

Sitting Pretty

Sitting Pretty Ltd is a small, family run company that makes plastic chairs in a variety of shapes and colours for children and 'fun at heart' adults. It buys in sheets of plastic which can be cut and bent into the correct shape and a plastic leg that is custom made by another company to Sitting Pretty's requirements. All off-cut plastic is sent back to the supplier who melts it down and re-uses it, for which Sitting Pretty receive a 10% discount off their purchase price.

For the stocktake, the factory manager ensures that no work in progress is outstanding and closes down production for the day. The factory workers come in early on the day of the stocktake to count the stock, and they are entitled to go home as soon as stock is counted. Good controls have always been maintained over the stocktake in previous years. There are no perpetual stock records. Raw materials are all kept in the stores and are only taken out when they are required for production. Finished goods are kept in the end of the factory, near the delivery exit.

You are the audit assistant assigned to attend the stocktake. You have just rung the factory manager and he has mentioned that on the day of the stocktake a large consignment of plastic is going to be delivered. It is the only day that his supplier can make the delivery, and he needs the material to continue with production on the day after the stocktake.

The audit engagement partner has told you that he is aware that Sitting Pretty changed the specification of their customised leg recently, after a series of complaints over the stability of their chairs. Last year's stock was valued at £200,000 in the balance sheet, of which £30,000 related to raw material stocks.

Finished goods are all carried at the same valuation as each other as there is very little difference between the stock ranges. Planning materiality for this year has been set at £5,000 on the grounds, at this stage, that the figures are expected to be similar to last years.

Required

- (a) Explain the importance of the stocktake in this situation. (3 marks)
- (b) Prepare notes for your audit supervisor detailing the procedures you propose to undertake in relation to your stocktake attendance. (7 marks)
- (c) Outline the procedures which should be taken in relation to cut off at the final audit. (5 marks)
- (d) List the audit procedures you would carry out on the valuation of stock at the final audit. (5 marks)

Sitting Pretty

(a) Importance of the stocktake

The stocktake provides important **audit evidence** as to the **existence** and **completeness** of stock included in the financial statements.

In this case, the stocktake is particularly important because the **company does not maintain perpetual stock records**. As no perpetual records are maintained, the only basis for the stock entries in the financial statements is the results of this stocktake.

Stocks are **generally material** to the balance sheet of a manufacturing company and they are also one of the **higher risk areas** on the balance sheet. The stocktake provides important audit evidence reducing the risk of a material misstatement in relation to stock.

(b) Planning for attendance

Gain knowledge: I must review the notes of last year's stocktake and I must contact the factory manager to obtain details of this year's. I must review this year's details to ensure that the stocktake appears to be planned efficiently and effectively.

Tutorial note. It is possible you assumed that this part of planning was already completed as the question tells you that you have just rung the factory manager. If so, you should have stated that assumption, or to cover yourself as we have, noted that this is a requirement. However, you should not have spent long on this aspect of the question.

Assess key factors: There are various key factors given in the scenario:

- (i) **Nature and volume of the stocks.** There should be no WIP, so I will count raw materials (approximately 10% of the stock) and finished goods. However, raw material plastic should be low because a delivery is required to continue with production.
- (ii) **Possible obsolescence.** I must make a note of the number of old chair legs maintained in raw materials as these are no obsolete, a new specification having been agreed.
- (iii) **Cut off issues.** I need to ensure that the delivery on the day is isolated and that I obtain details of the delivery made during the stocktake. I need to determine whether this should be included as deliveries for the year, but most of all ensure that it does not get counted twice (as it arrives, and if it is put into stores). I should also obtain copies of the relevant documents, for example, the last invoices in the year and the last goods received and despatched notes.
- (iv) **Off-cuts.** I need to consider whether any off cuts are maintained on site and whether these are being included in the stocktake. As the company receives a discount relating to them, they are unlikely to legally be considered Sitting Pretty's and so should not be included.
- (v) **Staff issues.** It appears that the stocktake is undertaken by the people who work in the factory and handle the stock on a daily basis. This is not best practice, although in practical terms it is difficult to avoid. However, I should discuss this with the factory manager to assess whether staff can be allocated to counting stock they have not produced. Also, as the staff are allowed to go home as soon as the stocktake is completed, there is a risk that the stocktake will be rushed and mistakes will be made. The manager should ensure that it is made clear that the stocktake should be thorough and that no one will leave before checks on the thoroughness of the counts have been made.

Plan procedures: I need to determine my sample sizes and whether there is a need for expert assistance at this stocktake.

- (i) **Procedures.** I will carry out test counts, checking from a sample of items to the count sheets and a sample of items from the count sheets to the physical items.

- (ii) **Samples.** There are no higher value items that I should concentrate particularly on. Materiality for the year has been set at £5,000 currently. Dividing last year's figures for stock by this materiality level would give a sample size of 6 items for raw materials and 34 items for finished goods. I need to determine the batches in which stock is valued to ensure that I count the correct items. I need to assess the levels of stock when I arrive to ascertain whether this remains appropriate.

(c) **Cut off at final audit**

General procedures

The audit team should take a **sample of delivery notes** for sales and purchases on either side of the year end and **trace these to invoices and ledgers and stock records** to ensure that **sales and purchases have been included in the correct period** and that **stock is accounted for where appropriate**. (That is, sales have not be counted twice and purchases have been included in stock.) As the factory has been shut down, there is a lower risk that sale cut off is inappropriate than purchase cut off.

Stocktake delivery

Once it is determined whether this delivery should count as this year's stock (which it should if the stocktake was the year end date), the delivery information should be traced to purchase invoices and ledgers to ensure that the purchase is recorded in the year and that the creditor is accounted for in the year. The stock should then be included also.

Other matters

If **stock returns** are material, the stock returns after the year end should be reviewed to ensure that items are not included as sales in the year and that the stock is added to the stock figure unless it is now obsolete, whereupon it should be written off.

(d) **Valuation of stock**

The auditors should obtain the client's working papers relating to the valuation of stock. Items which the auditor sampled at the stocktake should already have been verified to the stocktake records as part of the verification of existence.

Cost

The auditors should then **trace a sample of items to purchase invoices** to ensure that **cost has been correctly applied**. Cost of purchase (per SSAP 9) excludes trade discounts and rebates, so the auditors should ensure that the valuation **cost excludes the 10% discount** received for returning the off-cuts of plastic.

The auditors should then ensure that for a sample of finished goods items, **costs of conversion** (comprising costs of labour and overheads) have been included. This should be on a comparable basis to the previous year and therefore can be audited by analytical review.

Net realisable value

The auditors should ensure that **cost is lower than net realisable value** by tracing their sample to **after date sales**. If no invoices are yet available, the auditors can make confirmations by reviewing sales orders and price lists.

Obsolete

Lastly, the auditors should ensure by review and by discussion with management that stock which has been identified as **obsolete** at the stocktake has **not been attributed value** and has been **scrapped**.

Analytical procedures

The auditors will undertake general analytical procedures to ensure that the stock figure stacks up. This could include calculating ratios such as stock turnover and ensuring that they stack up with the facts that have been presented them in the course of the stock audit.