Risks and planning

Test your understanding 2

Nepco is a European company that manufactures high quality computer components and assembles computer parts. It has existed for some years and is part of a vertical supply chain for a well-known brand of computer hardware. Profits are coming under increasing pressure from manufacturers in the Far East and Asia with lower labour costs, and from rising raw material costs. Nepco is listed on a stock exchange. There is pressure from institutional investors for better returns in the form of dividends and the main institutional investors are considering selling a proportion of their shares in the company. The directors of Nepco are considering whether to move into new market areas.

Nepco has good accounting and internal control systems. Inventory is material to the accounts, and there is a good set of permanent inventory records. No year-end inventory count is conducted. Operational compliance issues are important to Nepco as many countries have inflexible quality standards and some projects are being held up because of difficulties in obtaining approval from regulators for new components. All staff and directors of Nepco are remunerated (at least in part) on a performance-related basis, some with share options. Staff are generally highly qualified and well-paid.

This is your first year as auditors. Your firm has very little experience in this industry. External audit costs are tightly controlled and your firm has agreed to a budget that will allow very little flexibility.

Required:

(a) **Describe the risks relating to Nepco under the headings of inherent risk, control risk and detection risk.**

(12 marks)

(b) **In the light of the risks identified in (a) above, list the matters to which you will pay particular attention during the audit of Nepco and explain the work you will perform in relation to them.**

(8 marks)

Test your understanding 2

(a) **Risks**

(i) Inherent risks include:

- The competition from Asian and Far Eastern companies, and rising raw material prices. This means that there is pressure on profits and the ability to reward employees and pay dividends to institutional shareholders which increases the pressure to manipulate the financial statements to show good returns.
- The potentially volatile market (computer components) in which new technology can render hardware obsolete in a very short time. This means that there is an ongoing risk to the business as a whole (a potential going concern risk) – the company must be adaptable.
- The risk that regulators may reject a product which has taken many months or years to develop.
- The pressures for returns from institutional investors which means that there may be a temptation to manipulate the financial statements.
- The possible sale of shares, increasing the pressure for returns in order to get the best possible price, which increases the pressure to manipulate the financial statements.
- The inherent risks in diversification into unknown areas (the supply of other customers) – but these are not current risks.

(ii) Control risks: there are apparently very few except for the performance-related payment, including share options, which provides an incentive to produce 'acceptable' figures.

(iii) Detection risk: this is the firm's first year as auditors and there are tight controls on audit costs, which may lead to inadequate audit evidence unless the audit is properly directed, supervised and reviewed. This is compounded by the firm's lack of experience in this area. It is important that those with experience are employed on this audit, at least in a review capacity.

(b) **Matters to which attention should be paid and work to be performed**

(i) The good accounting records and internal control combined with the need to keep audit costs down means that a compliance approach, rather than a substantive approach will be necessary wherever possible.

(ii) Audit work will need to be directed towards inventory (despite the fact that it is well controlled) because it is material to the accounts. There is no year-end inventory count, and inventory is relatively easy to manipulate. It is likely that there will be a substantial amount of work-in-progress and its valuation will need to be reviewed carefully. It may be possible to rely on any interim or cyclical inventory counting.

(iii) The projects on which compliance problems have arisen should be examined carefully as the costs may be significant and there may be a temptation to understate them.

(iv) Overall profits and any unadjusted errors should be examined carefully because of the inherent risks noted above and the performance-related pay.

(v) The company's going concern status should be reviewed by examining its financial status, financial support and likely future developments in high risk areas.