

## SECTION A

### QUESTION ONE

You are the audit senior of White & Co and are planning the audit of Redsmith Co for the year ended

30 September 2010. The company produces printers and has been a client of your firm for two years; your audit manager has already had a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts.

Redsmith's management were disappointed with the 2009 results and so in 2010 undertook a number of strategies to improve the trading results. This included the introduction of a generous sales-related bonus scheme for their salesmen and a high profile advertising campaign. In addition, as market conditions are difficult for their customers, they have extended the credit period given to them.

The finance director of Redsmith has reviewed the inventory valuation policy and has included additional overheads incurred this year as he considers them to be production related. He is happy with the 2010 results and feels that they are a good reflection of the improved trading levels.

#### Profit and Loss Account extracts for year ended 30 September

|                                     | DRAFT  | ACTUAL |
|-------------------------------------|--------|--------|
|                                     | 2010   | 2009   |
|                                     | \$m    | \$m    |
| Sales                               | 23.0   | 18.0   |
| Cost of Sales                       | (11.0) | (10.0) |
|                                     | <hr/>  | <hr/>  |
| Gross profit                        | 12.0   | 8.0    |
| Operating expenses                  | (7.5)  | (4.0)  |
|                                     | <hr/>  | <hr/>  |
| Profit before interest and taxation | 4.5    | 4.0    |
|                                     | <hr/>  | <hr/>  |

#### Balance Sheet extracts at 30 September

|                 |     |     |
|-----------------|-----|-----|
| Stock           | 2.1 | 1.6 |
| Debtors         | 4.5 | 3.0 |
| Cash            | —   | 2.3 |
| Trade creditors | 1.6 | 1.2 |
| Overdraft       | 0.9 | —   |

#### Requirement

Using the information above:

- (a) Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit; and (5 marks)
- (b) From a review of the above information and the ratios calculated, explain the audit risks that arise and describe the appropriate response to these risks. (20 marks)
- (c) Describe the investigations and checks you would carry out, in addition to those described above, to determine whether the company is a going concern. (15 marks)

**(TOTAL 40 MARKS)**

## QUESTION ONE

(A)

|                  | 2010                     | 2009                     |
|------------------|--------------------------|--------------------------|
| Gross margin     | $12/23 = 52.2\%$         | $8/18 = 44.4\%$          |
| Operating margin | $4.5/23 = 19.6\%$        | $4/18 = 22.2\%$          |
| Inventory days   | $2.1/11 * 365 = 70$ days | $1.6/10 * 365 = 58$ days |
| Receivable days  | $4.5/23 * 365 = 71$ days | $3.0/18 * 365 = 61$ days |
| Payable days     | $1.6/11 * 365 = 53$ days | $1.2/10 * 365 = 44$ days |
| Current ratio    | $6.6/2.5 = 2.6$          | $6.9/1.2 = 5.8$          |
| Quick ratio      | $(6.6 - 2.1)/2.5 = 1.8$  | $(6.9 - 1.6)/1.2 = 4.4$  |

(B)

### (1) Audit risk

Management were disappointed with 2009 results and hence undertook strategies to improve the 2010 trading results. There is a risk that management might feel under pressure to manipulate the results through the judgements taken or through the use of provisions.

#### Response to risk

Throughout the audit the team will need to be alert to this risk. They will need to carefully review judgemental decisions and compare treatment against prior years.

### (2) Audit risk

A generous sales-related bonus scheme has been introduced in the year, this may lead to sales cut-off errors with employees aiming to maximise their current year bonus.

#### Response to risk

Increased sales cut-off testing will be performed along with a review of post year-end sales returns as they may indicate cut-off errors.

### (3) Audit risk

Revenue has grown by 28% in the year however; cost of sales has only increased by 10%. This increase in sales may be due to the bonus scheme and the advertising however, this does not explain the increase in gross margin. There is a risk that sales may be overstated.

#### Response to risk

During the audit a detailed breakdown of sales will be obtained, discussed with management and tested in order to understand the sales increase.

### (4) Audit risk

Gross margin has increased from 44.4% to 52.2%. Operating margin has decreased from 22.2% to 19.6%. This movement in gross margin is significant and there is a risk that costs may have been omitted or included in operating expenses rather than

cost of sales. There has been a significant increase in operating expenses which may be due to the bonus and the advertising campaign but could be related to the misclassification of costs.

**Response to risk**

The classification of costs between cost of sales and operating expenses will be compared with the prior year to ensure consistency.

**(5) Audit risk**

The finance director has made a change to the inventory valuation in the year with additional overheads being included. In addition inventory days have increased from 58 to 70 days. There is a risk that inventory is overvalued.

**Response to risk**

The change in the inventory policy will be discussed with management and a review of the additional overheads included performed to ensure that these are of a production nature. Detailed cost and net realisable value testing to be performed and the aged inventory report to be reviewed to assess whether inventory requires writing down.

**(6) Audit risk**

Receivable days have increased from 61 to 71 days and management have extended the credit period given to customers. This leads to an increased risk of recoverability of receivables.

**Response to risk**

Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation.

**(7) Audit risk**

The current and quick ratios have decreased from 5.8 to 2.6 and 4.4 to 1.8 respectively. In addition the cash balances have decreased significantly over the year. Although all ratios are above the minimum levels, this is still a significant decrease and along with the increase of sales could be evidence of overtrading which could result in going concern difficulties.

**Response to risk**

Detailed going concern testing to be performed during the audit and discussed with management to ensure that the going concern basis is reasonable.

**C**  
**(1)**

The important steps to be taken by the auditors in determining whether or not the company may be properly regarded as a going concern at the year end would include:

- Review carefully the cash and profit forecasts for the next year to see if they suggested any improvement in the company's position: consider the basis of preparation of these forecasts and whether they appear comprehensive
- Seek some evidence that the company's bank is prepared to continue supporting the company
- Review the level of post balance sheet trading to see if this supports the forecast and show any signs of improvement in the company's position
- Examine correspondence files for any evidence that creditors might be putting pressure on the company for repayment of monies owing
- Consider how the company's position compares with similar companies in the same business
- Discuss generally the situation with management and review any recovery plans which they may have in mind