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Group8 Assignment: Risk assessment and Audit strategy

1)

The following points can increase risk.

Crème Ltd is trying to obtain a loan from a bank. The bank requires interest coverage of more than 12%. Data on September 30, 2019 shows that Crème Ltd's interest coverage is 9.1%. However, as of December 30, 2019, the interest coverage rate has skyrocketed. Increased to 12.1%. Management is likely to falsify financial statements in order to meet bank loan conditions.

Crème Ltd uses IT systems for statistical data and management. Crème Ltd completely trusts and relies on IT systems, and stores all company data in IT systems. Once the Limited's IT system receives a malicious attack similar to a hacker or human error causes system damage and data loss. The Limited runs the risk of losing all data records.

The management of Crème Ltd has always respected any suggestions made by the auditors. This respect may make the two parties have a good relationship and the auditors may commit fraud during the audit. This is an inherent risk of Crème Ltd.

Crème Ltd's operating costs have been increasing due to the exchange rate increase caused by inflation and the weak Australian dollar in 2019. Although the Limited continues to develop new products, the industry is highly competitive, and other large brand companies are constantly developing and innovating, which may cause Crème Ltd's profits to decrease.

The patents for Crème Ltd's most popular products have expired, and management has been working hard to find a market share that can make up for the loss. If affected by the auditing unit, management is likely to cover up the financial statements.

The following point can reduce risk.

The good relationship between the management and the board of directors indicates that the company's internal management is good, and there is also a good cooperative relationship between the joint departments, and the stability of the Limited increases. In addition, from the company's data in recent years, it can be seen that the Limited's profits have been rising and profitability has increased. The Limited's good business prospects and financial situation reduce the possibility of management exaggerating revenue and financial status to the board of directors, thereby reducing inherent risks.

In summary, the level of the Limited’s control risk is high.

2）

The following factors increase the risk of control because no potential problems were found:

The auditors found that Creme Ltd's online sales invoices were not reconciled with the delivery documents that had been signed. However, Creme Ltd requires that prior to authorizing online sales invoices, the delivered receipts and online sales invoice records must be checked. This may cause loss of sales invoices or delivery receipts, which may affect the accuracy of the cost of goods. This shows that the accountants within Creme Ltd have not strictly complied with the company's internal control, which means that Creme Ltd's internal control system is relatively loose and not rigorous enough.

A junior warehouse clerk at Creme Ltd revealed that during busy period, Creme Ltd's cycle inventory was done by the junior staff alone. However, Creme Ltd requires a senior staff member who needs to participate in the cycle count, report any discrepancies to the warehouse manager and conduct further investigation. It is possible that the junior staff could not detect the errors and then affect the accuracy of the cost of goods. It also shows that Creme Ltd's senior staff did not comply with internal controls. Creme Ltd's internal controls were not rigorous and there was insufficient supervision.

The following factors reduce control risks because they prevent overstating sales revenue:

Creme Ltd uses the incompatible power separation principle. Each department of Creme Ltd has a separate management system, and only authorized employees in each department can access the management systems of other departments through personal passwords. This principle and control can reduce the power of each department, enable each department to have separate power, strengthen Creme Ltd’s regulation and control efforts, and ensure the accuracy of the cost of goods.

Creme Ltd has a relatively complete trading system. Every transaction is conducted strictly in accordance with Creme Ltd's rules and regulations. When the customer places an order, the employee records the data into the sales system, the sales system sends the information to the inventory management system, and the warehouse employee uses this information to record. And the customer needs to sign a copy when paying, and the copy will be recorded in Creme Ltd's system and will be counted in real time. This approach allows every transaction of Creme Ltd to be clearly recorded, ensuring the integrity and authenticity of transaction and goods costs, and also making future regular inventory more convenient.

Creme Ltd used the perpetual inventory system. The accounting department has a separate system and is separate from those of other departments. This allows the accounting department to operate independently. Creme Ltd's management and accounting department use different systems to increase Creme Ltd's independence.

Creme Ltd's system updates its perpetual inventory records daily. This approach can ensure that Creme Ltd can accurately record and update each transaction, ensure the accuracy and authenticity of each transaction information in the system, and also ensure the accuracy of the cost of goods.

In summary, Creme Ltd has a less than high level of control risk.

3）

Creme Ltd's internal control system is relatively sound through the risk assessment findings of part (2). So I chose to audit Creme Ltd with a lower level of control risk assessment. And the control testing will be conducted under this audit strategy. If controlled trials confirm a preliminary assessment of control risk, the scope for the substantive trails will narrow.

4）

This case study provides data on two main areas. After an auditor's analysis, it was found that the data in each area was likely to be falsely reported. The first aspect is interest coverage ratio. Creme Ltd wants to borrow money, and the bank's condition is that Creme Ltd’s interest coverage rate must be maintained above 12, but according to the October 31, 2019 data, Creme Ltd interest coverage is only 9.1%, which is not enough for the bank’s requirement. By December 31, 2019, however, Creme Ltd data showed that interest coverage ratio had reached 12.1. Although meeting the bank’s requirements, Creme Ltd’s interest coverage rate increased by 3% in just last three months. The unaudited data is likely to be misreported by Creme Ltd in order to meet the bank’s loan requirements, such as increasing EBITDA or reducing interest charges. The second aspect is operating costs. According to the data given in the case, the sales of revenue and COGS were increasing during 2016 and 2019. However, in 2019, as inflation led to increased operating costs, the share of COGS divided by sales fell by 7%, while cost of good sold growth. Unaudited data of 2019 are likely to indicate a problem with Creme Ltd’s record for the cost of goods or revenue record. As a result, from the perspective of auditing, auditors need to pay special attention to Creme Ltd’s record of cost of sale and revenue records, and carefully examine whether there are any significant errors in the record.

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According to the crème limited case, the existing internal control that is specific to the accuracy of the cost of goods is related to the segregation of duties between warehouse staff and accounting department, where the sales invoices by accounting department and the delivery documents prepared by the warehouse staff are sequentially numbered. In addition, customers are required to sign the delivery document upon the ordered products are delivered to customers. Furthermore, there is a strict restriction on access to the systems, and the authorization of assigning passwords to staff is essential for accessing and changing information in the system to ensure the independence between departments. The test of control is to check the accuracy of documents and calculations in delivery records to ensure the accuracy of journal and subsidiary records in accounting system. As mentioned above, it shows that the internal control text is feasible.

6）

Substantive procedure to produce reasonably reliable evidence for the accuracy of the cost of goods sold is through vouching, which means that the sales invoices are randomly selected, and it is to vouch to the delivery documents that are signed by customers. This is to ensure that the cost of goods sold is accurate. In particular, vouching process is essential to ensure that there will be sufficient audit evidence to justify the sales invoices issued by accounting department will not automatically be processed for calculating the cost of goods sold. Instead, it is the delivery document that is signed by customers who have received the products that match the original sales invoice to result in the accounting records of the cost of goods sold. Besides, vouching will be based on the randomly selected sales invoices or the delivery documents with a sufficient number of records selected according to the probability.