

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 senior of Richards & Co and you are planning the audit of Knight Construction Ltd (Knight) for the year ended 31 March 2013. Knight specialises in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts:

Knight has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge.

The directors need to meet a target profit before interest and taxation of £0.5 million in order to be paid their annual bonus. In addition, to try and improve profits, Knight changed their main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To help with operating cash flow, the directors borrowed £1 million from the bank during the year. This is due for repayment at the end of 2013.

Financial statement extracts for year ended 31 March

PROFIT AND LOSS ACCOUNT (EXTRACT)

	DRAFT	ACTUAL
	2013	2012
	£m	£m
Turnover	12.5	15.0
Cost of sales	(7.0)	(8.0)
Gross profit	5.5	7.0
Operating expenses	(5.0)	(5.1)
Profit before interest and taxation	0.5	1.9

BALANCE SHEET (EXTRACT)

Stock	1.9	1.4
Trade Debtors	3.1	2.0
Cash	0.8	1.9
Trade creditors	1.6	1.2
Loan	1.0	–

Requirement:

Using the information above:

- (i) Calculate ratios, for BOTH years, which would assist the audit senior in planning the audit; and
(8 marks)
- (ii) Using the information provided and the ratios calculated, identify and describe the key audit risks and explain the auditor's response to each risk in planning the audit of Knight Construction Ltd.
(22 marks)

(TOTAL 40 marks)

QUESTION ONE

(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 to assist the audit supervisor in planning the audit:

	2013	2012
Gross margin	$5.5/12.5 = 44\%$	$7/15 = 46.7\%$
Operating margin	$0.5/12.5 = 4\%$	$1.9/15 = 12.7\%$
Stock days	$1.9/7 * 365 = 99 \text{ days}$	$1.4/8 * 365 = 64 \text{ days}$
Stock turnover	$7/1.9 = 3.7$	$8/1.4 = 5.7$
Debtor days	$3.1/12.5 * 365 = 91 \text{ days}$	$2.0/15 * 365 = 49 \text{ days}$
Creditor days	$1.6/7 * 365 = 83 \text{ days}$	$1.2/8 * 365 = 55 \text{ days}$
Current ratio	$5.8/2.6 = 2.2$	$5.3/1.2 = 4.4$
Quick ratio	$(5.8 - 1.9)/2.6 = 1.5$	$(5.3 - 1.4)/1.2 = 3.3$

(ii) Audit risks and responses

(1) Audit risk

Debtor days have increased from 49 to 91 days and management has significantly extended the credit terms given to customers. This leads to an increased risk of recoverability of debtors as they may be overvalued.

Audit response

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

(2) Audit risk

Due to the fall in demand for Knight Construction Ltd's houses, there are some houses where the selling price may be below cost. SSAP 9 requires that stock should be stated at the lower of cost and NRV.

In addition, stock days have increased from 64 to 99 days and stock turnover has fallen from 5.7 in 2012 to 3.7 in the current year. There is a risk that stock is overvalued.

Audit response

Detailed cost and net realisable value (NVR) testing to be performed and the aged stock report to be reviewed to assess whether stock requires writing down

(3) Audit risk

The directors have extended the useful lives of plant and machinery from three to five years, resulting in the depreciation charge reducing. Under FRS15, useful lives are to be reviewed annually, and if asset lives have genuinely increased, then this change is reasonable. However, there is a risk that this reduction has occurred in order to achieve profit targets. If this is the case, then plant and machinery is overvalued and profit overstated.

Audit response

Discuss with the directors the rationale for extending the useful lives. Also, the five year life should be compared to how often these assets are replaced, as this provides evidence of the useful life of assets.

(4) Audit risk

The directors need to reach a profit level of £0.5 million in order to receive their annual bonus. There is a risk that they might feel under pressure to manipulate the results through the judgements taken or through the use of provisions.

Audit response

Throughout the audit, the team will need to be alert to this risk and maintain professional scepticism. They will need to carefully review judgemental decisions and compare treatment against prior years. In addition, a written representation should be obtained from management confirming the basis of any significant judgements.

(5) Audit risk

Due to a change in material supplier, the quality of products used has deteriorated and this has led to customers claiming on their five-year building warranty. If the overall number of people claiming on the warranty is likely to increase, then the warranty provision should possibly be higher. If the directors have not increased the level of the provision, then there is a risk the provision is understated.

Audit response

Review the level of the warranty provision in light of the increased level of claims to confirm completeness of the provision.

(6) Audit risk

Knight has borrowed £1.0m from the bank via a short-term loan. This loan needs to be repaid in 2013 and so should be disclosed as a current liability. In addition, Knight may have given the bank a charge over its assets as security for the loan. There is a risk that the disclosure of any security given is not complete.

Audit response

During the audit, the team would need to check that the £1.0m loan finance was received. In addition, the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards and Companies Act 2006.

The loan correspondence should be reviewed to ascertain whether any security has been given, and this bank should be circularised as part of the bank confirmation process.

(7) Audit risk

The current and quick ratios have decreased from 4.4 to 2.2 and 3.3 to 1.5 respectively. In addition, the cash balances have decreased over the year, there is a fall in demand and Knight have taken out a short-term loan of £1 million, which needs to be repaid in 2013. Although all ratios are above the minimum levels, this is still a significant decrease and along with the fall in both operating and gross profit margins, as well as the significant increase in payable days could be evidence of going concern difficulties.

Audit response

Detailed going concern testing to be performed during the audit and discussed with the directors to ensure that the going concern basis is reasonable. The team should discuss with the directors how the short-term loan of £1.0 million will be repaid later in 2013.