Script for 'F8 Audit risks and responses – bringing an exam question to life'

Audit Manager (AM): So, before we look at these files in detail….

Remember, when we're looking at audit risks we have to consider issues that could affect the overall financial statement level – so for example, a risk around going concern, as this sort of issue can have an effect on lots of different areas of the financial statements.

If we were worried about Sycamore's going concern status, as auditors we would need to respond by thinking about things like, increased scepticism, or making sure we have a more experienced team working on the audit.

But, we also have to look for the issues that have an effect on a specific area of the accounts, and a particular assertion. When targeting those risks we have to identify the specific audit procedures that might deal with that assertion.

So, it's really important when planning our audit, and looking at the risks we identify, that we consider whether a general financial statement level response might be necessary, as well as specific assertion level procedures.

Ok, now looking at the file, I see that during the year Sycamore, spent $1.8m on developing additional products and that they've capitalised the whole amount as an intangible asset. Let's think about what some of the issues may be for the audit. Is there an accounting standard governing the treatment of intangible assets?

Audit Supervisor (AS): Yes. IAS 38, Intangible assets.

AM: And does IAS 38 set out specific requirements in relation to capitalisation?

AS: Yes it does. There are certain criteria which must be met. Only development costs can be capitalised, not research costs. The project must be technically feasible, and, the company must be able to complete the project and sell the new product.

AM: So as auditors what do we need to be concerned about? Is there a risk in what could be included in the financial statements?

AS: Yes. They may have incorrectly capitalised on research costs, or may not be able to complete all the projects or, be able to sell the products.

AM: What would be the impact on the financial statements if this was the case?

AS: Intangible assets may be overstated and this would have the effect of increasing profit. If the costs had been expensed, profit would be much lower.

AM: Yes. Good. So we've established the risk - that intangible assets and profit may be overstated as a result of non-compliance with IAS 38. What would be the best tests to apply to development costs to find out if it is overstated?

AS: We could look at a breakdown of the costs by project…. Then we have to apply detailed tests to understand what each of the costs related to.

AM: That's right. And specifically when we look at those costs, what do we need to check for?

AS: That the criteria of IAS 38 have been met - otherwise the cost should be expensed.

AM: Yes. So we need to understand how the balance is made up, and test the capitalised costs in line with the criteria of IAS 38. How exactly would we do that? Are there any particular documents we'd want to inspect or questions we'd want to ask?

AS: Well, to understand if the company is likely to make sales of the products that have been developed, we could look at their sales projections, and any records of any sales made since the year end. We could look at their budgets to check that they expect to have all available finances to complete the projects.

AM: Exactly. Well done. So, to establish the risk and response, we determined which accounting standard was relevant, we thought about how the accounting might contravene that standard, and we thought about what procedures to use in order to verify compliance - in other words what documents we might look at, or questions we might ask. I think we have the basis of a good audit plan in respect of that risk now.

Was there anything else at Sycamore that concerned you this year? So, for example, have there been any significant operational or financing changes?

AS: Well, there's been a new loan. I guess there's a risk the disclosures could be wrong – it should be split properly between current and non-current liabilities and any additional security should also be disclosed. We ought to make sure that any additional finance costs have been treated properly too.

AM: That's right. So, how would you check those?

AS: I would ask for the loan agreement, and compare the disclosures in the financial statements to what the agreement says. I might have to recalculate the balance of the loan to make sure it's accurate.

I ought to check if the loan has been received too, and when, as that would affect when it has to be repaid. I could check the current account bank statements to see that. And.. I guess I could recalculate the finance costs, and make sure they were paid by checking the bank statements.

AM: Well done. You've identified the key areas of the audit plan for the loan there. Does the loan covenant give us any concern as auditors?

AS: Mmmmm… I'm not sure.

AM: Well, what's the main thing that might be affected if the loan was recalled due to a breach in the covenants?

AS: Oh, of course, it will impact the going concern review. If the company doesn't have sufficient profit to meet the covenant restrictions, the loan may be recalled. If the company doesn't then have enough cash to meet the repayment, the going concern basis may not be appropriate for the financial statements.

AM: And that's not all. There's a further risk. Is there a way that a breach could be concealed? Who could influence the level of profits in the financial statements and submits the covenant calculations to the bank?

AS: Well, the finance director and the management team I suppose.

AM: Exactly.

AS: Ah… I see. There's a risk that management could manipulate the financial statements to ensure that the profit targets are met. Perhaps by manipulating the accounting judgements – so for example, if it was a close call between whether those development costs should be expensed or capitalised. That makes a big difference to profit.

AM: That's right. So what should our response be to those risks?

AS: Well, we'll have to maintain professional scepticism when reviewing judgemental accounting issues developed by the finance director and management, and we'll have to review and scrutinise decisions that affect profit because of our concerns that it could be overstated. Specifically, we have to make some calculations to assess whether the covenant has been breached or if it's close to being breached. If it has been breached, we'll have to discuss this with the directors when considering their assessment of going concern.

AM: Well done – you really are starting to sound like an experienced auditor now!!

I think we need to break for lunch in a minute but there's one more thing I think we should discuss first. Do you think there are any risks we need to consider related to the sale of the plant and machinery?

AS: Well, we have talked already about the fact that we are worried about profit manipulation, so I guess we have to think about whether there's a chance that the profit on the sale of those assets are overstated.

AM: That's what I was thinking too - we should get those calculations and recalculate them to satisfy ourselves that it's correct. Does anything else bother you?

AS: Well it is quite a substantial profit. Could it imply that the depreciation policy might not be right? Depreciation is supposed to match the cost of the asset to its useful life isn't it?

AM: Yes, and that's something we should be aware of when auditing non-current assets. Can you suggest what we ought to do?

AS: Well, we have to discuss the depreciation policy with the finance director and consider whether we think it is reasonable.

AM: That's right. We'll base our review of whether it is reasonable on our understanding of the business and how the company uses the assets. That will be an auditor judgement. Well done – I think we've made good progress here but I think we'll have to break there - do you think we have identified all the audit risks here?

AS: I think there are some that we should discuss but let's break for lunch first – but from what we've talked about so far I think we've identified some risks and understood their impact on the financial statements as well as what we should do in terms of planning our audit for this year. I really feel that this has helped my understanding – thank you!!