

Solutions to Student Self Assessment Questions

Chapter 12

Final Work: General Principles, Analytical Review of Financial Statements, Fixed Assets and Trade receivables

Questions

12.1 Consider the following statements and explain why they may be true or false.

- (a) The audit approach to any asset will involve the auditor in a consideration of condition.
- (b) If the analytical review discloses no variations from the previous year, the auditor need not enquire further.
- (c) Analytical review is an evidence-gathering procedure performed as part of substantive procedures.
- (d) Planning feedback means that audit plans are altered to take account of changed circumstances.
- (e) A genuine transaction is one that has been authorized by an independent responsible official

12.2 Turn to the Pykestone example (Case study 12.3) and draft an audit programme for:

- (a) Non-current asset additions during the year.
- (b) Non-current asset disposals during the year.
- (c) Non-current assets held at 31 December 2011.
- (d) The depreciation charge of the year.

12.3 Draft a request for confirmation of a trade receivables balance in the accounting records of a company audited by you, explaining why you have included each item.

12.4 Consider the following items of income and expense and state: whether they bear a relationship to each other or not; if they are related in any way, in what way they should move in relation to each other; the reasons for your answer in each case.

(a) Sales of manufacturing concern:

- Bank interest
- Administrative expense
- Commission to sales personnel
- Distribution cost
- Production royalties

(b) Cost of production of a manufacturing concern:

- Trade receivables
- Cost of non-current assets in use
- Loss on disposal of factory equipment
- Inventory levels
- Directors' emoluments

(c) Gas company income

- Number of units of gas used
- Temperature in winter months

- Electricity company prices
- Number of employees.

Solutions

12.1 (a) *True*

Condition must be considered in respect of any asset. Thus, an item of inventory or equipment should be in a condition to be sold or used within the organisation. A trade receivables balance should be valued in the financial statements at the lower of its monetary value recorded initially in the accounts and its realisable value (being the recorded amount less bad debts provision). A trade receivables balance against which a provision of this nature has been made is clearly not in good condition. The auditor looks for evidence of collectability by assessing the 'condition' of trade receivables balances. Even cash can have a condition that renders it of less value. Consider a company having cash balances in a country that forbids remittances or taxes remittances to the company's home country.

b) *False*

The analytical review is only one of several forms of substantive procedure. Normally, it will not stand on its own but will be interpreted in the light of other evidential matter, including the strength of the entity's control systems. Lack of variation from prior years may cause the auditor to enquire further if variations were expected.

c) *True*

Analytical review is normally a very important part of substantive procedures, the objective of which is to substantiate transactions and figures and the analytical review will aid the auditor in this respect.

d) *True*

Planning feedback is the term used to indicate the alteration of original plans because of changes in circumstances or of events unexpected at the time the plan was originally conceived.

e) *False*

This is an incomplete statement. Authorisation is an important procedure to ensure that recorded transactions are genuine, but it is only part of the story. Thus approval of purchase orders is an important control, but proof is also needed that goods have been received in the quality and quantity required and that purchase invoices agree with orders and goods received notes. 'Genuine' in this case means that a recorded purchase represents real goods or services received, in other words that a real event has caused the purchase invoice to be prepared.

12.2 (a) Programme for audit of fixed asset additions:

- Discuss acquisition policy with senior officials.
- Compare fixed asset additions with fixed asset budget on a global basis. Enquire into any major variation between budget and actual additions in total.
- Select all additions to freehold land and buildings and additions to plant and machinery and motor vehicles on a random basis and trace to:
 - Fixed asset budget
 - Purchase invoice
 - Suppliers despatch note
 - Goods received note
 - Documents of title (such as land and building title deeds).
 - Fixed assets register

- Entry in general ledger account
 - (iv) Check that fixed asset budget has been properly authorised by appropriate authority.
 - (v) Consider the propriety of capitalisation of each item selected.
 - (vi) Peruse the repairs and maintenance listings and check revenue nature.
- (b) Programme for audit of fixed asset disposals:
- (i) Discuss disposals policy with senior officials
 - (ii) Consider the disposal procedures used, such as auction and selection by management of long-standing customers
 - (iii) Check that major disposals have been authorised, if necessary by the board of directors.
 - (iv) Trace major disposals to:
 - Sales invoice
 - Goods despatch note
 - Cash book or sales day book entry
 - Sales ledger entry (if any)
 - General ledger entry
 - Fixed asset register (removal of entry)
 - (v) Enquire into any material profits or losses on sale and satisfy yourself that these are in order.
- (c) Programme for audit of fixed assets at 31 December 2011:
- (i) Perform analytical review and identify areas requiring further investigation and testing
 - (ii) Check that opening balances have been brought forward correctly
 - (iii) Check reconciliation between fixed assets register and fixed assets accounts in the general register and enquire into any discrepancies.
 - (iv) Enquire into the results of the company's own inspection of fixed assets and reconciliation to fixed assets register. (This will help to determine the number of tests the auditor will make).
 - (v) Select major assets from the fixed assets register and physically inspect them, noting condition and whether in use.
 - (vi) Select physical pieces of equipment and motor vehicles and trace to the fixed assets register.
 - (vii) Check ownership where possible to evidence of title
 - (viii) Check revaluation of freehold land and buildings to the valuer's certificate, and check that the valuer is of good repute and has valued on existing use basis. If possible check valuation to similar properties in the neighbourhood.
 - (ix) Check that disclosure has been properly made in the fixed assets note supporting the fixed assets entry in the balance sheet.
- (d) Programme for audit of depreciation charge of the year
- (i) Determine the depreciation policies of the company and check on a global basis that the depreciation charge appears to be reasonable.
 - (ii) Obtain the company's reconciliation between depreciation recorded in the fixed assets register and the charge in the profit and loss account. Enquire into the reasons for discrepancies, if any.
 - (iii) Reconsider useful lives of selected plant and machinery by discussing with management and production staff.

- (iv) Review the fixed assets register to determine if any assets are in existence with written down values at or near zero. Discuss these specific cases with management and consider whether assets should be restated.
- (v) Select assets from the register randomly, both existing and new, and test calculation of depreciation, taking into account the stated rate for the asset and the policy on additions.
- (vi) Check that depreciation note has been properly stated.

12.3 Request for confirmation of a trade receivables balance:

Sterndale plc
27 Andrews Street
RUFFORD

A Adams
36, Muir Street
CARLTON

15 December 2011

Dear Sirs,

In connection with their audit of our accounts, our auditors, Messrs John Gunn and Co., 57 High Street, RUFFORD wish to obtain direct confirmation of your indebtedness to us at 30 November, 2011, which according to our records amounted to £1,100.

We should therefore be grateful if you would confirm direct to our auditors using the enclosed pre-addressed stamped envelope that you are in agreement with the stated balance or to report details of any differences by completing the attached slip. We enclose a copy of a statement to aid you in agreeing the balance. Please do not send any remittance with your reply.

We should appreciate an early reply to this request.

Yours faithfully,
Name and designation

From: A Adams .
36, Muir Street .
CARLTON .

To John Gunn and Co 57 High Street RUFFORD

We confirm that the balance of £1,100 shown on the attached statement is in agreement with our records.

We cannot agree the balance of £1,100 shown on the attached statement for the reasons indicated below:

(Please delete as appropriate)

Signed.....(Title or position)-----

Notes:

- (a) This is a positive confirmation request, so that a reply is required whether in agreement or not. A negative confirmation request only requires a reply if the recipient disagrees with the balance.
- (b) The credit customer is given both the balance and its composition. This is a common procedure but you might argue that it would be better not to give these details in case the balance in the customer's books is higher than the client has indicated. There is some force in this argument but as a practical matter a larger number of replies is likely the more information is given.
- (c) The request is from the client and not the auditor because the business relationship is between client and customer.
- (d) The stamped pre-addressed envelope is enclosed to increase the likelihood of reply and to ensure the reply is returned direct to the auditor.
- (e) Remember that should the debtor send a remittance to the auditors they should immediately forward it to the client
- (f) The title or position of respondents is required to judge whether they have the requisite authority.

12.4 i) The following items are likely to bear a direct or partially direct relationship to sales of a manufacturing concern:

Commission to sales personnel (normally bearing direct relationship to sales on commission)

Distribution expense, except to the extent that there is a fixed cost element

The following are not likely to be directly related to sales, although there may be some relationship:

Administrative expense (normally containing overhead unaffected by sales levels).

Bank interest (This is a finance expense not normally directly related to sales, although if turnover is expanding rapidly additional finance may be required to finance expansion).

Royalties payable for use of a production process (If royalties are paid on the basis of product sales, the relationship would be a direct one. In this case, however, they are related to production and not to sales, although there might be a relationship if production was made to order or if finished inventory levels were constant).

ii) The following are likely to bear a direct relationship to cost of production of a manufacturing concern:

Cost of fixed assets in use (Depreciation of production fixed assets will be an element of cost of production and bears, therefore, a direct relationship.

However, there are many more costs in cost of production than depreciation and you would need to analyse the cost of production figure to establish whether the depreciation charge seemed reasonable).

Inventory levels (Inventory levels of raw materials and components are likely to be determined on the basis of production needs and the relationship is therefore a direct one. Levels of finished goods are more likely to be related to sales needs).

The following are not likely to be directly related to production cost:

Trade receivables (Related to sales)

Loss on disposal of factory equipment (This loss is likely to be affected by the market for second- hand equipment and the skill of the person disposing of it).

Directors' emoluments (The production director's salary is likely to be a component of production cost and there may be a direct relationship if his bonus is production-related but directors' emoluments generally are not likely to bear a relationship to cost of production).

The following are likely to bear a direct relationship to Gas company income:

Number of units of gas sold

Temperature in winter months (This will tend to cause a higher rate of consumption of gas and have a direct bearing on income. However, cold weather in January and February may not have an effect until March or April, when the gas usage is billed to customers).

Electricity company prices. (Electricity is an alternative energy source to gas and the price charged to the consumer may, therefore, have an effect on gas prices and on income of a gas company. The price of energy is often a matter of political significance and the gas company may feel it necessary to keep its prices in line with other energy sources, even if consumers are tied to the company because of (say) investment in gas central heating.

It is not likely that the total number of employees will in the short run have a relationship to income from gas sales, as most employees will not have a direct role in generating income.