Risks and planning

Test your understanding 1

You are an audit senior at JPR Edwards & Co and you are currently planning the statutory audit of Hook Co for the year ending 30 June 2013. Your firm was appointed as auditor in January 2013 after a successful tender to provide audit and tax services. JPR Edward & Co were asked to tender after the lead partner, Neisha Selvaratalm, met Hook Co's CEO, Pete Tucker, at a charity cricket match. Neisha explained that they were unhappy with the previous auditors as Pete Tucker felt their audit didn't add much value to Hook Co.

Hook Co was established in 1985 and manufacturers electrical goods such as MP3 players, smart phones and personal computers for the entertainment market. They do not retail their goods under their own name but manufacture for larger companies with established brands. Their key client, who represents 70% of their revenue, was the market leader in smart phones and MP3 players in 2012 with 60% market share.

Hook Co uses a number of suppliers to source components for their products. Most suppliers are based in the UK however Hook Co imports microchips, a key component in all their goods, from a number of suppliers based in San Jose, Costa Rica. The suppliers invoice Hook Co in US$ (the UK currency is the £). They assemble their goods in their one factory in Staines, UK, and package their products for their customers before distribution across the UK.

During the year Hook Co started developing applications which can be downloaded onto their smart phones. They have spent $1million on an application called "snore-o-meter" which allows the users to record the sounds they make while they are asleep. There was a technical difficulty in production which meant the launch of "snore-o-meter" was delayed from the 31 March 2012 to its anticipated release on the 31 July 2013.

To fund their expansion into Smartphone applications Hook is seeking a listing on the London Stock Exchange in the fourth quarter of 2013. In preparation Pete Tucker has read the 'UK Corporate Governance Code' and understands the need and benefit of many of its principles however he is unsure how the formation of an audit committee will benefit Hook Co.

Required:

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

(10 marks)

Test your understanding answers

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(a) **Audit risks and effect on audit approach**

Risk and explanation	**Effect on audit approach**
This is the first year JPR Edwards & Co have audited Hook Co. There may not be as deep an understanding of Hook Co's business as if they had audited in previous years and therefore detection risk is increased. Opening balances may be hard to audit as JPR Edwards & Co were not the auditors last year and cannot rely on their own previous work.	More time should be devoted to understanding the business at the start of the audit. More substantive procedures may be planned to lower detection risk. JPR Edwards & Co will have to design specific audit procedures to obtain sufficient evidence regarding opening balances. [illegible]
Hook Co is a manufacturing business. Hook will have a combination of raw materials, work in progress and finished goods in inventory. The calculation and valuation of work in progress and finished goods is subject to error and possible overstatement.	Appropriate time should be allocated to attending the inventory count and understanding the inventory valuation process for work in progress and finished goods. Expert assistance may be required to assist the auditor assessing the degree of completion of work in progress.
Hook Co manufactures electrical goods for the entertainment market. This is a rapidly changing market and goods can become obsolete quickly and therefore be valued incorrectly in the financial statements.	Hook Co's process for identifying obsolete items should be reviewed thoroughly as changes in technology are likely to render items obsolete quicker than in a more stable market. The nature and extent of audit procedures may be increased to ensure inventory is valued appropriately at the lower of cost and NRV.

Their key client represents 70% of their revenue. Hook Co may be over reliant on this client which could threaten its going concern status if this key client was lost. There is a risk that disclosures of material uncertainties relating to going concern are inadequate.	Procedures should be designed at the planning stage to allow the auditor to assess the going concern risk faced by Hook Co. Contracts and other correspondence from the key customer should be reviewed to identify any specific risks that the client may be lost. Analytical procedures should be designed to assess the impact on Hook Co's financial position if the contract was not renewed.
One of Hook Co's key suppliers is based in Costa Rica. Hook Co will translate foreign currency transactions into their reporting currency. There is an increased risk of simple arithmetical error or the wrong exchange rate being used in calculations.	Procedures should be designed to test the arithmetical accuracy of a sample of translations against the published exchange rate from an external source, for example the Financial Times.
Hook Co spent $1m on developing a new product. There is a risk that Hook Co have capitalised development expenditure which should have been expensed through the statement of profit or loss as research costs. If the application does not meet the criteria required to classify as development costs they should be expensed to the statement of profit or loss in the year they were incurred. There is a risk over overstatement of intangible assets.	Enquiries should be made as to how Hook Co identifies whether the criteria for capitalisation has been met in accordance with accounting standards (IAS 38). Where amounts have been capitalised further procedures should be designed, for example, to assess how Hook Co measures whether the project would be profitable.

criteria for capitalization

Hook Co is aiming to list on the London Stock Exchange this year. The directors may have greater incentive to 'window dress' the accounts to show a more favourable position in order to increase the proceeds generated from flotation.	Procedures should be planned to ensure areas of judgement and estimates exercised by the directors are reasonable and can be justified. Special consideration should be given to sales cut-off testing