

Solutions to Student Self Assessment Questions

Chapter 14

Final review: post-balance sheet period, provisions, contingencies, letter or representation

Questions

14.1 Consider the following statements and explain why they may be true or false:

- (a) Audit working sheets should be a record of all evidence collected by auditors in forming the audit opinion.
- (b) Auditors' responsibility ceases at the date they sign the audit report.
- (c) The financial statements signed by directors on or slightly before the date of the audit report must be identical with the financial statements submitted to shareholders.
- (d) Oral evidence from management that can be confirmed from other sources need not be acknowledged in writing in the letter of representation.
- (e) If management refuse to sign the letter of representation, auditors will be unable to form an opinion as to whether the financial statements give a true and fair view.
- (f) FRS 12 and IAS 37 apply to provisions for accrued electricity and telephone usage and provisions for doubtful debts.

14.2 Show how the following events should be reflected in the accounts at 31 December 2011 and describe audit procedures you would carry out to verify them:

- (a) Company A estimated that the profits on a construction contract that was 75 per cent complete at 31 December 2011 would amount to £100 000 and had taken up £75 000 in the profit and loss account on the portion of the contract certified as complete by a qualified surveyor. On completion on 21 February 2012, company records show profit on the contract amounted to £30 000.
- (b) Company B acquired non-current assets for £500 000 on 31 January 2012. The financial statements at 31 December 2011 showed non-current assets at cost less depreciation amounting to £250 000.
- (c) Company C has shown in its financial statements at 31 December 2011 an investment in another company at cost of £750 000. On 1 March 2012 there is a significant decline in prices on the Stock Exchange resulting from unexpected foreign exchange movements.
- (d) Company D is in dispute with a supplier as to the quality of goods supplied and has provided for the amount it believes to be correct (£100 000). The supplier has sued for the full amount invoiced (£150 000) but on 12 March 2012 the company and supplier agree the liability out of court at £120 000.
- (e) Company E had prepared draft financial statements at 30 November 2011, showing an acid test ratio of 0.85 to 1. (The normal acid test ratio in its industry is 1 to 1.) Shortly before 31 December 2011, the company sold trade investments for £450 000, incurring a loss of £100 000 and this had the effect of increasing the acid test ratio to 0.98 to 1. On 16 January 2012, the company repurchased the trade investments for £500 000.

14.3 Bandon Limited acquired a subsidiary, Gateside Limited, ten years ago and goodwill on consolidation is being written off over 20 years. Gateside made good profits until two years ago, but in the year to 31 December 2010, made a small loss and in the year to 31 December 2011 made a significant loss. Do you think that this would provide good grounds for an impairment review? What audit steps would you perform to satisfy yourself that the results of the impairment review are valid?

14.4 During an audit of the cost records of Robertson Ltd at 31 March 2011 you discover that Prospect Limited has sued the company, claiming that it is using a manufacturing process which has been patented by Prospect. However, the directors of Robertson say that the manufacturing process used is sufficiently different from the one patented and that no disclosure of any potential liability is required. Discuss the accounting and auditing implications of this matter.

Solutions

14.1 a) *True*

Audit working papers should be a synopsis of the assignment. This means that all important evidential matter should be included in them, the basic rule being that they should be self-explanatory. To give only one example, if the auditor has discovered that not all sales orders have been subjected to a credit control check, the working papers should contain identifying references to the documents in question and ideally should contain copies of some if not all of them. There should also be a reference to the impact on control risk and to the scope decision on the nature and extent of substantive tests

b) *False*

While it is generally true that auditors' responsibilities cease on the date the audit report is signed (that is, they are not expected to search for evidence of balance sheet after that date), ISA 560 - Subsequent events - makes clear that, should auditors become aware of such events they do have certain responsibilities. Read paragraphs 10 and 14 of ISA 560.

c) ?

As a matter of practicality the financial statements signed by the directors may not be in the precise printed or typewritten form submitted to members. However, auditors should satisfy themselves that the approved financial statements are complete in all **material** respects with those subsequently issued to members.

d) *True*

Auditors would certainly not wish to overload the written representations from management on matters about which there is little uncertainty. For instance, if management has explained orally to the auditors that the reason for a reduction in gross profit percentage has been a decision not to increase prices to match cost increases, it would probably be possible for them to confirm this by checking sales invoices and cost records and no reference would be needed in the letter of representation. On the other hand, if the auditors were aware that there was a pending legal case the auditors might have concluded that the matter had been appropriately dealt with in the financial statements with as a provision of disclosure as a contingent liability. They would probably ask management that there were no other legal claims against the company.

You should note too that paragraph 6 of ISA 580 makes clear that the auditors should obtain written representations from management and, where appropriate, those charged with governance that they believe that they have fulfilled their responsibility for the preparation of the financial statements and for the completeness of the information provided to the auditor.

e) ?

It is unlikely that the auditor would be able to form conclusions in the absence of a letter of representation from management. See paragraphs 16 to 20 of ISA 580. It might be possible for the auditor to form conclusions as to truth and fairness by reference to other sources particularly where the areas of contentious judgement were slight, but we would not be too sanguine about this. A refusal to sign the letter might indicate a breakdown in the working relationship between auditor and management or of problems in the company that management wish to hide.

f) *False*

The word 'provision' was often used by accountants to mean the setting up of an accrual or for amounts deducted from assets, such as trade receivables and fixed assets. FRS 12 and IAS 37, however define a 'provision' in a very particular and restrictive way, but exempts a number of items from its application, including so-called executory contracts, except where the contract is onerous. Contracts of this kind are defined as contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. They generally relate to the delivery of future services, including electricity and telephone. This means that this kind of accrual is not covered by FRS 12 and IAS 37.

- 14.2 a) **Company A.** The discovery that the profit on the long-term contract amounted to £30,000 and not £100,000 is an adjusting event in the terms of IAS 10 and FRS 21 as it gives more information about a condition that existed at the balance sheet date. It would therefore seem appropriate to take up a profit of £22,500 and not £75,000.

The auditor would determine why the company had been so wrong about the estimated profits on this contract and might consider examining the records of the company to determine extent of completion at the balance sheet date, including the reports from the qualified surveyor. The costing records in the old and new period should be tested to ensure costs (including overhead costs) and income have been properly allocated to the contract in question. The matter should be fully discussed with management, and in addition, whether there were implications for other contracts not complete at the balance sheet date..

- b) **Company B.** The acquisition of the fixed assets does not appear to be a matter providing more information about conditions existing at the balance sheet date. The acquisition does seem to be very material and disclosure should be made in the notes to the financial statements that it has been effected. CA 2006 does require capital commitments to be stated in the notes and there seems to be a good case for indicating the actual date of acquisition in this note. The auditors would examine the contract for the supply of the fixed assets, the purchase invoice and the entry in the fixed assets register. They would ensure that all related costs (such as installation costs) had also been determined and, in view of the significance of the amount, may feel that a physical inspection would be appropriate.
- c) **Company C.** The decline in stock market prices seems to be a further example of a non-adjusting event, but if material the reduction in market value by £200,000 should be disclosed in the notes to the accounts.

The auditors would need to obtain the stock market quotation at the audit report date and ensure the disclosure in the notes reflected it. If the stock markets are volatile (that is, see-sawing up and down or moving downwards or upwards) the auditors may feel the need to ensure that the quoted value of the investment is made known to the shareholders at the AGM. To this end they should discuss the matter with the directors to determine the action they intend to take. They may also consider making a statement to the shareholders at the AGM, depending on the materiality of the matter.

- d) **Company D.** This event has the hallmark of an adjusting event as it gives more information about conditions that existed at the balance sheet date and the amount of the provision should therefore be adjusted to £120,000. The auditors would wish to inform themselves of the background of the dispute and to examine the agreement between the two parties.

- e) **Company E.** This scenario looks very much like deliberate window dressing by the company to improve the appearance of liquidity. The auditor should look carefully into the circumstances of the sale and repurchase, considering in particular if the transaction was other than arms length to a related party. Transactions with related parties should be disclosed and, if they are not, the auditor would wish to qualify the audit report. The sale and repurchase might need to be the subject of an 'emphasis of matter' in the audit report. We discuss audit qualifications and emphases of matter in Chapter 16.

14.3 Clearly, any asset only has value if it can generate profits and positive cash flow, so a downturn in profits and the occurrence of losses might indicate that impairment has occurred. Unlike tangible assets, goodwill cannot be sold, so an impairment review would concentrate on value in use within the company, unless the decision was made to dispose of the whole subsidiary, in which case net realisable values for goodwill might be appropriate if it were to be sold as a going concern. The auditors would discuss the future of Gateside and its operations with management. To assist in these discussions, the auditors would establish the trend of profits over the last ten years. It seems that the trend into a loss-making situation has been evident in 2010 and 2011. If this trend continues, Gateside may be in even more trouble in the year to 31 December 2012 and the auditor would determine what actions the directors of Bandon are taking to remedy the situation of their subsidiary. What are their views on why the downward trend has occurred? For instance, has a new competitor entered the market, or has there been new legislation that has made the company less viable, or have one or more key employees left Gateside, rendering the company less well managed. The auditors would ask management if they have a response to these matters that might turn the company round. They may find that the directors have decided to change product lines and management structures, in which case it may become clear that the existing goodwill has little to do with the 'new' company, in which case write down or even complete write-off of the goodwill might follow the impairment review. The carrying amount of the investment in Gateside in Bandon's own financial statements should probably be written down. This is clearly a subjective matter, but the auditors should find as much external evidence as possible by reviewing industry trends, reading business news and specialist industry news-sheets.

- 14.4 The auditors are clearly concerned that the third party will be successful in an action against the company and that material damages may become payable. From the accounting point of view the auditor has to decide if this is:
- A provision in the terms of FRS 12 and IAS 37 that is an event has occurred (the use of the patent registered by a third party) that creates a present obligation (either legal or constructive) that is expected to result in the outflow of economic benefits that can be assessed with sufficient reliability.
 - A contingent liability that is not remote and should therefore be disclosed under the terms of FRS 12 and IAS 37.

This is clearly both a legal matter and a technical matter. If the patent has been infringed, then legally the company may well be liable. However, if there is doubt that the patent has been technically infringed, Prospect may not be able to make a successful claim for damages in court. The first step for the auditors would be to determine the facts. They would examine a copy of the patent held by Prospect and determine the nature of the claims made. There would be a need to determine the nature of the manufacturing process concerned and the technical matters that are involved in its operation. The auditor might seek expert advice about the patent and about the process and whether the latter has or has not been using the former. The process may prove to be in the public domain, in which case the claim for damages would be unlikely to be successful and the success of the court case regarded as remote. If, however, the

contingency is other than remote, the decision must be taken whether to it is a provision in the terms of FRS 12 and IAS 37 or merely a disclosable contingent liability. Legal advice should also be sought once the technical matters have been clarified.