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- It is 1 July 20X5. You are an audit supervisor with Morph & Co responsible for planning the final audit of a new client, Hart Co, for the year ending 30 September 20X5. Hart Co specialises in the design and construction of customised playgrounds. The audit manager recently met with Hart Co's finance director and has provided you with the following notes:
- **Planning meeting notes**
- Hart Co has a forecast profit before tax of $12.2m (20X4: $9.8m) and total assets are expected to be $28.5m (20X4: $24.3m). The finance director has indicated that the directors are very pleased with the forecast performance for the year as the directors are paid a bonus based on a percentage of profit before tax.
- Hart Co is undertaking the construction of playgrounds at 16 sites in various locations across the country. All playgrounds are constructed to specific customer specifications.

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- Customers pay a 25% deposit on signing the contract, with the balance payable when control of the playground is transferred to the customer.
- The balance of work in progress (WIP) at 30 June 20X5 is $7.6m in respect of the playgrounds under construction. A WIP count and valuation will be carried out at all sites on 30 September 20X5. Arrangements have been made for the audit team to attend only five of the WIP counts.
- Hart Co offers its customers a warranty at no extra cost, which guarantees that the playgrounds will function as expected for a period of three years. The warranty provision for the current year has been calculated as 2% of revenue. In the previous year the warranty was based on 6% of revenue. The finance director has made this change despite no significant difference in construction techniques or the level of claims in the year.

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- Hart Co has incurred expenditure of $1.8m relating to the research and development of a new type of environmentally friendly building material. $0.6m of the expenditure to date has been written off to the statement of profit or loss. The remaining $1.2m has been capitalised as an intangible asset. No amortisation has been recognised to date as the material has not yet been brought into use.
- In June 20X5, the company contracted to purchase new machinery costing $2.4m. It paid $1m on signing the contract to secure the machinery, which was due to be delivered in July 20X5. Due to a supplier problem, the delivery is delayed and is now scheduled to be delivered in October 20X5.
- In order to finance the research and development costs and the machinery purchase, Hart Co made a rights issue to existing shareholders at a price of $0.75 for each $0.50 share.

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- Hart Co’s payroll function is outsourced to an external service organisation, Chaz Co, which is responsible for all elements of payroll processing and maintenance of payroll records.
- Hart Co’s directors correctly disclosed their remuneration details in the forecast financial statements in line with IFRS Standards; however, local legislation in the country in which Hart Co is based, requires more extensive disclosure. The directors have stated that they consider this onerous and so do not intend to provide the additional information.
- **Required**
- (b) Describe EIGHT audit risks and explain the auditor's response to each risk in planning the audit of Hart Co.

- **(16 marks)**

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Audit risk	Auditor's response
Hart Co is a new client for Morph & Co. As the audit team is not familiar with the accounting policies, transactions and balances of Hart Co, there will be an increased detection risk on the audit. There is also less assurance over opening balances as Morph & Co did not perform the audit last year.	Morph & Co should ensure it has a suitably experienced team assigned to the audit and that adequate time is allowed for team members to obtain an understanding of the company and the risks of material misstatement, including a detailed team briefing to cover the key areas of risk. Increased audit procedures should be performed over opening balances.

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Audit risk	Auditor's response
The directors are paid a bonus based on a percentage of profit before tax for the year. There is a risk that the directors will try to overstate the profit, and therefore increase their bonuses, by increasing the revenue and income recorded and decreasing expenses. This is a particular risk relating to judgemental areas such as provisions and estimates.	The audit team should be aware of the increased risks of manipulation and should assign more experienced audit members to significant estimates and judgemental areas. Also, adequate time should be allocated for team members to obtain an understanding of the company and the significant risks of overstatement of profit, including attendance at an audit team briefing. The team needs to maintain professional scepticism and be alert to the increased risk of manipulation. Increased testing should be performed relating to adjusting journal entries.

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Audit risk	Auditor's response
Customers pay a 25% deposit on signing the contract to purchase the playgrounds. The deposits should not be recognised as revenue immediately and instead should be recognised as deferred income (contract liabilities) within current liabilities until the performance obligations, as per the contracts, have been satisfied. This is likely to be at a point in time when control of the playground is passed to the customer. There is a risk that revenue is overstated and current liabilities understated if the deposits have been recorded within revenue.	The audit team should obtain a copy of the contracts with customers and review them to understand the performance obligations. They should discuss with management the criteria for determining whether performance obligations have been satisfied and the treatment of deposits received to ensure it is appropriate and consistent with relevant standards. During the final audit, the audit team should undertake increased testing over the cut-off of revenue and the completeness of deferred income (contract liabilities).

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Audit risk	Auditor's response
The audit team will only attend the WIP counts at five of the 16 sites. WIP is a material balance and the valuation of WIP is a judgemental area. As the audit team is not attending all sites, detection risk is increased as the team will be unable to directly obtain evidence relating to WIP.	The auditor should assess which inventory counts the team will attend, most likely to be those with the most material WIP balances or which are assessed as having the greatest risk of misstatement. For those inventory counts not attended, the audit team will need to obtain and review documentation relating to the controls surrounding the counts and will need to review reports from any experts used to value the WIP, and any exceptions noted during the count and discuss with management any issues which arise during the count.

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Audit risk	Auditor's response
Hart Co offers its customers a warranty at no extra cost, which guarantees the playgrounds will function as expected for three years. The provision is calculated as 2% of revenue in the current year against 6% in the prior year, despite there being no changes in the construction techniques or the level of claims. Under IAS® 37 *Provisions, Contingent Liabilities and Contingent Assets* this should be recognised as a warranty provision. Calculating warranty provisions requires judgement as it is an uncertain amount. There is a risk that the warranty provision could be understated, leading to understated expenses and liabilities.	The audit team should discuss with management the basis of the provision calculation and compare this to industry averages and the level of post year-end claims, if any, made by customers. In particular, they should discuss the rationale behind reducing the level of provision this year. The audit team should also compare the prior year provision with the actual level of claims in the year, to assess the reasonableness of the judgements made by management.

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Audit risk	Auditor's response
Hart Co has recognised $0.6m of research expenditure in profit or loss with the remaining $1.2m having been capitalised as development expenditure. IAS 38 *Intangible Assets* has strict criteria as to which costs can be capitalised as development expenditure. There is a risk that the requirements of the standard have not been applied correctly. If research costs have been incorrectly classified as development expenditure, there is a risk that intangible assets could be overstated and research expenses understated.	The audit team should obtain a breakdown of the research expenditure recognised in profit or loss and of the development costs capitalised and review supporting documentation to determine whether they have been correctly classified. Any development expenditure should then be agreed as meeting the relevant criteria for capitalisation as set out in IAS 38. The team should also discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.

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Audit risk	Auditor's response
Hart Co placed an order for $2.4m of machinery, paying $1m in advance. The machinery was due to be received in July 20X5 but will now be delivered post year end. Only assets which physically exist at the year end should be capitalised as property, plant and equipment (PPE). The $1m deposit paid in advance should be recognised as a prepayment. If the deposit of $1m paid in advance has been capitalised within PPE then prepayments are understated and PPE will be overstated.	Review the non-current asset register to determine if the $1m paid in advance has been capitalised. Discuss the correct accounting treatment with management to confirm that the amount paid in advance is recognised as a prepayment and, if incorrectly recognised, review the correcting journal entry.

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Audit risk	Auditor's response
Hart Co made a rights issue in the year. This is a non-standard transaction and there is increased risk that the issue has not been recorded correctly. The rights issue has been made at a premium and therefore requires to be split into its share capital and share premium elements. There is a risk that the split between share capital and share premium has not been accounted for correctly and that these balances are misstated. There is also a risk that the rights issue has not been disclosed in accordance with accounting standards and local company legislation.	The audit team should obtain legal documentation in support of the rights issue to agree the number of shares issued and the rights price. They should recalculate the split of share capital and share premium and agree this to the journal entry to record the rights issue. The audit team should also agree that disclosures are adequate and consistent with standards and legislation.

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Audit risk	Auditor's response
Hart Co’s payroll function is outsourced to an external service organisation. A detection risk arises as to whether sufficient and appropriate evidence is available at Hart Co to confirm the completeness and accuracy of controls over the payroll cycle and liabilities at the year end. Consideration should be given to the level of controls in place at the service organisation and whether the data is reliable. If any errors occurred these could result in the wages and salaries expense and any accruals being misstated.	Discuss with management any changes to the extent of records maintained at Hart Co since the prior year audit and any monitoring of controls which has been undertaken by management over payroll. Consideration should be given to contacting the auditor of the service organisation, Chaz Co, to confirm the level of controls in place. A type 1 or type 2 report could be requested. Consider the extent to which sufficient appropriate audit evidence can be obtained from records held at Hart Co in respect of the wages and salaries expense and liabilities.

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Audit risk	Auditor's response
Directors' remuneration disclosures have been made in line with IFRS® Standards but not local legislation. Where the local legislation is more comprehensive than IFRS Standards, it is likely that the company must comply with local legislation. The directors' remuneration disclosure will not be complete if the additional information is not disclosed.	Discuss this matter with management and review the requirements of local legislation to determine if the disclosure in the financial statements is included appropriately.