AUDIT RISKS AND AUDITOR'S RESPONSE

e.g

Illustration 3: Murray Co risk assessment

Your firm Wimble & Co has recently accepted appointment as auditor of Murray Co (a manufacturer of Sports equipment).

Having sold your shares in Murray Co, you have been assigned as audit manager and you have started planning the audit (although you were an employee of Murray Co, this was many years ago and you did not have any involvement in preparation of the financial statements). You have held a meeting with the client and have ascertained the following:

Murray Co manufactures sports equipment in its UK factory (the currency of the UK is the Pound Sterling). Components are sourced from suppliers in Europe, who invoice Murray Co in the Euro. Most items of equipment, such as tennis rackets, hockey sticks and goals, take less than one day to manufacture. Murray Co's largest revenue generating product, ergometers (rowing machines), takes up to one week to manufacture. Murray Co refurbished the assembly line for the ergometers during the year. Murray Co uses a third party warehouse provider to store the manufactured ergometers and approximately one quarter of the other equipment.

Historically, Murray Co has only sold to retailers. For the first time this year, Murray Co has made sales directly to consumers, via a new website. The website is directly linked to the finance system, recording sales automatically. Website customers pay on ordering. The website development costs have been capitalised. This initiative was implemented to respond to market demands, as retailer sales have fallen dramatically in the last two years. Some of Murray Co's retail customers are struggling to pay their outstanding balances. Several of the sales team were made redundant last month as a result of the falling retailer sales.

Murray Co is planning to list on the stock exchange next year.

Exercise:

Using the information provided, describe SIX audit risks and explain the auditor's response to each risk in planning the audit of Murray Co.

Solution: Murray Co risk assessment

Audit Risks	Auditor's Response
This is the first year Wimble & Co have audited Murray Co. There is a lack of cumulative audit knowledge and experience, increasing detection risk. Opening balances may be misstated.	More time and resource will need to be devoted to obtaining an understanding of Murray Co at the start of the audit. More substantive procedures will need to be planned and performed, and larger samples tested in order to lower detection risk.
Components are sourced from suppliers in Europe, who invoice Murray Co in the Euro. There is a risk of arithmetical error or the wrong exchange rate being used when translating foreign currency transactions. Payables, purchases and inventory may be misstated.	Recalculation of a sample of transactions to confirm mathematical accuracy. Agreement of the rates used to a reliable external source (e.g. The Financial Times).
Inventory is stored at a third party warehouse. It may be difficult to obtain sufficient appropriate evidence over the quantity and condition of inventory held. There is increased detection risk over completeness, existence and valuation of inventory.	Additional procedures to ensure that inventory quantities and condition have been confirmed for both third party and company owned locations, e.g: • Attend the inventory count (if one is to be performed) at the third party warehouses to review the controls in operation • Inspect any reports produced by the auditors of third party warehouses in relation to the adequacy of controls over inventory.
Ergometers take up to one week to manufacture. There is likely to be a material work in progress (WIP) inventory balance at the year end. Determining the value and quantity of WIP is complex. There is a risk of misstatement of WIP inventory.	Consideration should be given as to whether an independent expert is required to value WIP. If so, this will need to be arranged with consent from management and in time for the year-end count.

Murray Co refurbished the assembly line for the ergometers during the year. There is a risk that the expenditure incurred has been incorrectly treated as capital in nature and included within assets or expensed as repairs.	Review a breakdown of the costs and agree to invoices to assess the nature of the expenditure and if capital agree to inclusion within the asset register, and if repairs agree to expense in the statement of profit or loss.
There is a new website directly linked to the finance system, which records sales automatically. There is increased risk over completeness of income if the system fails to record all sales made on the website; revenue may be understated.	Extended controls testing to be performed over the sales cycle, including the use of test data where possible. Detailed testing to be performed over the completeness of income.
The website development costs have been capitalised. In order to be capitalised, it must meet all of the criteria under IAS 38 *Intangible Assets.* Research costs should be expensed rather than capitalised. There is a risk that intangible assets are overstated.	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.
Retailer sales have fallen dramatically in the last two years. If retailer sales continue to fall and direct consumer sales do not compensate for the loss of retailer revenue, Murray Co may not be able to continue to operate for the foreseeable future. There is a risk that disclosures of material uncertainties relating to going concern may be inadequate.	Perform a detailed going concern review, including: obtain and review the company's cash flow forecast and evaluate the reasonableness of the assumptions used to understand if management will have sufficient cash. Review post year end order books from retailers and post year end direct consumer sales to assess if the revenue figures in the cash flow are reasonable.
Several of the sales team were made redundant last month as a result of the falling retailer sales. Under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets,* a redundancy provision will be required for any staff not yet paid at the year end. There is a risk of understated liabilities.	Discuss with management the progress of the redundancy programme and review and recalculate the redundancy provision.

Some retail customers are struggling to pay their outstanding balances to Murray Co. There is a risk of overstatement of receivables and understatement of irrecoverable debt allowance.	Extended post-year end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation An allowance for receivables to be discussed with management.
Murray Co is planning to list on the stock exchange next year. There is an increased risk of manipulation of the financial statements. There is a risk of overstatement of assets and profits, and understatement of expenses and liabilities.	Plan and perform procedures to ensure accounting estimates and judgemental areas are reasonable. Maintain professional scepticism and be alert to the risks identified in order to achieve a successful listing.

4 Risk assessment procedures

ISA 315 (Revised) requires auditors to perform the following risk assessment procedures:

- **Enquiries** with management, of appropriate individuals within the internal audit function (if there is one), and others (with relevant information) within the client entity (e.g. about external and internal changes the company has experienced)
- **Analytical procedures**
- **Observation** (e.g. of control procedures) and **inspection** (e.g. of key strategic documents and procedural manuals).

Understanding the entity and its environment

In order to identify the risks of material misstatement in the financial statements the auditor is required to obtain an understanding of: their clients; their clients' environments; and their clients' internal controls. This generally includes:

- relevant industry, regulatory and other external factors (including the financial reporting framework)