sites where construction is in progress. There is not sufficient audit team resource to attend all inventory counts.

In line with industry practice, Prance Construction Co offers its customers a five-year building warranty, which covers any construction defects. Customers are not required to pay any additional fees to obtain the warranty. The finance director anticipates this provision will be lower than last year as the company has improved its building practices and therefore the quality of the finished properties.

Customers who wish to purchase a property are required to place an order and pay a 5% non-refundable deposit prior to the completion of the building. When the building is complete, customers pay a further 92.5%, with the final 2.5% due to be paid six months later. The finance director has informed you that although an allowance for receivables has historically been maintained, it is anticipated that this can be significantly reduced.

Information from management accounts

Prance Construction Co's prior year financial statements and August 20X7 management accounts contain a material overdraft balance. The finance director has confirmed that there are minimum profit and net assets covenants attached to the overdraft.

A review of the management accounts shows the payables period was 56 days for August 20X7, compared to 87 days for September 20X6. The finance director anticipates that the September 20X7 payables days will be even lower than those in August 20X7.

Required:

(a) Describe the process Cupid & Co should have undertaken to assess whether the PRECONDITIONS for an audit were present when accepting the audit of Prance Construction Co. (3 marks)

(b) Identify THREE main areas, other than audit risks, which should be included within the audit strategy document for Prance Construction Co, and for each area provide an example relevant to the audit. (3 marks)

(c) Using all the information provided describe SEVEN audit risks, and explain the auditor's response to each risk, in planning the audit of Prance Construction Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (14 marks) (20 marks)

Question 02

You are an audit supervisor of Caving & Co and you are planning the audit of Hurling Co, a listed company, for the year ending 31 March 20X7. The company manufactures computer components and forecast profit before tax is $33.6m and total assets are $79.3m.

Hurling Co distributes its products through wholesalers as well as via its own website. The website was upgraded during the year at a cost of $1.1m. Additionally, the company entered into a transaction in February to purchase a new warehouse which will cost $3.2m. Hurling Co's legal advisers are working to ensure that the legal process will be completed by the year end. The company issued $5m of irredeemable preference shares to finance the warehouse purchase.

During the year the finance director has increased the useful economic lives of fixtures and fittings from three to four years as he felt this was a more appropriate period. The finance director has informed the engagement partner that a revised credit period has been agreed with one of its wholesale customers, as they have been experiencing difficulties with repaying the balance of $1.2m owing to Hurling Co. In January 20X7, Hurling Co introduced a new bonus based on sales targets for its sales staff. This has resulted in a significant number of new wholesale customer accounts being opened by sales staff. The new customers have been given favorable credit terms as an introductory offer, provided goods are purchased within a two-month period. As a result, revenue has increased by 5% on the prior year.

The company has launched several new products this year and all but one of these new launches has been successful. Feedback on product Luger, launched four months ago, has been mixed, and the company has just received notice from one of their customers, Paranaque Co, of intended legal action. They are alleging the product sold to them was faulty, resulting in a significant loss of information and an ongoing detrimental impact on profits. As a precaution, sales of the Luger product have been halted and a product recall has been initiated for any Luger products sold in the last four months.

The finance director is keen to announce the company's financial results to the stock market earlier than last year and in order to facilitate this; he has asked if the audit could be completed in a shorter timescale. In addition, the company is intending to propose a final dividend once the financial statements are finalized.

Hurling Co's finance director has informed the audit engagement partner that one of the company's non-executive directors (NEDs) has just resigned, and he has enquired if the partners at Caving & Co can help Hurling Co in recruiting a new NED. Specifically he has requested the engagement quality control reviewer, who was until last year the audit engagement partner on Hurling Co, assist the company in this recruitment. Caving & Co also provides taxation services for Hurling Co in the form of tax return preparation along with some tax planning advice. The finance director has recommended to the audit committee of Hurling Co that this year's audit fee should be based on the company's profit before tax. At today's date, 20% of last year's audit fee is still outstanding and was due to be paid three months ago.

Required:

(b) Describe EIGHT audit risks, and explain the auditor's response to each risk, in planning the audit of Hurling Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (16 marks)

(c) (i) Identify and explain FIVE ethical threats which may affect the independence of Caving & Co's audit of Hurling Co; and (ii) For each threat, suggest a safeguard to reduce the risk to an acceptable level. Note: The total marks will be split equally between each part. Prepare your answer using two columns headed Ethical threat and Possible Safeguard respectively. (10 marks)

Question 03

You are an audit supervisor of China & Co and are planning the audit of your client, Satie Sparkle Co which manufactures cleaning products. Its year end was 31 July 20X6 and the draft profit before tax is $33.6 million. You are supervising a large audit team for the first time and will have specific responsibility for supervising and reviewing the work of the audit assistants in your team.

Satie Sparkle Co purchases most of its raw materials from suppliers in Africa and these goods are shipped directly to the company's warehouse and the goods are usually in transit for up to three weeks. The company has incurred $1.3 million of expenditure on developing a new range of cleaning products which are due to be launched into the market place in November 20X6. In September 20X5, Satie Sparkle Co also invested $0.9 million in a complex piece of plant and machinery as part of the development process. The full amount has been capitalized and this cost includes the purchase price, installation costs and training costs.

This year, the bonus scheme for senior management and directors has been changed so that rather than focusing on profits, it is instead based on the value of year-end total assets. In previous years an allowance for receivables, made up of specific balances, which equaled almost 1% of trade receivables was maintained. However, the finance director feels that this is excessive and unnecessary and has therefore not included it for 20X6 and has credited the opening balance to the profit or loss account.

A new general ledger system was introduced in May 20X6; the finance director has stated that the data was transferred and the old and new systems were run in parallel until the end of August 20X6. As a result of the additional workload on the finance team, a number of control account reconciliations were not completed as at 31 July 20X6, including the bank reconciliation. The finance director is comfortable with this as these reconciliations were completed successfully for both June and August 20X6. In addition, the year-end close down of the purchase ledger was undertaken on 8 August 20X6.

Required:

Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Satie Sparkle Co. Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively. (12 marks)

Question 04

You are an audit supervisor of Amethyst & Co and are currently planning the audit of your client, Aquamarine Co (Aquamarine) which manufactures elevators. Its year end is 31 July 2016 and the forecast profit before tax is $15.2 million.

The company undertakes continuous production in its factory, therefore at the yearend it is anticipated that work in progress will be approximately $950,000. In order to improve the manufacturing process, Aquamarine placed an order in April for $720,000 of new plant and machinery; one third of this order was received in May with the remainder expected to be delivered by the supplier in late July or early August.

At the beginning of the year, Aquamarine purchased a patent for $1.3 million which gives them the exclusive right to manufacture specialized elevator equipment for five years. In order to finance this purchase, Aquamarine borrowed $1.2 million from the bank which is repayable over five years.

In January 2016 Aquamarine outsourced its payroll processing to an external service organization, Coral Payrolls Co (Coral). Coral handles all elements of the payroll cycle and sends monthly reports to Aquamarine detailing the payroll costs. Aquamarine ran its own payroll until 31 December 2015, at which point the records were transferred over to Coral.

The company has a policy of revaluing land and buildings and the finance director has announced that all land and buildings will be revalued at the year end. During a review of the management accounts for the month of May 2016, you have noticed that receivables have increased significantly on the previous year end and against May 2015.

The finance director has informed you that the company is planning to make approximately 65 employees redundant after the year end. No decision has been made as to when this will be announced, but it is likely to be prior to the year end.

Required:

(b) Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Aquamarine Co. (12 marks)

(c) Explain the additional factors Amethyst & Co should consider during the audit in relation to Aquamarine Co's use of the payroll service organization. (3 marks) (20 marks)

Question 05

You are an audit supervisor of Pluto & Co and are currently planning the audit of your client, Venus Magnets Co (Venus) which manufactures decorative magnets. Its year end is 31 December 2015 and the forecast profit before tax is $9.6 million.

During the year, the directors reviewed the useful lives and depreciation rates of all classes of plant and machinery. This resulted in an overall increase in the asset lives and a reduction in the depreciation charge for the year.

Inventory is held in five warehouses and on 28 and 29 December a full inventory count will be held with adjustments for movements to the year end. This is due to a lack of available staff on 31 December. In October, there was a fire in one of the warehouses; inventory of $0.9 million was damaged and this has been written down to its scrap value of $0.2 million. An insurance claim has been submitted for the difference of $0.7 million. Venus is still waiting to hear from the insurance company with regards to this claim, but has included the insurance proceeds within the statement of profit or loss and the statement of financial position.

The finance director has informed the audit manager that the October and November bank reconciliations each contained unreconciled differences; however, he considers the overall differences involved to be immaterial.

A directors' bonus scheme was introduced during the year which is based on achieving a target profit before tax. In order to finalize the bonus figures, the finance director of Venus would like the audit to commence earlier so that the final results are available earlier this year.

Required:

Describe FIVE audit risks, and explain the auditor's response to each risk, in planning the audit of Venus Magnets Co. (10 marks)

Question 06

You are the audit supervisor of Maple & Co and are currently planning the audit of an existing client, Sycamore Science Co (Sycamore), whose year-end was 30 April 2015. Sycamore is a pharmaceutical company, which manufactures and supplies a wide range of medical supplies. The draft financial statements show revenue of $35.6 million and profit before tax of $5.9 million.

Sycamore's previous finance director left the company in December 2014 after it was discovered that he had been claiming fraudulent expenses from the company for a significant period of time. A new finance director was appointed in January 2015 who was previously a financial controller of a bank, and she has expressed surprise that Maple & Co had not uncovered the fraud during last year's audit.

During the year Sycamore has spent $1.8 million on developing several new products. These projects are at different stages of development and the draft financial statements show the full amount of $1.8 million within intangible assets. In order to fund this development, $2.0 million was borrowed from the bank and is due for repayment over a ten-year period. The bank has attached minimum profit targets as part of the loan covenants

The new finance director has informed the audit partner that since the year end there has been an increased number of sales returns and that in the month of May over $0.5 million of goods sold in April were returned. Maple & Co attended the year-end inventory count at Sycamore's warehouse. The auditor present raised concerns that during the count there were movements of goods in and out the warehouse and this process did not seem well controlled. During the year, a review of plant and equipment in the factory was undertaken and surplus plant was sold, resulting in a profit on disposal of $210,000.

Required:

Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Sycamore Science Co. (12 marks)

Question 07

You are the audit senior of Rhino & Co and you are planning the audit of Kangaroo Construction Co (Kangaroo) for the year ended 31 March 2013. Kangaroo specializes in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts: Kangaroo has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge. The directors need to meet a target profit before interest and taxation of $0.5 million in order to be paid their annual bonus. In addition, to try and improve profits, Kangaroo changed their main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To help with operating cash flow, the directors borrowed $1 million from the bank during the year. This is due for repayment at the end of 2013.

Financial statement extracts for year ended 31 March

	DRAFT 2013 $m	ACTUAL 2012 $m
Revenue	12.5	15.0
Cost of Sales	(7.0)	(8.0)
Gross Profit	5.5	7.0
Operating Expenses	(5.0)	(5.1)
Profit before interest and taxation	0.5	1.9
Inventory	1.9	1.4
Receivable	3.1	2.0
Cash	0.8	1.9
Trade Payables	1.6	1.2
Loan	1.0	-

Required:

Using the information above:

(i) Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit; and (5 marks)

(ii) Using the information provided and the ratios calculated, identify and describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Kangaroo Construction Co. (10 marks)

(20 marks)