**Example 2 Answer**

Audit risk and auditor’s response

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| Audit risk | Auditor’s response |
| Ham Co upgraded their website during the year at a cost of Shs 11m. The costs incurred should be correctly allocated between revenue and capital expenditure.As the website has been upgraded, there is a possibility that the new processes and systems may not record data reliably and accurately. This may lead to a risk over completeness and accuracy of data in the underlying accounting records. | 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 or agree to the statement of profit or loss.The audit team should document the revised system and undertake tests over the completeness and accuracy of data recorded from the website to the accounting records. |
| Ham Co has entered into a transaction to purchase a new warehouse for Shs 32m and it is anticipated that the legal process will be completed by the year end.Only assets which physically exist at the year-end should be included in property, plant and equipment. If the transaction has not been completed by the year end, there is a risk that assets are overstated if the company incorrectly includes the warehouse at the year end. | Discuss with management as to whether the warehouse purchase was completed by the year end. If so, inspect legal documents of ownership, such as title deeds ensuring these are dated prior to 1 January 2022 and are in the company name. |
| Significant finance has been obtained in the year, as the company has issued Shs 50m of irredeemable preference shares.This finance needs to be accounted for correctly, with adequate disclosure made. As the preference shares are irredeemable, they should be classified as equity rather than non-current liabilities. Failing to correctly classify the shares could result in understated equity and overstated non-current liabilities. | Review share issue documentation to confirm that the preference shares are irredeemable. Confirm that they have been correctly classified as equity within the accounting records and that total financing proceeds of Shs 50m were received.In addition, the disclosures for this share issue should be reviewed in detail to ensure compliance with relevant accounting standards. |
| The finance director has extended the useful lives of fixtures and fittings from three to four years, resulting in the depreciation charge reducing. Under IAS 16 *Property, Plant and Equipment*, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable.However, there is a risk that this reduction has occurred in order to boost profits. If this is the case, then fixtures and fittings are overvalued and profit overstated. | Discuss with the directors the rationale for any extensions of asset lives and reduction of depreciation rates. Also, the four-year life should be compared to how often these assets are replaced, to assess the useful life of assets. |
| A customer of Ham Co has been encountering difficulties paying their outstanding balance of Shs 12m and Ham Co has agreed to a revised credit period.If the customer is experiencing difficulties, there is an increased risk that the receivable is not recoverable and hence is overvalued. | Review the revised credit terms and identify if any after date cash receipts for this customer have been made.Discuss with the finance director whether he intends to make an allowance for this receivable. If not, review whether any existing allowance for uncollectable accounts is sufficient to cover the amount of this receivable. |
| A sales-related bonus scheme has been introduced in the year for sales staff, with a significant number of new customer accounts on favourable credit terms being opened before the year end. This has resulted in a 5% increase in revenue.Sales staff seeking to maximise their current year bonus may be tempted to open new accounts from poor credit risks leading to irrecoverable receivables. In addition, there is a risk of sales cut-off errors as new customers could place orders within the two-month introductory period and subsequently return these goods post year end. | Increased sales cut-off testing will be performed along with a review of any post year-end returns as they may indicate cut-off errors. In addition, increased after date cash receipts testing to be undertaken for new customer account receivables. |
| Ham Co has halted further sales of its new product Lima and a product recall has been initiated for any goods sold in the last four months.If there are issues with the quality of the Lima product, inventory may be overvalued as its NRV may be below its cost.Additionally, products of Lima sold within the last four months are being recalled, this will result in Ham Co paying customer refunds. The sale will need to be removed; a refund liability should be recognised along with the reinstatement of inventory, although the NRV of this inventory could be of a minimal value. Failing to account for this correctly could result in overstated revenue and understated liabilities and inventory. | Discuss with the finance director whether any write downs will be made to this product, and what, if any, modifications may be required with regards the quality.Testing should be undertaken to confirm cost and NRV of the Lima products in inventory and that on a line-by-line basis the goods are valued correctly.Review the list of sales made of product Lima prior to therecall, agree that the sale has been removed from revenue and the inventory included. If the refund has not been paid pre-year end, agree it is included within current liabilities. |
| Panta Co, a customer of Ham Co, has announced that they intend to commence legal action for a loss of information and profits as a result of the Lima product sold to them.If it is probable that the company will make payment to the customer, a legal provision is required. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If Ham Co has not done this, there is a risk over the completeness of any provisions or the necessary disclosure of contingent liabilities. | Cane & Co should write to the company’s lawyers toenquire of the existence and likelihood of success of any claim from Panta Co. The results of this should be used to assess the level of provision or disclosure included in the financial statements. |
| The finance director has requested that the audit completes one week earlier than normal as he wishes to report results earlier. A reduction in the audit timetable will increase detection risk and place additional pressure on the team in obtaining sufficient and appropriate evidence.In addition, the finance team of Ham Co will have less time to prepare the financial information leading to an increased risk of errors arising in the financial statements. | 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 March or early April; this would then reduce the pressure on the final audit.The team needs to maintain professional scepticism and be alert to the increased risk of errors occurring. |
| The company is intending to propose a final dividend once the financial statements are finalised. This amount should not be provided for in the 2021 financial statements, as the obligation only arises once the dividend is announced, which is post year end.In line with IAS 10 *Events after the Reporting Date* the dividend should only be disclosed. If the dividend is included, this will result in an overstatement of liabilities and understatement of equity. | Discuss the issue with management and confirm that the dividend will not be included within liabilities in the 2021 financial statements.The financial statements need to be reviewed to ensure that adequate disclosure of the proposed dividend is included. |