

Question 1

Pekka Ltd are wholesalers of domestic cleaning products. You are the senior in charge of the audit for the year ended 30 April 2008. You have carried out an analytical review on the profit and loss account and are concerned that there has been a significant fall in the gross profit margin, as shown by the following statements (2008 figures are from the accounts and 2007 figures are from the audited accounts).

Year ended 30 April	<u>2008</u> £000	<u>2007</u> £000
Sales	2,623	3,218
Opening stock	480	512
Purchases	<u>2,200</u>	<u>2,186</u>
	2,680	2,698
Closing stock	<u>534</u>	<u>483</u>
Cost of goods sold	<u>2,146</u>	<u>2,215</u>
Gross profit	<u>477</u>	<u>1,003</u>
Gross profit %	<u>18.1%</u>	<u>31.2%</u>

You have been asked to determine whether the fall in profit is correct or due to errors in the preparation of the financial statements.

The company does not maintain book stock records and stock quantities were ascertained from a physical stocktake at 30 April 2008. For sales to customers:

- the sales department receive orders from customers and raise a multi-copy dispatch note when the goods are available
- the credit controller authorises the dispatch note
- the dispatch department send the goods to the customer and a copy of the dispatch note is sent to the sales accounting department
- the sales accounting department prepare the sales invoice from the dispatch note.

The company only prepares annual accounts. Assume that the accounts for the year ended 30 April 2007 show a true and fair view.

Required:

- Suggest possible reasons for the fall in the gross profit margins;
(6 marks)
- Describe the work you will carry out to highlight any understatement of the value of closing stock.
(7 marks)
- Your audit partner is concerned that, with the huge drop in gross profit margin, Pekka Limited may not be a going concern. Describe the work that you would carry out in order to satisfy yourself that the company is a going concern.
(7 marks)

Total: 20 marks

Question 1 – Pekka Ltd

a) Suggest possible reasons for the fall in the gross profit margins;

(6 marks)

a) The possible reasons for the fall in the gross profit margin include:

- (i) there has been a reduction in selling prices (e.g. because of competitive pressures), or the increase in selling prices has not kept pace with the increase in purchase costs or there has been a change in sales mix to lower margin products;
- (ii) sales are understated, either because some dispatches are not invoiced or sales are made at a lower than normal price. Also, the issue of credit notes for unsatisfactory products would reduce the gross profit margin (i.e. if the stock was not returned, but the credit note was issued as an allowance to the customer). Returns by customers could adversely affect the gross profit margin, if subsequently this stock had to be sold at less than the normal selling price;
- (iii) closing stock is understated, either because not all the stock has been counted, or too low a price per unit has been put on the stock. Write-down of closing stock (because it is worth less than cost) could reduce the gross profit margin;
- (iv) there are sales or purchases cut-off errors, particularly:
 - goods dispatched in April have not been included in sales until May
 - goods received in May have been included in April's purchases;
- (v) purchases are overstated, probably because there has not been proper checking of goods received (i.e. that the full sum has been paid for short deliveries). As stated in part (i) above, purchases could be larger than expected if suppliers are either charging a higher than expected price, or overcharging on their purchase invoices (which the company accepts);
- (vi) there could be misappropriation of stock, probably by employees. Is it worthwhile for employees to steal the stock and are the procedures over custody of stock effective (e.g. video recorders would be attractive for employees to steal);
- (vii) has a significant amount of stock been written down or written off in the year. Such stock may be obsolete, damaged or slow moving;
- (viii) as the question says that the 2007 accounts are correct, no error can arise from this source. However, if there is doubt about the accuracy of 2007's accounts, overstatement of the value of the closing stock and cut-off errors in 2007 could result in an understatement of gross profit in 2008's accounts.

1 mark for each reason - possible marks 8 – maximum 6.

b) Describe the work you will carry out to highlight any understatement of the value of closing stock.

(7 marks)

Quantities

- I will check that cut-off was carried out correctly. In particular, there should be no movement of stock during the stocktake (i.e. it is best to carry out the stocktake at a week-end when there are no purchases or sales) as movement of stock may result in stock being counted twice or not at all.
- Stock should be marked when counted and the management should select items randomly at the end of the count to ensure they appear on the stock sheets. The stock sheet numbers used in the count should be recorded and all the stock sheets should be used when valuing stock. I will check that this occurred.

Valuation

- The stock may be undervalued because too low a price per unit has been used, or stock has been written down to net realisable value. I will ask the appropriate manager which stock has been written down to net realisable value and I will determine the reduction in value of this stock below cost (this will affect the reported gross profit margin).
- It will be quite difficult to identify stock which has been underpriced as it is unlikely that I will be aware of which stock may be of high value. So, I will ask the appropriate manager which stock is of high value, I will locate this on the stock sheets and check to purchase invoices that it has been valued at cost.
- Also, I will locate high value stock at 30 April 2007 and find this stock at 30 April 2008. The price used to value this stock at 30 April 2007 should be similar to the price at 30 April 2008. If it is significantly less at 30 April 2008 I will check it is correct by checking to the appropriate purchase invoice.
- In addition, I will select a sample of large value purchase invoices posted to the purchase ledger in the year and check that the stock has been valued at the same price as the purchase invoice.

Overall reconciliation

- For large value lines of stock, I will attempt to reconcile the quantities of opening and closing stock, purchases and sales in order to see if there is any stock loss or uninvoiced sales. In terms of quantity:

$$\text{closing stock} = \text{opening stock} + \text{purchases} - \text{sales}.$$

- The stock quantities will be found from the stock sheets and purchases and sales will be found from purchases and sales invoices. I will note any discrepancies I find and quantify the value of the 'lost stock'.

Analytical review

- I will compare stock turnover with previous years and I will ask the management if they consider that the current year's stock turnover and value are reasonable. The stock turnover in April is 2.39 months and in 2007 it was 2.1 months. However, the fall in sales in 2008 (18.4%) could suggest that the age of stock should have

increased, as many companies do not reduce purchases immediately sales fall, so one would expect the age of stock in 2007 to be higher than in 2008.

This question has a lot of scope for marks – but Tucketttdents may not find this easy. One mark for each reasonable piece of audit work.

12. Your audit partner is concerned that, with the huge drop in gross profit margin, Pekka Limited may not be a going concern. Describe the work that you would carry out in order to satisfy yourself that the company is a going concern.

(7 marks)

1. Review of profit and cash flow forecasts
2. Consider quality of the systems in place for producing forecasts and keeping them up to date
3. Ensure company can pay debts as they fall due
4. Perform sensitivity analysis on key components
 - a. particularly in respect of anticipated efficiencies/reduced labour costs
 - b. also on turnover and interests rates
5. Ascertain whether post year-end management accounts support efficiencies
6. Up to date with loan installments
7. Ensure any covenants not breached
8. Status of major debtors
9. Outcome of any negotiations with bank
10. Obtain written confirmation from directors regarding their assessment that the company is a going concern

1 mark for each point – 10 possible, 7 maximum