

(a) Define audit risk and the components of audit risk. (4 marks)

You are an audit supervisor of Caving & Co and you are planning the audit of Hurling Co, a listed company, for the year ending 31 March 20X7. The company manufactures computer components and forecast profit before tax is \$33.6m and total assets are \$79.3m.

Hurling Co distributes its products through wholesalers as well as via its own website. The website was upgraded during the year at a cost of \$1.1m. Additionally, the company entered into a transaction in February to purchase a new warehouse which will cost \$3.2m. Hurling Co's legal advisers are working to ensure that the legal process will be completed by the year end. The company issued \$5m of irredeemable preference shares to finance the warehouse purchase.

During the year the finance director has increased the useful economic lives of fixtures and fittings from three to four years as he felt this was a more appropriate period. The finance director has informed the engagement partner that a revised credit period has been agreed with one of its wholesale customers, as they have been experiencing difficulties with repaying the balance of \$1.2m owing to Hurling Co. In January 20X7, Hurling Co introduced a new bonus based on sales targets for its sales staff. This has resulted in a significant number of new wholesale customer accounts being opened by sales staff. The new customers have been given favourable credit terms as an introductory offer, provided goods are purchased within a two-month period. As a result, revenue has increased by 5% on the prior year.

The company has launched several new products this year and all but one of these new launches have been successful. Feedback on product Luge, launched four months ago, has been mixed, and the company has just received notice from one of their customers, Petanque Co, of intended legal action. They are alleging the product sold to them was faulty, resulting in a significant loss of information and an ongoing detrimental impact on profits. As a precaution, sales of the Luge product have been halted and a product recall has been initiated for any Luge products sold in the last four months.

The finance director is keen to announce the company's financial results to the stock market earlier than last year and in order to facilitate this, he has asked if the audit could be completed in a shorter timescale. In addition, the company is intending to propose a final dividend once the financial statements are finalised.

Hurling Co's finance director has informed the audit engagement partner that one of the company's non-executive directors (NEDs) has just resigned, and he has enquired if the partners at Caving & Co can help Hurling Co in recruiting a new NED. Specifically he has requested the engagement quality control reviewer, who was until last year the audit engagement partner on Hurling Co, assist the company in this recruitment. Caving & Co also provides taxation services for Hurling Co in the form of tax return preparation along with some tax planning advice. The finance director has recommended to the audit committee of Hurling Co that this year's audit fee should be based on the company's profit before tax. At today's date, 20% of last year's audit fee is still outstanding and was due to be paid three months ago.

Required:

(c) (i) Identify and explain FIVE ethical threats which may affect the independence of Caving & Co's audit of Hurling Co; and

(ii) For each threat, suggest a safeguard to reduce the risk to an acceptable level.

Note: The total marks will be split equally between each part. Prepare your answer using two columns headed Ethical threat and Possible Safeguard respectively. (10 marks)