

8. **FREEWHEEL LTD**

Your new client, Freewheel Ltd, sells new cars, parts and accessories and undertakes workshop repairs. The company operates through 5 divisions in the Midlands.

Each division deals with a different overseas vehicle supplier and has 3 managers, one for each trading activity. Each division makes sales to companies and individuals but only corporate customers are granted credit terms.

The computer-based accounting system was installed nearly 3 years ago in the 'head office' which is annexed to the premises of the largest division. All nominal ledger codes are suffixed 1 to 5 to identify each division's transactions.

The majority of purchases are imported and settled on bills of exchange.

Detailed stock records include dates of movements, original purchase price and latest actual selling price. Purchase requisitions are computer-generated when stock line quantities fall to pre-determined re-order levels.

Gross selling prices for cars and parts are established on receipt of each consignment at standard mark-ups on cost, as specified in the franchise agreements with each manufacturer. Parts transferred to workshops are charged at cost plus 10%.

At the end of each month the computer generates trading and profit and loss accounts and balance sheets for each division and 'consolidated' results for the company.

New car sales managers prepare monthly returns showing the number of cars sold, gross selling prices, extras and discounts.

All salaries and wages are processed centrally at head office. Divisional managers all have profit-related bonus incentives.

Requirement

Set out the audit planning issues to be addressed and explain why they are important.

(14 marks)

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Planning issues

Importance

New audit client

- Lack of cumulative/prior knowledge, from which assurance can be derived, increases inherent risk.
- Accounting systems and internal controls need to be ascertained. Flowcharting will probably be appropriate.
- Current period audit work should have regard to the opening balances to provide assurance as to the accuracy of the opening position.
- Adequate planning is essential for audit efficiency to prevent over-auditing in first year.

Divisionalised operations

- The accounts of each division are not being reported on individually.
- Materiality, risk, the audit approach and extent of audit procedures must be assessed in the context of the company ('consolidated') accounts.
- Sample sizes should be apportioned between divisions (eg, by stratifying populations to divisions) to curb tendency to over-audit.
- Assets which are material to the balance sheet (stock and possibly premises, equipment, fixtures, etc) are kept at 5 different locations.
- The year-end attendance at stocktake should cover all locations and take the opportunity to verify other assets including fixed assets and cash.

Cash transactions

- If material, cash sales to individual customers increase inherent risk.
- Controls over cash must be evaluated and any weaknesses reported to management.
- Audit effort should be directed to confirming the completeness of recorded sales for parts and accessories and workshop in particular.

Computer-based accounting system

- Knowledge and skills appropriate to the use of computer-assisted audit techniques (CAATs) must be assessed. CAATs may be essential if the visible audit trail is lost.
- The costs and benefits of using test data and/or audit software should be ascertained.
- The availability of audit staff with the necessary expertise and appropriate CAATs has a significant bearing on the conduct of the audit (eg, time-savings afforded by computerised sample selection).

Bills of exchange

- Creditors for overseas purchases of new cars and parts will be material and represented by bills of exchange.
- Exchange profits and losses may be material if currencies of suppliers fluctuate significantly between dates of purchase transactions and bill settlements.
- Although non-adjusting, post balance sheet movements must be monitored and their effect, if material, disclosed.
- If exchange rates do not fluctuate significantly an average rate may be used as an approximation.
- Bills outstanding at the year-end should be translated at year-end rates and exchange differences reported in the current year profit and loss account.

Book stocks

- Computerised stock records should be materially accurate and up-to-date (otherwise they would not be appropriate for raising purchase requisitions).
- If there are no significant differences between physical and book stocks:
 - reliance may be placed on the accuracy of accounting entries to stock records;
 - annual stocktake need not be confined to the year end as 'roll-forward' is possible;
 - continuous stock-checking may be facilitated.
- Computerised stock information includes dates of movements, cost and selling price relevant to determining the adequacy of stock provisions.
- Audit software may be used to produce a stock ageing and report by exception:
 - slow-moving items (eg, no movements in x months);
 - actual selling price less than original purchase price.

Pricing policy

- Standard mark-ups facilitate budgetary control of divisional activities.
 - Transfer pricing parts sales to workshops at a 10% mark-up gives incentive to interdivisional trading.
 - Analytical review including 'proof in total' may confirm the completeness (or otherwise) of recorded revenue.
 - Divisional trading at lower mark-ups could:
 - distort GP% subject to analytical review;
 - conceal parts sales at more than the allowed margin.
- Therefore inter-divisional trading should be separately identified.
- Value of parts stock held by workshop is inflated by 10% unrealised profit.
 - Although this is unlikely to be sufficiently material to warrant a year-end adjustment, consideration should be given to the level of parts stocks held in the workshops. Quantities should be sufficient (to meet most immediate requirements) but not excessive (giving rise to risk of damage/theft).

Franchise agreements

- A breach of terms and conditions (eg, concerning prescribed mark-ups) could bring penalty clauses into effect.
- This aspect of inherent risk must be assessed:
 - if low, there may be no implications for the financial statements (eg, any contingent liability may be disregarded as being remote);
 - if high (see also management bias) a provision for penalties could be required.
- The appropriateness of the going concern assumption should be considered in the light of:
 - any known breaches;
 - foreseeable renewals.

Monthly management accounts

- Monthly accounts and returns indicate a control-conscious head office to mitigate the inherent risk attributable to divisional operations.
- The disaggregated financial information (by divisions and certain activities) should highlight key audit areas and fluctuations requiring investigation.
- For analytical review of the company's 'consolidated' accounts, the inter-divisional trading and balances must be eliminated.

Profit-related bonuses

- Inherent risk is increased by possible management bias to overstate profit by:
 - overstating sales;
 - understating expenses.
- This bias may reduce other aspects of inherent risk, for example, of loss of cash/stocks through unrecorded sales.
- Risk of sales overstatement may not be great as:
 - maximum prices set by franchise agreement; and
 - market is fiercely competitive at present time.
- Risk of expense understatement is restricted, for example, because head office controls payroll expenditure.
- Audit tests should be directed to most likely area of misstatement (for example, cut-off 'errors' arising through suppression of invoices).

Tutorial notes

'Planning issues' are not mere restatements of information given in the question. Any regurgitation of a question only tells the examiner what he already knows and is therefore 'padding' which earns no marks.

Information in the question needs to be turned into an observation, inference or implication. Only by demonstrating insight into audit situations will the examiner give credit.

In a question of this length there is a wealth of information. It is therefore vital that time is given to planning an answer to show an appreciation of the scope which the examiner is offering.