Auditing and stewardship of companies

Questions and Answers (A level)

Question 1

November 2017

LS Limited has completed its first year of trading. The company has four directors, of whom two are not shareholders. The auditors are currently carrying out the end of year audit.

REQUIRED

(a) (i) Explain the term 'stewardship'. [2]

(ii) Explain how directors carry out their role of stewardship within a limited company. [2]

(iii) Explain the purpose of an end of year audit. [2]

Additional information

The draft financial statements for the year showed the following:

	$
Sales	182 000
Sales returns	8 000
Purchases	154 000
Purchases returns	12 000

All sales were at a mark-up of 150%.

During the audit the auditors discovered that included in the sales records was a sales invoice for $6000 which had been prepared for a customer but not yet been sent. The customer had received the inventory on a sale or return basis, but had yet to decide whether or not to keep the inventory.

REQUIRED

(b) (i) Calculate what should have been the value of the closing inventory. [5]

(ii) Calculate the gross profit for the year. [1]

Additional information

During the year the warehouse manager had been absent from work for a long period of time. There had been little control over the movement of inventory. Staff had valued the inventory **actually** in the warehouse at the end of the year at $24 000.

REQUIRED

(c) Calculate the percentage change in gross profit if the inventory valuation from the warehouse had been used. [3]

(d) Discuss **three** possible reasons for the difference between the warehouse inventory valuation and the calculated value of inventory. [6]

(e) Discuss whether the directors should use the warehouse inventory valuation or the amount from the accounting records as the inventory figure in the financial statements. Justify your answer. [4]

[Total: 25]

Question	Answer	Marks
3(a)(i)	Stewardship is the responsibility which managers/directors have for the management of resources **(1)** within a business on behalf of the owners/shareholders. **(1)**	2
3(a)(ii)	The directors have responsibility as stewards of the company to report **(1)** at the AGM **(1)** to the shareholders on the performance of the company. **(1)** To maintain proper accounting records. **(1)** Responsible for the preparation of financial statements. **(1)** Manage the business on a day to day basis. **(1)** Safeguard the assets. **(1)** **Max 2**	2
3(a)(iii)	External auditors are appointed by the shareholders to carry out an audit, which is a systematic and independent examination **(1)** of books, accounts, documents and vouchers of an organization, **(1)** to ascertain how far the financial statements present a true and fair view of the business **(1)** and comply with IAS/Companies Acts. **(1)** To prepare an audit report expressing an opinion. **(1)** **Max 2**	2

Question	Answer	Marks

3(b)(i)	$ $
	Sales 182 000
	Less: returns (8 000) **(1)**
	sale or return (6 000) **(1)**
	  168 000
	Purchases 154 000
	Less: returns 12 000
	  142 000 **(1)**
	Closing inventory 74 800 **(1 OF)**
	Cost of sales 67 200 **(1 OF)**
	Gross profit 100 800
		5

3(b)(ii)	168 000 · 60% (3/5) = $100 800 **(1OF)**	1
3(c)	Percentage change is 100 800 – 50 000 (100 800 – *50 800) **(1OF)** = 50 800 **(1OF)** / 100 800 = 50.4% **(1OF)** * 74 800 – 24 000	3
3(d)	Reasons for closing inventory to be different than as per records: Inventory has been stolen/damaged **(1)** due to little control. **(1)** Inventory is obsolete, **(1)** so has no value in reality but might in the inventory records. **(1)** Sales have been omitted in the records, **(1)** i.e. Inventory has been sent out on consignment or a sale or return basis, so not yet sold. **(1)** Purchases of inventory have been recorded twice, **(1)** or not all inventory was counted. **(1)** Sales returns were amended in the records **(1)** but the purchases returns were not. **(1)** **2 marks · Max 3 points** (1 mark for stating and 1 mark for developing)	6
3(e)	If book value is used, profit and current assets would be overstated **(1OF)** which is against the prudence concept **(1) and** does not give a true and fair view. **(1)** Inventory should be recorded at the lower of cost and net realisable value, **(1)** in line with IAS2 **(1).** Therefore the warehouse inventory valuation should be used. **(1)** 1 for decision + max 3 for comments	4

Question 2

May June 2019

The financial statements of W Limited for the year ended 31 December 2018 are ready to be audited.

The directors have provided the following assets balances from the statement of financial position.

	$
Property, plant and equipment	682 000
Inventory	94 200
Trade receivables	87 400
Other receivables	9 430
Cash and cash equivalents	21 170

The following information is available.

1 Included in property, plant and equipment was equipment with a carrying value of $140 000. The fair value of the equipment was $132 000 and the value in use was $136 000.

2 The retained earnings for the year ended 31 December 2018 were $184 000. This is after deducting a proposed final dividend of $12 000.

3 The directors had budgeted to incur $25 000 advertising in 2019. A provision was made for this expenditure.

Answer the following questions in the Question Paper. Questions are printed here for reference only.

(a) Explain **one** benefit of auditing. [2]

(b) Explain to the directors the appropriate accounting treatments for item 1, 2 and 3, making reference to the relevant International Accounting Standards (IAS). [7]

Additional information

The following information is also available.

1 A deposit of $3000 had been paid to a supplier for goods to be delivered in April 2019. This amount had been recorded as purchases.

2 Goods costing $5400 and with a sales value of $7000 were sent to a customer on sale or return basis. The directors had recorded $7000 as a sale. At 31 December 2018 the customer had not decided whether to buy the goods.

(c) Calculate the revised retained earnings at 31 December 2018 using all the information available. [6]

(d) Calculate the **corrected** figure for the following items for inclusion in the revised statement of financial position at 31 December 2018.

(i) Property, plant and equipment

(ii) Inventory

(iii) Trade receivables

(iv) Other receivables

(v) Total assets

[5]

Additional information

At the annual general meeting, some of the shareholders queried that the final dividend proposed by the directors was too low.

(e) Advise the directors whether or not they should increase the proposed dividend. Justify your answer by discussing benefits and drawbacks of your advice for **both** the company and the shareholders. [5]

[Total: 25]

Question	Answer	Marks
3(a)	The answers may include: Increases the credibility of the financial statements which ensures they are fair and true Helps detect errors and frauds which increases the confidence of shareholders Represents an independent review of the financial statements which increases their reliability **1 mark for identifying one benefit and 1 further mark for development, up to a maximum of 2 marks.** **Accept other valid points.**	2
3(b)	Item 1 – IAS 36 **(1)** *Impairment of assets* suggests that an impairment loss should be made if the carrying amount of an asset is more than its recoverable amount. **(1)** The carrying amount of the equipment is $140 000 which is more than the recoverable amount $136 000, **(1)** (the higher of $132 000 fair value and $136 000 value in use), impairment of $4000 should be made. **(1)** Item 2 – IAS 10 **(1)** *Events after the reporting period* is relevant as a proposed dividend is a non-adjusting event **(1)**. In this case, the proposed dividend is not a liability at the year-end and will be disclosed as a note to the accounts. **(1)** Item 3 – IAS 37 **(1)** *Provision, contingent liabilities and contingent assets* suggests that a provision is made only when there is a present obligation arising from a past event. **(1)** Therefore no provision is recognised for costs that will be incurred in the future. **(1)** **Item 1: Max 3 marks** **Item 2: Max 2 marks** **Item 3: Max 2 marks**	7

Question	Answer	Marks
3(c)	Revised retained profits at 31 December 2018 $\qquad$ $ Retained earnings 184 000 Impairment loss (4000) **(1)** Proposed dividend 12 000 **(1)** Provision for advertising expenses 25 000 **(1)** Deposit 3000 **(1)** Sales – sale or return basis (7000) **)** Inventory – sale or return basis 5400 **) (1)** Revised retained earnings 218 400 **(1) OF**	6
3(d)	$ (i) Property, plant and equipment ($682 000 – $4000) = 678 000 **(1)** (ii) Inventory ($94 200 + $5400) = 99 600 **(1)** (iii) Trade receivables ($87 400 – $7000) = 80 400 **(1)** (iv) Other receivables ($9430 + $3000) = 12 430 **(1)** (v) Total assets: = $678 000 + $99 600 + $80 400 + $12 430 + $21 170 = $891 600 **(1) OF**	5

Question	Answer	Marks
3(e)	*Arguments for increasing the dividend* Existing shareholders will be satisfied resulting in them retaining their shares **(1)** Higher dividend policy may convey a strong message to shareholders leading to a possible increase in share value **(1)** Increased dividends may be attractive to potential new investors providing investment for growth **(1)** *Arguments for not increasing the dividend* Company may be short of cash **(1)** Directors are retaining earnings for future development **(1)** Higher retained earnings may lead to a higher share value in the long run **(1)** **Max 4** for comments plus **1 mark** for recommendation **Accept other valid points.**	5

Question 3

October 2018

R plc has the year end of 30 September.

The directors have provided the following information before preparing the financial statements.

1 For the year ended 30 September 2017

	$
Administrative expenses	397 500
Carriage inwards	6 320
Carriage outwards	8 650
Distribution costs	156 850
Inventory at 1 October 2016	426 750
Provision for doubtful debts at 1 October 2016	12 150
Purchases	2 150 000
Returns inwards	24 200
Returns outwards	19 750
Sales revenue	3 832 500
Trade receivables	630 000

2 Inventory was valued at cost of $462 350 on 30 September 2017. This included inventory costing $85 000. This can now only be sold for $33 500.

3 The provision for doubtful debts was to remain at 2% of trade receivables. Any change in the provision is to be treated as an administrative expense.

4 A bank loan of $600 000 was taken on 1 May 2017. The agreed fixed rate of interest payable on the loan was 4% per annum. No capital repayments will be made on the loan for 5 years.

5 The taxation charge for the year was $162 600.

6 All sales are made on credit.

Answer the following questions in the Question Paper. Questions are printed here for reference only.

(a) Explain what is meant by a 'non-adjusting event'. [2]

(b) Prepare the income statement for the year ended 30 September 2017. [13]

Additional information

Sales for the year ended 30 September 2016 were $4 500 000.

The industry average for the trade receivables collection period is 35 days.

(c) Calculate the percentage change in trade receivables during the year ended 30 September 2017. [3]

(d) **(i)** Calculate the trade receivables collection period for **both** years. [2]

(ii) Advise the directors whether or not their present credit control procedures are satisfactory. Justify your answer. [5]

[Total: 25]

Question	Answer	Marks
2(a)	A non-adjusting event is an event that occurs after the period end **(1)** where the conditions did not exist at the period end. **(1)** It is usually shown by a note to the final financial statements. **(1)** **Max 2**	**2**
2(b)	see below	**13**

	$		$	
Revenue (3 832 500 – 24 200)			3 808 300	**(1)**
Cost of sales **W1**			(2 152 470)	**(3)**
Gross profit			1 655 830	**(1) OF**
Administrative expenses **W2**	397 950	**(2)**		
Distribution costs **W3**	165 500	**(2)**	(563 450)	
Profit from operations			1 092 380	**(1) OF**
Finance costs			(10 000)	**(1)**
Profit before tax			1 082 380	**(1) OF**
Taxation			(162 600)	
Profit for the year			919 780	**(1) OF**

W1 Cost of sales

Opening inventory			426 750	
Purchases	2 150 000			
Returns outwards	(19 750)	}(1) both		
	2 130 250			
Carriage inwards	6 320	}	2 136 570	
			2 563 320	
Closing inventory			(410 850)	**(1)**
			2 152 470	**(1) OF***

Max 3 marks awarded only with the correct 'cost of sales' label.
*Opening inventory must be included for OF mark.

W2 Administrative expenses = 397 500 **(1)** + 450 = 397 950 **(1)**
W3 Distribution costs = 156 850 **(1)** + 8650 **(1)** =165 500

Question	Answer	Marks
2(c)	Change in trade receivables = 630 000 – 607 500 = $22 500 **(1)** Percentage change = $\frac{22\,500}{607\,500}$ **(1) OF*** · 100% = 3.7 **(1) OF** ***OF mark only awarded where the denominator equals the 2016 trade receivables figure.**	3
2(d)(i)	Trade receivables collection period (2016) = 595 350 / 4 500 000 · 365 = 49 days **(1)** **Or** Trade receivables collection period (2016) = 607 500 / 4 500 000 · 365 = 50 days **(1)** Trade receivables collection period (2017) = 617 400 / 3 808 300 · 365 = 60 days **(1)** **Or** Trade receivables collection period (2017) = 630 000 / 3 808 300 · 365 = 61 days **(1)**	2
2(d)(ii)	The directors are advised that their credit control procedures are not satisfactory. **(1) OF** The collection period has increased during 2017. **(1) OF** The collection period(s) are greater than the industry average. **(1) OF** May cause cash flow problems **(1)** and an increase in irrecoverable debts. **(1)** **Accept other valid points.** **1 mark** for advice **+ Max 4 marks** for comments	5