

Solutions to Student Self Assessment Questions

Chapter 13

Final work: Specific problems related to inventories, long term contracts and trade payables

Questions

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

- (a) The omission of a short-term liability from the balance sheet will result in the acid test ratio showing that the company is less liquid than it really is.
- (b) Trade payables may be regarded as complete once auditors have carried out their search for unrecorded liabilities.
- (c) Accurate cut-off means that trade payables are genuine.
- (d) In valuing inventories it is permissible to include an element of administrative expense.
- (e) In planning work on construction contracts the auditor should identify the points where management is exercising judgement.

13.2 You are auditing a company that operates a computer-controlled warehouse. There is no human entry to the warehouse except when essential maintenance is carried out and products are taken into the store and taken out on pallets controlled by an operator using a desktop computer. Suggest how you might approach that section of your audit where you are seeking to prove existence and condition of inventory.

13.3 The following is a record of inventory movements and recorded sales of Whygate Ltd, a company buying and selling products on credit with a December 2011 year-end. Consider these figures and then attempt the following questions.

Figures as on page 528'

- (a) Assuming that inventory was determined by count at 31 December 2011 state the adjustment required to sales and debtors and indicate the effect on profits of the adjustment.
- (b) Assuming that inventory was determined on the basis of recorded inventory movements, state the adjustment required to sales and trade receivables and indicate the effect on profits of the adjustment. The company carries out periodic inventory counts.

You may assume in both cases that purchases have been recorded in the correct period.

- (c) What action would you take as auditor to prove that sales/inventory cut-off was accurate?

13.4 You are responsible for the audit of trade payables and purchases of Powerbase for the year ended 31 May 2011. You carried out interim audit work on purchases and trade payables at 30 November 2010 and concluded that purchases were being properly processed although you were somewhat concerned that delays in processing were occurring. Your concern was heightened by a comment by a member of the accounting staff: 'I don't know what you are worried about. If we haven't recorded a liability, the supplier will soon remind us!' You have now been given the following figures (including some ratios) and aim to ensure that the purchases and trade payables at 31 May 2011 are fairly stated. Design substantive programme steps that will help you to accomplish this aim. You should refer to our comments on the Powerbase case study (10.1 on page 361).

Figures as on page 528.

Solutions

13.1 a) *False*

The omission of a short-term liability from the balance sheet will cause liabilities to be understated, and the company will appear more liquid than it really is.

b) ?

The auditor's search procedures are designed to prove that trade payables are complete, so the statement is true as far as the auditor is concerned. However, management may well have formed this conclusion earlier as a result of their own procedures to ensure that all liabilities, including trade payables have been detected.

(c) *False*

Cut-off is usually regarded as an accuracy matter as it is one measure to ensure that trade payables have been identified at the balance sheet date. Of course, it is also true that cut-off procedures will be designed to prove that trade payables represent genuine transactions.

d) ?

Generally it is not permissible to include administrative expense in the valuation of inventory at cost as such expense is not directly related to current production or to getting the goods for sale to their present condition and location. However, it may be difficult to decide in practice how costs are to be classified (for instance as production overhead or administrative expense). Note also that in certain circumstances it may be permissible for administrative expense to be included in overheads (where, for instance, a large project is using a significant proportion of the company's resources).

e) *True*

Judgment has to be exercised in many accounting situations and long-term contracts are no exception. Sometimes judgment is about the genuineness, accuracy and completeness of accounting records, such as the allocations of costs to individual contracts, but frequently judgment has to be exercised in relation to accounting estimates. An example from long-term contracts is estimated costs to be incurred in completing the contract. The auditor has to identify the points where management exercises judgment, as it is at these points that management is asserting that accounting treatments are valid. As we made clear in the text, these assertions become audit objectives that set the scene for the efficient and effective evidence search.

13.2 Computer controlled warehouse

The auditors are faced with an unusual situation where technology is being used to do a task formerly performed by human beings. The first task of the auditors would be to find out how the company satisfied itself that the goods in the warehouse were in existence and in good condition. It may be, for instance, that the company withdraws complete inventories of goods on a rotation basis for test checking. If the company does this, the auditors should enquire into the results of the counts and any other investigations the company carried out into discrepancies between count and inventory records.

The auditors would also wish to ascertain that the system for controlling inventory movements was satisfactory. For instance, they would wish to find out if movements could only take place as the result of properly authorised documentation and if there was segregation of duties between computer operations, custody of goods and inventory control.

The auditors may decide that a test count will also be appropriate, in which case arrangements should be made with top management for them to be provided with proper authority (The auditors may decide to do this on a surprise basis). The test count should be carried out by company personnel in the presence of the auditors, immediate comparisons made with inventory records and investigation of differences conducted.

13.3

(a) *Inventory determined by count*

At the time of the inventory count the auditors would have noted that the last despatch note number was 1460 and would test that sales attributable to that and prior numbers were recorded in 2011 and to subsequent numbers in 2012. The following adjustments would be required:

1457	Add to sales in 2011	+ 12,550
1460	Add to sales in 2011	+ 6,000
1461	Deduct from sales in 2011	- 5,600
1464	Add to sales in 2011	+ 5,995
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		+ 18,945

In making the above calculation we have assumed that inventory despatched on 31 December 2011 has not been included in inventory. The auditor would enquire into this. The journal entry would be:

Debit trade receivables	£18,945
Credit sales	£18,945

The effect of this adjustment would be to increase profit by £18,945. The auditor would wish to determine why sales despatch note number 1464 had been used to record a movement at 31 December 2011. If it transpired that the movement had occurred in 2012 the sales and trade receivables would be increased by £18,945 less £5,995 = £12,950

(b) *Inventory determined from inventory records*

The inventory records will have been updated for transactions up to and including 1460, dated 31 December 2011. Inventory records should be adjusted to include despatch note 1464, assuming the movement was genuinely in 2011. The sales record should be amended to record 1457, 1460 and 1464 in sales of 2011 and to remove 1461 from the sales record. Cut-off adjustments are identical to those required for inventory determined by count. Cut-off must be tested whether inventory is determined by count at the year-end or taken from the inventory records.

- (c) *Sales/inventory cut-off.* Cut-off should be tested to ensure all sales in the year have been recorded in that year and that no sales in the subsequent period are included. A useful procedure would be to record the last inventory despatch note number for subsequent matching to sales invoices. A suitable substantive test would be to select a number of despatch notes before the critical number and ensure that sales invoices have been prepared and recorded before the year-end. This is an important completeness test because it helps to ensure that all the sales had been recorded and in the correct period. Of course the test would also help to prove that the sales transactions are genuine because it will show that a genuine movement of goods to customers has occurred.

Further, comparing the quantities on the despatch note and invoices will be an accuracy test. A selection of despatch notes after the year-end should be checked to sales invoices to ensure they are included in the following year. Tests may also be performed from invoices to despatch notes to ensure that a despatch note has been raised for each invoice issued. We looked at this in some detail when we discussed inventory count procedures earlier. The auditor should ascertain that a responsible official is given the task of considering cut-off matters at the time of the inventory count. Sometimes the company may have a system of continuous inventory taking throughout the year, taking year-end quantities from inventory records. This is acceptable provided that inventory records can be shown to be accurate. Accurate cut-off must be established at the time of count AND at the balance sheet date.

13.4 Powerbase plc. The gross profit percentage of 53.64% at 31 May 2011 is much higher than the previous year-end, and some 3 points higher than at 30 November 2010 (See comments on case study 9.2), so it may be that many liabilities remain unrecorded. This conclusion is supported by the higher number of days that inventory bears to cost of sales at 31 May 2011 (84 compared to 75 for the previous year), which suggests that inventory may have been received without a corresponding purchase being recorded. You will remember that we decided at the interim that delay was occurring in recording liabilities and at the final examination we should direct particular audit effort to testing for unrecorded trade payables. Interestingly, the relationship between trade payables and cost of sales does not provide a warning signal. Appropriate programme tests at the year-end would include the following:

Assertions to be tested:

All trade payables are properly recorded in the accounting records (all purchases of goods and services have been recorded.)

Trade payables represent amounts due at the balance sheet date (purchases of goods and services have been recorded in the right period)

- (1) Perform bridging tests similar to those performed at the interim date to ensure purchases are being properly processed in the whole year. This would include obtaining assurance that goods received notes are complete.
- (2) Search for unrecorded liabilities by selecting all invoices recorded for one month after 31 May 2011 and checking to goods received notes to ensure that none should have been accrued at 31 May 2011.
- (3). Carry out a similar search in the cash book to ensure that no payments are in respect of items purchased in the period prior to 31 May 2011, unless in respect of purchases recorded in the prior period or accrued.
- (4) Reconcile credit suppliers statements to suppliers balances outstanding in the accounting records. If management have already done this you may test their reconciliation work.
- (5) Circularise selected suppliers and ask them to inform you of the balance outstanding at 31 May 2011 and of invoices issued 14 days prior to and after 31 May 2011.