

19. GALAXY LTD

You are the senior in charge of the audit of Galaxy Ltd, a long established company which manufactures biscuits and confectionery.

The draft figures for 'Creditors: Amounts falling due within one year' as at 30 September 1993 are as follows:

	1993	1992
	£	£
Trade creditors	261,521	177,625
Accruals	21,162	18,177
Provisions: - Legal Action	40,000	-
- Factory repairs	72,000	62,000
	392,683	257,802

You have obtained the following additional information:

- (1) The provision for legal action relates to a competitor's claim that their manufacturing process has been illegally copied.
- (2) The provision for factory repairs was first set up in 1992 in respect of sums required to be spent on urgent repairs to the factory foundations and structural steel work. £58,500 was spent during the year ended 30 September 1993.

The audit of trade creditors, accruals and provision as shown in the balance sheet at the year end is to be performed under your supervision by a junior member of staff with no previous experience in this area.

Requirements

- (a) Explain why the audit of trade creditors, accruals and provisions is a more difficult area for the auditor than gross trade debtors and prepayments. (4 marks)
- (b) State, with reasons, the procedures that should be undertaken by the junior member of staff carrying out the audit of:
 - (i) trade creditors;
 - (ii) accruals; and
 - (iii) provisions. (9 marks)

(16 marks)

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(a) Explanation of relative difficulty

[Tutorial note: It is assumed that gross trade debtors means before provisions for bad and doubtful debts (which are a more difficult audit area).]

Creditors are tested primarily for understatement whereas debtors are tested primarily for overstatement. It is more difficult to test the completeness of creditors (ie. for something which isn't there!) than to verify a debtor's balance.

Provisions are usually estimates based, for example, on management's expectation of future outcomes. Although prepayments are accounting estimates they are less subjective, being calculated on a known amount (the amount paid).

Accruals and provisions do not arise through the processing of transactions but through period-end adjustments (ie. via journal entries). The need for an accrual/provision must therefore be identified before it can be recorded.

Sufficient relevant and reliable audit evidence may not be available to form an unqualified opinion on creditors, accruals and provisions. For example, not all major suppliers may provide statements and payments to them do not confirm the completeness of the recorded liability [unlike cash receipts from debtors].

[The prudence concept creates a disparity between recognition and accounting treatment of costs/creditors and revenues/debtors. A probable loss should be provided for even though the amounts involved may be unknown (therefore less evidence). Revenue can only be recognised when its ultimate cash realisation is reasonably certain (can therefore expect more evidence).

If management is biased to overstating profit it may be easier for expenditure to be suppressed than for revenue to be inflated. If management sent unsolicited goods/invoices to customers financial loss could result (through loss of goodwill/non-return).]

(b) Procedures

Reasons

[Tutorial note: It is assumed that trade creditors represents creditors per the creditors ledger control account (CLCA) in the nominal ledger(N/L) and that purchase invoice/GRN accruals are included in accruals.]

(i) Trade creditors

- Check (on a sample basis) the client's extraction of a creditors listing from the creditors ledger.
- Reperformance of the extraction verifies the completeness of the creditors listing.
- Alternatively, prepare a list of trade creditor balances from the creditors ledger.]

- Compare the list of balances with the previous year and enquire into the significant increase [£80k+ is nearly 50% increase].
- Increase could signify:
 - an increase in creditor days due to cash flow difficulties;
 - cut-off errors (eg. between cash and creditors);
 - business expansion.]
- Check the cast of the creditors listing and agree the total to the balance per the CLCA in the N/L.
- Any reconciling items identified (eg. in respect of discounts received/debtors ledger contras) will need to be accounted for.
- Select the most significant suppliers accounts as identified by:
 - creditors listing balances;
 - last year's working papers;
 - purchase invoices selected for testing.
- Potentially material balances could be misstated by their omission (since the primary testing of creditors is for understatement).
- Obtain year-end suppliers statements (eg. by circularisation request) and agree the client's reconciliation of amounts due to the creditors listing balance.
- Suppliers statements provide independent third party evidence of amounts payable.

[Other

- For (a sample of) purchase invoices received immediately prior to the year end and included in creditors confirm (eg. by reference to GRNs) their inclusion in year-end physical stock.
- If omitted from stock, the cut-off error gives rise to understatement of profit.
- List all debit balances over £x and obtain explanations.
- If material, amounts recoverable should be reclassified to trade debtors/prepayments.]

(ii) *Sundry accruals*

- Obtain/prepare a schedule of accruals and compare with prior year.
- An apparent omission in current year may be included in current year trade creditors.

- Trace 'Goods received not invoiced' on the suppliers statement reconciliations to the GRN accrual.
- If these reconciling items are not accrued the cut-off error will result in an profit overstatement.
- Prepare or obtain a control account for PAYE and other deductions and agree the amount paid after the year-end.
- To ensure that payroll deductions are promptly accounted for [as penalties may otherwise accrue].
- Check calculations to ensure that adequate accrual has been made for:
 - periodic payments (rent, rates, insurance, etc.);
 - accrued salaries, wages and employer's social security contributions;
 - payroll deductions;
 - professional charges (eg. audit); and
 - VAT].
- To test for omission or other understatement resulting in the overstatement of profit. [To verify completeness and accuracy of financial statements.]

(iii) Provision - legal action

- Discuss with management the basis of their provision (eg. legal costs and/or damages) [and possible consequences for going concern].
- To ascertain whether (say) the provision is an admission of guilt or for an out-of-court settlement to prevent lengthy/costly legal proceedings/adverse publicity.
- Review correspondence with competitor/solicitors.
- To ascertain the nature and amount of the claim (probably an injunction +/- damages).
- Inspect the manufacturing process and capital expenditure thereon.
- A recent change in the manufacturing process may substantiate the competitor's claim.
- Ask client to request confirmation from Galaxy's legal advisers.
- To provide independent third party evidence to appraise the likely outcome.
- Ask management for written assurance (representation) that they are not aware of any other matters referred to solicitors.
- To confirm that the information so far provided is complete.]

(iii) *Provision - factory repairs*

- Obtain/prepare a schedule of the current year expenditure and compare its make-up with the prior year provision.
- Obtain/prepare a schedule of the current year-end provision and compare with surveyor's estimate.
- Vouch building contractor's invoices:
 - in year to current year expenditure;
 - post year end to the year-end provision.
- To assess the reasonableness/reliability of provisions previously made by management.
- To assess whether the need for additional repairs has come to light in the current year or whether the prior year provision was grossly underestimated.
- Provides independent documentary evidence.

Tutorial notes

A substantive approach is suggested by a number of points in the question:

- the year-end balance sheet amounts are being audited;
- the size of the client/amounts involved do not suggest a system-based approach;
- accruals and provisions are created by period-end adjustments.

The junior can be expected to have some audit experience (since the question only precludes previous experience in this area).

MARKERS' COMMENTS

This was one of the better-answered questions on the paper, probably because it was the first question attempted and required students to apply knowledge to a well-defined problem

Answers to part (a) were generally very good or very poor. Good answers explained the difficulty in relative terms in the context of risk of misstatement using the examples of Galaxy Ltd.

Some answers to part (b) were rather mechanical, as if students were describing their own firms' procedures, e.g. 'Prepare a lead schedule showing . . .'. Some students adopted a systems-based approach inappropriate to the circumstances of the question. Better answers made a clear distinction between the procedures appropriate to each of creditors, accruals and the provisions in a way in which a junior member of staff could be expected to undertake. Poorer answers were vague and did not clearly address the audit of creditors *in the balance sheet of Galaxy Ltd.* The quality of reasons was generally weaker than the procedures proposed.

②

i) Trade Creditors:

as well as creditors

- 1) Obtain a breakdown of the total creditors
- 2) Test for arithmetical accuracy (it adds up).
- 3) Review for unusual trends and discuss with management why?
- 4) Select a sample of creditors:
 - Material Balances - (Larger balances)
 - Unusual Balances - (Zero balances/old balances for e.g.)

- 5) Obtain a copy of the supplier's statement (at end of month statement). (Will also show age of debt 30 days/60/90 etc.)
 - Reconcile o/s balance to this
 - If any differences appear, have to be investigated.

- 6) Contact supplier and ask for statement, if we do not have statement from suppliers. Or written evidence such as e-mail from supplier will suffice as evidence.

- 7) Confirm the o/s balance (creditor) to post-year end cash payment (book).

- 8) Confirm o/s balances to individual ~~supplier~~ purchase invoices, that make up that balance.

(3)

Accruals

Steps 1-4 (with creditors/debtors) as before.

(Obtain breakdown / Test arithmetically accuracy / Review for unusual breaks /
Select a sample of accruals.)

- 5) Confirm to actual invoice received post year end and potentially its payment.

(Goods received by supplier not yet invoiced ~~to goods~~ is an accrual).

- 6) Confirm PAYE/VAT creditor (as paid 14 days after month end) to post-year end payment.
(Plus same for VAT) (VAT paid every 14).

- 7) Review post year end cash book payments for any unrecorded liabilities (accruals).

(4)

Provisions:

Provision for legal action:

- 1) Discuss with management as to how they have arrived at £40,000. ~~At~~
(+ MGT confirm this in writing).
- 2) Review correspondence with solicitors.
- 3) Review outcome of case if complete. (And outcome of case)
→ ~~At~~ ~~At~~ If case closed, and won, used to adjust for provision and vice versa.

Factory Repairs:

- 1) Discuss with management, how they arrived at £72,000
- 2) Review correspondence with contractors for a written quote.
- 3) Last year's provision was £63,000. Actual expenditure this year was £58,500.
∴ A reasonable estimate
∴ Adds to confidence in this year's figure.
- 4) If repairs completed, compare provision to actual expenditure.