a. Carry out a preliminary analytical procedure (using ratios) to review KMD Brands' (Kathmandu) annual financial statements as they are appropriate. Explain the reason for choosing selected ratios, what you find, and, how the results will influence your planning for the audit.

>Ratios are used to assess profitability, liquidity, solvency and for valuation purposes. They are useful for comparison with similar companies in the industry, budgets, and historical performance of the company. A ratio that appears too high, too low or unchanged (when expected) may reveal a risk factor for an auditor (e.g going concern risk). If ratios produce an unexpected result the auditor should discuss significant variation with management and further investigate.

	Statutory	Underlying[1]		
NZ$ million[2]	**FY21**	**FY21**	**FY20**	**Change %**
Sales	922.8	922.8	801.5	15.1%
Gross Profit	541.6	541.6	467.0	16.0%
Operating Expenses	(333.6)	(428.3)	(383.7)	11.6%
EBITDA	208.0	113.3	83.4	35.9%
EBIT	92.2	83.8	56.2	49.3%

Price to earning ratio	20.2
Debt to equity ratio	31%
Return on equity	4.4%
Current ratio	1.92
Gross profit margin	58.69%
Earnings Per Share	$0.05

https://simplywall.st/stocks/nz/retail/nzx-kmd/kmd-brands-shares#past

https://www.listcorp.com/asx/kmd/kmd-brands-limited/news/preliminary-final-report-2595377.html

b. Based on 'business risk' and 'industry risk' identified (in workshop 1) for Kathmandu, what assertions over account balances and other disclosures in the financial statements will impact these risks and how? Identify key assertions that you think need to be tested and explain the audit objective behind these tests.

>Income in advance (Completeness): there is a risk that amounts paid in advance by customer are not correctly recorded as prepayments (e.g added to revenue on occurrence).
Auditor should:
o Inspect all invoices, determine if amounts have been paid in advance and determine if they are recorded correctly in the accounts.

>Prepayments (Completeness): there is a risk that amounts paid in advance to suppliers are not correctly recorded as prepayments (e.g debited to expense on occurrence).
<u>Auditor should:</u>
o Inspect all outstanding contracts for supply of inventory, determine if amounts have been paid in advance and determine if they are recorded correctly in the accounts.

>Inventory assertion (Existence): There is a risk that inventory purchased from suppliers have not been received, and/or inventory sold have not been removed from inventory records.
<u>Auditor should:</u>

o Observe Kathmandu's stock take, perform test counts, to obtain evidence that inventory records are accurate.

>Inventory assertion (rights and obligations): rights and obligations for inventory could also be at risk because some items may be sold for other companies for commission (ownership of the items remains with the supplier until Kathmandu sells them). These items should not be included in kathmandu's inventory.
Auditor should:
o Inspect the terms of the contract with suppliers to determine basis of ownership.
o Inspection of inventory record to determine if any third party items are included in the inventory balance by mistake.

>Inventory assertion (valuation): valuation of apparel inventory will be at risk due to the changing nature (fashion trends) - some items will become obsolete (and their value impaired) each season. Additionally, branding and packaging will make it difficult for the company to sell these items after the promotional period, and it will be unlikely that Kathmandu will be able to return items to the supplier.
Auditor should:
o inspect the terms of the contract with suppliers to determine if there is any support provided for return of items not sold.
o Inspection of inventory records/physical store room to determine if any items are obsolete (held for long periods).

c. Determine the appropriate benchmark and calculate the overall materiality level for Kathmandu's (Group) balance sheet. Justify your decision for both the selected benchmark and percentage applied to calculate overall materiality. Based on your understating of the client's entity, the effectiveness of the entity level and transaction level control environment, and your assessment of the expected economic environment and aggregation risk, calculate the performance materiality amount and justify your decision. Discuss the impact on audit risk, audit evidence and audit cost if you choose a larger or a smaller 'materiality' amount.

>Level of materiality determines amount of items considered material e.g When materiality is set at a high level, less items will be material, while setting a lower level of materiality there will be more items to be considered as material. An appropriate base to determine this value is net assets (1 billion), KMD group may consider 0.05% of this base an appropriate bench mark for materially meaning any error which has an effect of $500,000 or more would be Considered as material. However, if the materiality level is reduced to 0.025%, then errors between $500,000 and $250,000 would be considered as material.

>Lower materiality level increases the quality of evidenced gathered by auditors, evidence required, increased testing due to increase need for assurance that an error with a lower effect has not occurred (better evidence for small/large error more obvious).
- When lower materiality is set, it is more likely that the auditor will conclude that the misstatements are material and further testing will be required.

d. Question below is developed for teaching purposes, and it does not relate to any real circumstances pertaining to KMD Brand's internal control systems or financial statements: The audit partner in charge of the audit of Kathmandu planned to obtain evidence of its revenue recognition by relying on internal controls and the use of analytical procedures. Assume that Kathmandu's revenue recognition policy relating to money received in advance against export goods is to initially hold them in a deferred revenue account and later transfer the appropriate amount to sales revenue when goods are transported. Suppose that during subsequent testing of internal controls, a significant number of instances occurred where revenue was incorrectly recognised immediately upon customers' payment in advance, rather than when goods are transported. Analyze the implication of the above issues in planning the audit of Kathmandu and prepare a draft audit strategy for Kathmandu

>These issues would first require the auditor to determine the scale of the problem, in order to assess whether this issue is material. If found to be material it is then determined that the auditor cannot rely on solely on the client's internal controls in this case (failed to prevent).
Given that we have determined that control risk are high in this instance we should adopt a predominantly substantive approach.
A method gather substantive evidence for income in advance may be to test timing/amount of year end revenue by reviewing long-term contracts, service agreements, license agreements, or any other appropriate documentation to detect errors and/or estimate amount of incorrect revenue recorded.