

SECTION A

QUESTION ONE

- (a) Describe the role of analytical review procedures within the audit process, indicating their strengths and weaknesses

(10
marks)

- (b) You are the audit manager of King & Co and you have been provided with financial statements extracts and the following information about your client, Select Kitchen Designs Ltd (Select), who is a kitchen manufacturer. The company's year end is 30 April 2013.

Select has recently been experiencing trading difficulties, as its major customer who owes £0.6m to Select has ceased trading, and it is unlikely any of this will be received. However, the balance is included within the financial statements extracts below. The sales director has recently left Select and has yet to be replaced. The monthly cash flow has shown a net cash outflow for the last two months of the financial year and is forecast as negative for the forthcoming financial year. As a result of this, the company has been slow in paying its suppliers and some are threatening legal action to recover the sums owing.

Due to its financial difficulties, Select missed a loan repayment and, as a result of this breach in the loan covenants, the bank has asked that the loan of £4.8m be repaid in full within six months. The directors have decided that in order to conserve cash, no final dividend will be paid in 2013.

Financial statements extracts for year ended 30 April:

	DRAFT 2013 £m	ACTUAL 2012 £m
Current Assets:		
Stock	3.4	1.6
Debtors	1.4	2.2
Cash	—	1.2
Current Liabilities:		
Trade creditors	1.9	0.9
Overdraft	0.8	—
Loans	4.8	0.2

Requirement:

Explain, using appropriate ratios, the potential indicators that Select Kitchen Designs Ltd is not a going concern.

(20 marks)

Describe the audit procedures that you should perform in assessing whether or not the company is a going concern.

(10 marks)

(TOTAL 40 marks)

QUESTION ONE (Select Kitchens Design Ltd)

(a)

(a) The Role of Analytical Review

- In Planning: to identify potential audit problems, identify materiality, highlight areas of risk
- In Testing: as a part of substantive testing, to provide evidence about completeness, accuracy and validity of transactions and balances. To provide evidence to support substantive tests.
- At Final Review: as a final confirmation of the reasonableness of the financial statements

Strengths:

- Efficient method of testing
- Identifies key relationships and changes
- Provides good overview of the situation of the business
- These features are not available through substantive tests

Weaknesses:

- Will only identify material fluctuations unless a good level of detail is obtained
- Non-financial data may be unreliable
- Detailed data may not be readily available
- Annual comparisons may be too global to provide good level of assurance
- Requires good knowledge of the business and ability to enquire assertively of management

(b)

Ratios

	2013	2012
Current Ratio	0.64	4.55
Quick Ratio	0.19	3.1

Going concern indicators

(i) A major customer of Select Kitchen Designs Ltd (Select) has ceased trading owing them £0.6m. This will result in a significant loss of future revenues and profit, and unless this customer can be replaced then there will be a reduction of future cash flows.

(ii) The sales director has recently left the company and has yet to be replaced. Loss of a key director will impact on the company's sales, as Select has already lost a major customer,

then without an experienced sales director to generate new sales the company will face significantly reduced sales and cash flows.

(iii) Select is experiencing negative monthly cash flows and this is expected to continue. If the company continues to have cash outflows then it will increase its overdraft further and will start to run out of available cash.

(iv) The company has been late paying some of its suppliers. If suppliers are being paid late then they may refuse to supply Select with goods or impose 'cash on delivery' terms which will disrupt service or sales to customers.

(v) A number of the suppliers are threatening legal action. If this occurs then Select will have legal costs on top of the amounts owed already and this will further increase the pressure on cash flows. In addition, other suppliers may hear about the legal action and, as a result, stop supplying goods to Select.

(vi) Select has missed a loan repayment which is a breach in the loan covenant and hence the loan of £4.8m is now all repayable. The company only has six months to raise £4.8m; as it currently stands they do not have this level of cash available and unless they are able to raise alternative finance or sell non-current assets, it is difficult to see how they will be able to raise this amount.

(vii) In order to conserve cash Select has decided not to pay a final dividend for 2012. This may result in shareholders losing faith in the company and they may attempt to sell their shares; in addition, they are highly unlikely to invest further equity, and Select urgently needs to raise finance to repay their loans.

(viii) The current ratio has significantly declined from 4.55 in 2012 to 0.64 in 2013. The current ratio is showing that the current assets are not sufficient to pay the current liabilities. This is another indication of the worsening liquidity position of the company, which has mainly occurred due to the loan becoming repayable.

(c) Going concern procedures

- Obtain the company's cash flow forecast and review the cash in and out flows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows.
- Perform a sensitivity analysis on the cash flows to understand the margin of safety the company has in terms of its net cash in/out flow.
- Discuss with the finance director whether the sales director has yet been replaced and whether any new customers have been obtained to replace the one lost.
- Review the company's post year-end sales and order book to assess if the levels of trade are likely to increase and if the revenue figures in the cash flow forecast are reasonable.
- Review the loan agreement and recalculate the covenant which has been breached. Confirm the timing and amount of the loan repayment.
- Review any agreements with the bank to determine whether any other covenants have been breached, especially in relation to the overdraft.

- Discuss with the directors whether they have contacted any alternative banks for finance to assess whether they have any other means of repaying the loan of £4.8m.
- Review any correspondence with shareholders to assess whether any of these are likely to increase their equity investment in the company.
- Review post year-end correspondence with suppliers to identify if any others have threatened legal action or refused to supply goods.
- Enquire of the lawyers of Select as to the existence of any additional litigation and request their assessment of the likely amounts payable to the suppliers.
- Perform audit tests in relation to subsequent events to identify any items that might indicate or mitigate the risk of going concern not being appropriate.
- Review the post year-end board minutes to identify any other issues that might indicate further financial difficulties for the company.
- Review post year-end management accounts to assess if in line with cash flow forecast.
- Consider whether the going concern basis is appropriate for the preparation of the financial statements.
- Obtain a written representation confirming the director's view that Select is a going concern.