**Question**

Interappliance Inc. (II) is a medium sized private company in the business of developing, manufacturing and distributing wireless Internet devices. These devices permit users to browse the Internet and to send and receive e-mail while mobile. II’s niche is in commercial Internet devices, which are more durable than retail consumer versions. II’s special keyboard, the most advanced in the industry, is very small, easy to use and durable.

According to a leading market research firm, the market for this segment is growing at 70% per annum. Competition in this segment is fierce. II operates in an industry characterized by heavy expenditures in research and development and products that are regularly updated and revised. Recent innovations by one of II’s rival suggest that the industry is in a period of intense competition. Most of II’s production is exported.

The company was founded by James Scollon, CA and was incorporated in March 2003. II obtained a $5 million bank loan that was personally guaranteed by Scollon. According to the loan agreement II must maintain a current ratio of 2:1 at all times otherwise the loan becomes payable. The company has a December 31 year end. Cotton & King LLP (C&K), a large public accounting firm, have been the auditors since 2003.

II operates out of a single location in Canada and has 72 employees. The company has grown rapidly with annual revenue growth of approximately 40%. This was less than the forecasted 80% annual growth.

Shares of high technology companies have taken a major plunge over the last year. On the positive side, the tremendous shortage of high tech employees, which had hurt II, has eased due to widespread layoffs in the industry and the downturn in the economy.

Cash flow has been tight recently, but II in most cases has been able to pay suppliers on time. Management is looking at various options of obtaining additional financing over the next year. One of the considerations is to go public and to issue an initial public offering. Management is aware that if the company goes public that governance will be more important than it is now.

You are a recently qualified CA with C&K and have been assigned to the audit team for the audit of II’s financial statements for the year ending December 31, 2011. It is now October 12, 2011 and you have been assigned to start the planning for the year- end audit. In preparation for the audit planning you obtained the following information:

* II’s key financial information for the past two years was:

 ( thousands)

 2010 2009

Revenues 19,061 14,044

Net loss before taxes 1,800 230

Total assets 15,631 8,908

* During March 2011, Scollon authorized a change in credit policies. Previously, customers were granted credit based upon the credit ratings developed by II’s credit manager, which took into account the outstanding balance of the customer’s account and an analysis of its financial condition. Due to the recent downturn in the economy Scollon decided that II must use a more lenient credit policy to keep sales flowing.

 Accordingly, as a cost cutting measure, the credit manager was laid off in February 2011. Scollon now evaluates each customer contract or purchase

 order individually to determine whether credit should be granted. As a result of

 this new policy, no customer orders were declined for poor credit since February

 2011.

* Scollon’s wife, Glenda, was hired in early 2009 to replace the accountant who left due to family obligations. Prior to joining II, Glenda was a bookkeeper for a not for profit organization for 5 years. Glenda regularly consults with Scollon on how to record any complex transactions.
* In August 2011, the company was sued by a supplier in California for breach of contract related to the cancellation by II of a firm order for software. II’s U.S. lawyers have said that they can probably drag out the case until at least February 2012. The order was for $1,280,000 and this is the amount of the claim. Scollon believes the company should be able to settle for about half of that amount.

**Required**

a) Based upon the above information, what are three industry and environmental factors that increase II’s business risk? Explain why. Link the business risk factors you identified to specific risks of material misstatements. Use the following table to complete your answer. (6 marks)

|  |  |
| --- | --- |
| Identify business risk. Explain why.) | Link to risk of material misstatement  |
| 1. |  |
| 2. |  |
| 3. |  |

b) What would you set audit risk (high, medium, or low) for the II audit engagement? Explain why.

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c) Based upon your analysis in (a) what two financial statement accounts would be high inherent risk? Explain why – include in this discussion the most relevant assertions and the potential misstatement for the account.

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d) Provide a recommendation for the appropriate materiality benchmark (base) and the related appropriate percentage for the II audit and explain why.)

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