Small company financial statement example

Management System

DJs Ltd is a private limited company that is run in the style of a regular partnership firm. The two directors David Golding and John Selwood have divided the operating responsibilities of the company into two distinct areas and take care of their individual functions, while doubling up for each other if the need arises. While functional responsibilities are clearly defined, the organisation is otherwise loosely managed with four employees, two managers, (one for sales and front ending responsibilities, and the other for operational management), the chef, and a part time bookkeeper being the key operating persons. Operating systems, rules and procedures lack clarity and are, on occasion, ignored. Recording, accounting, and custodial functions are weak, possibly because of the small size of the business, its single location, and the presence of two hands on owners who exercise their own informal controls and checks to ensure the smooth functioning of the business.

Risk of Fraud

The risks of fraud, as in any business without structured control and checking systems, are significant. Fraud deterrence and control occurs mainly because of the presence of the two owners of the business, its small size and its compact single locational operations. Frauds can occur, and that too very easily in purchasing, inventory operations, cash management, payment of wages, cash sales and through tampering with the accounting system.

Detection of Fraud

While the current recording and accounting system is too loose to be of much help in immediately spotting frauds and throwing up alerts, the presence of irregularities and potential fraud can be detected through a number of overall checks in different operational areas. Tracking of movement of goods from the placing of purchase orders through inventory receipts, issues for consumption, and closing stock balances followed by reconciliation of opening and closing inventories with purchases and consumption, will reveal buying, consumption, and pilferage irregularities. Similarly tallying of total sales with cash, credit card and cheque payments, as well as of cash sales with money receipts will give an indication of the accuracy if records and the presence of dishonesty in the sales and collection function. Daily checks may well be unhelpful in this area as the guilty employees may become alert and become careful. It is best to do such checks for fairly long past periods to get accurate results. Overpayment of wages can again come to light if attendance records are tallied with actual wages paid for a specific number of months.

Small companies in the UK, while they are mandated to prepare and file annual accounts that represent a true and fair picture of the operations and financial condition of the company, are exempted from statutory audit if their turnover does not exceed 5. 6 million GBP or their balance sheet total remains at less than 2. 8 million GBP. Considering the size of DJs Ltd and the nature of its business, the company will, in all probability, not be required to face statutory audit.

The audit plan should commence with a detailed understanding of the operations of the company and progress to laying out the audit objectives. The audit objectives should include the ascertainment of the reliability of accounts, the legality and validity of company transactions and the adequacy of financial management under practice. The scope of the audit should thus incorporate two separate issues, the assessment of the financial accounting status, as evidenced by (a) the correct recording of assets and liabilities, including off balance sheet items, (b) the existence, ownership, valuation, description, classification and disclosure of assets (c) the legality and correctness of transactions, (d) the completeness and accuracy of recording entries pertaining to the period, as well as their description, classification and disclosure, and the financial management procedures, which need to ascertain economy, efficiency and effectiveness through an analysis of input/output ratios, cash management practices, financial ratio analysis, and the availability of resources in time, as well as their effective utilisation.

Apart from laying down the objectives and scope of the audit the audit plan will need to provide for time planning, (based upon a quantification of necessary audit tasks), the criteria for choosing transactions and items for audit scrutiny, the audit methodology to be followed, (involving procedures for checking of vouchers and postings, carrying out reconciliations of bank and supplier accounts, taking physical stock of inventory items, and checking accounts receivables and payable balances with the external parties), the required audit tests, and the allocation of manpower resources. The establishment of materiality is significant in the formulation of a plan. A proper understanding of the business will help in identifying matters of significance and will enable the plan to incorporate materiality factors vis-a-vis nature, amount and significance of transactions. Identification of areas where controls and checks are loose, as elaborated in task 1, will throw up the possibility of risks and frauds. These areas will warrant more detailed and intensive scrutiny, as well as the need for overall and input/output checks.

Formulation and execution of appropriate audit tests are integral to the successful execution of an audit. While audit tests are mainly framed in accordance with established accounting and auditing procedures they need to be adapted to the nature of the industry and provide for the peculiarities of the business. In the subject case the company uses standard SAGE accounting software, which eliminates to a great degree the need to check for manual accuracy and the correctness of posting entries and arithmetical accuracy of generated accounts. However, errors and irregularities can arise in many other areas and a number of audit tests will need to be included in the required audit methodology.

Audit tests should start with a sample checking of the accounting correctness of vouchers to ensure that correct accounts have been debited and credited for both revenue and capital transactions. A sample testing procedure involving complete checking of three months vouchers and varying percentage checks for the other nine months should serve the purpose adequately. Journal vouchers need to be checked to test whether proper accounting procedures have been followed for incorporating extraordinary entries or corrections. Audit tests should include checking of purchases for rates accepted, with those available in the market, tallying of purchase orders, goods inward notes and bills, both for value and quantity, as well as reconciliation of inventory, checking of book and actual balances, sales bills for billing accuracy, both for rates and quantities, sales and collection totals. Apart from these tests, bank and supplier reconciliations, and carrying out of ratio analyses for operating and profit margins, debt and liquidity, will help in providing the auditors with an idea of the financial condition of the company.

The following statement outlines the details of work to be carried out and its manner of recording for incorporation in the audit report.

The scope of the audit will cover work involved in ascertaining whether the prepared accounts reveal a true and fair picture of the operations of the company for the specified period, the financial condition of the company at the end of the period, and whether financial management practices are appropriate for the efficient and effective running of the company's operations. Audit activity will include assessing the scope of audit, checking of accounts for accuracy and adherence to stipulated accounting requirements and the appropriate financial framework, through standard auditing procedures involving sample and complete checking, carrying out of audit tests, interviewing and questioning required company officials, use of reconciliations, and other analytical tools like input/output studies, ratios and trends.

The results of the audit will be recorded in different sections of the audit report, namely in (a) an introduction identifying the accounts that were the subject of the exercise and the relevant financial framework, (b) an explanation of the scope of the audit, (c) an assessment of the preparation of the accounts in accordance with the Companies Act, (d) a section on inconsistencies, if any between the directors report and the actual position, and (e) a description of irregularities, which, if material will find place in qualifications to the report.

Companies registered in the UK companies with turnover exceeding 5. 6 million GBP or with net assets more than 2. 8 million GBP need to undergo statutory audits conducted by registered auditors. Statutory audit reports are part of the annual financial statements prepared by the company for the use of people who wish to obtain reliable information about the operations and financial condition of companies. They are as such used by all stakeholders, namely investors, banks, lenders, buyers, customers and employees for information checked, verified, and certified by independent, external, registered professionals with domain knowledge about their subject.

A statutory audit report must begin with an introduction describing the accounts that were the focus of the audit and the financial structure that has been applied in their preparation (i. e. either UK GAPP or IAS) and further contain (a) a clarification on the audit scope along with the accounting standards used in the audit, (b) the opinion of the auditors on whether the accounts have been prepared in accordance with the Companies Act (and, if appropriate, Article 4 of the IAS Regulation), and whether they give a true and fair view of the company’s financial affairs. The auditors must also include their opinion on whether the directors’ report is inconsistent with the accounts, and can, if so warranted, contain qualifications to the prepared accounts. Irrespective of the qualifications the report must include references to matters to which attention needs to be drawn without qualifying the report. Quoted companies also need the statutory report to contain details on directors' remuneration and the consistency of the operational and financial review with the prepared accounts.

Provided below is the draft of a suitable letter to the management in relation to the audit of the business under discussion.

DJs Limited,

Address

Dear Sirs,

We are glad to inform you that the financial audit of your company has commenced and is proceeding as planned. The scope of the audit has been defined and agreed between the undersigned and your directors, Mr. Golding and Selwood.

Our staff will visit your offices on Monday, July 30 to begin the audit work and convey to your officials the details of documents required.

We shall be obliged if the required documents are provided and they are given the cooperation required.

Yours truly

XYZ and Associates

Signature

Name of Signatory

Partner

Reference

ICAEW, 2007, Institute of Chartered Accountants of England and Wales,

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