AUDIT AND ASSURANCE/ FINANCIAL REPORTING

June 2005
AAT Fast-Track

MARKING SCHEME

Question 1

The marking scheme represents the points a well-prepared candidate would make following study of the learning materials. There are other relevant comments, which might be made and for which candidates will be awarded appropriate marks.

(a) Reliance on internal auditors

SAS 500 sets out the circumstances in which external auditors may rely on the work of internal auditors.

In planning their work external auditors should perform a preliminary assessment of internal audit. A favourable assessment might enable external audit to modify the nature, timing and extent of their procedures.

The following points will be considered as part of the external auditor's preliminary review:

Organisational status: This will determine the extent to which internal audit can be objective and thus the extent of any reliance to be placed upon it. At best internal audit will report to the highest level of management.

Scope of function: The nature and extent of internal audit work performed and the extent to which management acts upon its recommendations will determine the areas in which external audit can rely upon it.

Technical competence: Do the internal auditors have the right level of training and experience to enable them to do their work?

Due professional care: This will be judged by a review of internal audit's plans, manuals and work programmes.

As part of their detailed review internal audit will review detailed working files and associated reports from the internal auditors.

When relying on internal audit, external auditors must bear in mind that ultimately they, not the internal auditors, are responsible for the judgements arrived at.

Usually internal audit work alone will be insufficient for the external auditors to come to a conclusion on a matter or audit area.

Internal audit might do work on behalf of the external auditors for management.

External auditors will need to make representations to management if insufficient notice is being taken of internal audit work.

(1 mark per point for these and other relevant points up to a maximum of 6 marks)

(b) Value for Money Audit

Value for Money audit involves reviewing and reporting upon the success of public agencies in their use of public resources.

"The 3E's"

These are:

"Economy"- acquiring resources of appropriate quality and quantity at the lowest cost- the measure of input.

"Efficiency"- Maximising the useful output from the resources used or minimising the level of work in producing a given level of input- the measure of the relationship between inputs and outputs.

"Effectiveness"- Ensuring that the output from any given activity is achieving the desired result- the measure of outputs and outcomes.

(1 mark per point for these and other relevant points up to a maximum of 4 marks)

(c) External audit arrangements for Registered Social Landlords

Audit is by a private sector accounting firm.

Exact audit arrangements depend upon the body's origin and are covered by various legislation.

APB Practice note 14 "The Audit of Registered Social Landlords in the UK" applies.

Individual RSL's appoint their own auditors who must be qualified under the provisions of the Companies Acts.

External Audit arrangements for Local Authorities

(English situation described. Credit will also be given for description of the arrangements in other parts of the UK).

Audit Commission Act 1998 is the piece of legislation setting out the audit arrangements.

The Audit Commission appoints auditors to all local authorities either from its own staff or private firms.

The Commission sets the scale of fees for the audits.

The Audit Commission prepares a Code of Practice under the legislation which details the work its appointed auditors must do for local authorities.

Part of the Commission, the Best Value Inspectorate, is responsible for carrying out value for money work for local authorities. Members of the Inspectorate are separate individuals from those working on the financial audit work.

(1 mark per point for these and other relevant points up to a maximum of 3 marks for each type of body, a maximum of 6 marks in total)

(d) (i) Pre-Contract Stage

There should be an assessment of need to ensure that the project is actually required.

There should be feasibility, design and cost benefit studies to ensure that there are good reasons for going ahead with the project and that the project can be achieved within budget.

Potential tenderers should be vetted to ensure they are capable of undertaking the work and are financially sound.

There should be arrangements in place to ensure tenders are received securely and evaluated fairly.

Particular attention must be given to tender custody and opening arrangements.

External experts might be required to assist in the evaluation of tenderers and their bids.

EU procurement law must be followed with advertisement in the Official Journal of the European Communities if necessary.

(ii) Currency of Contract Stage

A separation of duties between the client and contractors' offices.

A certification of interim stage payments.

The authorisation by the client of claims for the contractor for unforeseen delays or expense.

Authorisation of variations from the contract specification.

Contract monitoring arrangements including site visits by client management to ensure work progressing according to plan.

Mechanism for escalating complaints against contractor for poor performance.

(1 mark per point for these and other relevant points up to a maximum of 4 marks for each subsection, a maximum of 8 marks in total)

(e) Role of External Audit in Respect of Controls and Risks

External auditors require knowledge of internal control and risk management to assist in their assessment of inherent and control risk.

SAS 300 provides the professional guidance on internal control and risk for external auditors.

External auditors are required to obtain an understanding of accounting and internal control risk systems sufficient to plan the audit and develop an effective audit approach.

Professional judgement must be used to assess the components of risk and design audit procedures to ensure it is reduced to an acceptable level.

In the public sector there are also sometimes requirements for the auditors to report upon financial aspects of the audited body's corporate governance.

External auditors review of internal audit (as required by SAS 500) is also a form of evaluation of internal control and risk, as internal audit is a "control of controls".

(1 mark per point for these and other relevant points up to a maximum of 6 marks)

Question 2

Quiktrac plc
Profit and loss account for the year ended 31 May 2005 *1*

	£000	
		½
Turnover	3,550	*1*
Cost of sales	(2,586)	*5*
Gross profit	964	
Distribution costs	(197)	*1*
Administrative expenses	(455)	*2*
Other operating income	88	*1*
Operating profit	400	
Income from fixed asset investments	38	*1*
Interest payable	(32)	*1*
Profit on ordinary activities before taxation	406	
Tax on profit on ordinary activities	(110)	*1*
Profit for the financial year	296	
Dividends paid and proposed	(128)	*1*
Amount set aside to reserves	168	*½*
		(16)

Quiktrac plc
Balance sheet as at 31 May 2005 *½*
½

Fixed assets		£000	
Intangible			
Unamortised goodwill		50	*1*
Development expenditure		25	*½*
		75	
Tangible		664	*3*
Investments		223	*1*
		962	
Current assets	£000		
Stock	121		*1*
Debtors	424		*1*
Cash at bank and in hand	74		*½*
	619		
Creditors: amounts falling due within one year			
Trade creditors	170		*½*
Taxation	122		*½*
Proposed dividend	72		*½*
Bank loan, repayable 1 February 2006	40		*½*
	404		
Net current assets		215	
Total assets less current liabilities		1,177	
Creditors: amounts falling due after more than one year			

Bank loans	(50)		½
11% Debentures, repayable 2008	(140)	(190)	½
Net assets		987	
Capital and reserves			
Issued ordinary share capital		400	½
Share premium account		85	½
Revaluation reserve		61	*1*
Profit and loss account		441	*1*
		987	
		Overall presentation	*4*
			(19)

Workings

Allocation of expenses

	Cost of sales	Administrative expenses	Distribution costs
	£000	£000	£000
Per trial balance	2,556	445	185
Reduction in closing stock	7		
Development expenditure deferred	(25)		
Depreciation for the year			
Buildings	4	1	1
Fixtures and fittings	34	11	11
Amortisation of goodwill	10		
Provision for bad debts		(2)	
	2,586	455	197
	5	*2*	*1*

Provision for bad debts	£000
Old provision for bad debts	22
New provision for bad debts	20
Increase/(decrease)	(2)

Debtors	£000
per list of balances	444
less provision for bad debts	20
	424

Dividends paid and proposed	£000
Interim dividend	56
Proposed dividend	72
	128

Profit and loss account	£000
Balance b/f	249
Retained profit for the year	168
	417

Fixed asset investments	£000	
Carrying value of revalued investments	105	
New valuation	98	
Diminution in value	7	
Written off Revaluation Reserve	7	

Revaluation reserve	£000
per trial balance	68
Written off	(7)
	61

Closing stock	£000	
per trial balance	128	
Write off (27 - 20)	7	
	1	

Goodwill	£000	
Cost of goodwill	100	
Carrying value	60	
Estimated life	10	years
So annual amortisation	10	

Corporation tax	
Provision for the current year	122
Previous overprovision	(12)
Charge for the year	110

Calculation of depreciation

Buildings	£000
Cost as at end of year	310
Depreciation rate	2%
	6
Fixtures and fittings	
Cost as at end of year	445
Accumulated depreciation	223
	222
Depreciation rate	25%
	56

Fixed assets	Land & buildings	Fixtures & fittings
	£000	£000
Cost/valuation	550	445
Depreciation b/f	46	223
Charge for the year	6	56
Depreciation c/f	52	279
Net book value at end of year	498	166

Question 3

(a) Calculation of net cash flow from operating activities using the indirect method:

	£	
Operating profit	625,240	*638,830 -14,610 + 1020*
Depreciation	363,480	
Profit on sale of tangible fixed assets	(2,500)	
Increase in stocks	(5,000)	
Increase in debtors and prepaid expenses	(36,000)	
Increase in creditors and accrued expenses	52,550	*50,500 + 2050*
	997,770	

Operating profit 3 marks
Other figures 1 mark
Except creditors 2 marks
(9)

(b) Treatment of government capital grant

This is dealt with in SSAP 4 Accounting for government grants.
The government grant should be treated as a deferred credit and not deducted from the cost of the asset (as this is a depreciable asset). The deferred credit will be shown in the balance sheet – but not as part of shareholders' funds. One possibility is to include it in 'Accruals and deferred income'.
The asset will be written off over 10 years so depreciation will be £30,000 a year.
The deferred income will be credited to profit and loss account as deferred income of £12,000 a year.
The annual depreciation charge and the annual transfer from deferred income should not be offset.
Candidates will also get credit if they discuss the disclosure requirements.

Government grant as a deferred credit – 1 mark
Balance sheet treatment of deferred credit – 1 mark
Depreciation of asset £30,000 a year – 1 mark
Deferred income credited to P & L as deferred income, £12,000 a year – 1 mark
No offset – 1 mark
Disclosure requirements – 1 mark
(6)

(c) Finance lease.

- The rental payments should be split into the interest element and repayment of capital.
- The asset should be capitalised at its fair value in the balance sheet and depreciated over its economic life of 5 years.
- A liability should be reported in the balance sheet for the capital sum outstanding in the lease.
- This liability will be split into the amount payable within 1 year and the amount payable after more than one year. *4*

Profit and loss account for year 1 using rule of 78

	£
Finance charge	2,440
Depreciation	13,280

3

Balance sheet as at end of year 1

Fixed assets

Leased assets	£
at cost	66,400
less accumulated depreciation	13,280
	53,120

Creditors: amounts falling due within one year

Leasing obligations	12,670

Creditors: amounts falling due after more than one year

Leasing obligations	41,670
	54,340

Workings - Rule of 78

Year	Number of Instalments not yet due	Interest £	Rental paid £	Capital Repayment £
1	4	2,440	14,500	12,060
2	3	1,830	14,500	12,670
3	2	1,220	14,500	13,280
4	1	610	14,500	13,890
5	0	-	14,500	14,500
	10	6,100	72,500	66,400

Leased assets 1 ½ + 1 ½ = 3
Creditors < 1 year = 1 ½
Creditors > 1 year = 1 ½
Total = 4 + 3 + 6 = 13

(d) Revaluation of building

(i) Basis of valuation would be existing use value. *1*

Asset should be shown at its current value which is the lower of replacement cost and recoverable amount (i.e. the higher of net realisable value and value in use). *2*

(ii) The increase in value would be included in the balance sheet as a revaluation reserve, reported as part of shareholders' funds. *1*

(iii) The revalued building would be depreciated so as to write off its revalued amount over its remaining economic life. *1*

(iv) It would not be possible to leave the other assets *in this class* at depreciated historical cost. *1*

They would all need to be revalued ie a full revaluation every 5 years, and an interim valuation in year 3. *2*

(7)

Question 4

(a) Some of the limitations in reliably using return on capital employed ratios are:

- Definition & consistency

  There are various measures that could be used for 'return' (eg operating profit, profit before tax, or profit after tax) and various measures for 'capital employed' (eg total assets, net assets, shareholders' funds, ordinary shareholders' funds). The various combinations that are possible will all give different results! The important thing is that whatever measure is used as 'return' should be consistent with the definition used for 'capital employed'.

- Valuation problems with valuing net assets

  Despite the efforts of the ASB there are still inconsistencies in the ways companies identify and value assets, particularly fixed assets. In pure historical cost accounting there is a systematic overstatement of return on capital employed figures because in periods of rising prices profit will have been calculated using more up to date prices than capital employed.

- Historical data

  Investors make decisions which need to be based on how a company is going to perform in the future. However, financial statements attempt to describe and quantify past performance. Return on capital employed figures attempt to achieve objectivity by using past audited data. Investors need to subjectively adjust and project these figures into the future.

- Problems of comparability

  There may be pitfalls in comparing return on capital employed figures between different businesses and over time. These partly result from the limitations identified above. However, there may be in addition a lack of comparability because different accounting policies have been used either from year to year or between different businesses.

(1 mark per valid limitation plus 2 marks each for discussion, to a maximum of 9)

(b) (i)

- The overall performance of the two companies as measured by return on capital employed is the same over the two years for both companies.
- Both companies have achieved relatively high returns on capital suggesting good profitability and efficiency.
- However, performance has fallen significantly in 2004 for each company.
- The ratios indicate that the decline in Rose Ltd's overall efficiency was due to falling profitability on trading.
- The ratios indicate that the decline in Lynn Ltd's overall efficiency was due to falling efficiency in use of capital employed for Lynn Ltd.

(1 mark per valid point, to a maximum of 5)

(ii) Rose Ltd needs to improve its profitability on trading. This could be achieved by:

- increasing selling prices – although the number of units sold would need to be maintained
- improving the sales mix so that a greater proportion of sales is made up of more profitable items
- reducing purchase prices, perhaps by changing suppliers or negotiating better terms with existing suppliers
- tighter control of overheads i.e. reducing selling, distribution and administrative expenses relative to turnover.

(1 mark per valid point up to a maximum of 3)

Lynn Ltd needs to improve the efficiency with which it utilises its capital employed. This could be achieved by:

- More intensive use of fixed assets or disposing of redundant or underused fixed assets.

- Better stock control with a view to minimising the investment in stocks.

- Better credit control with a view to reducing the period of credit taken by credit customers, reducing bad debts by better vetting of prospective credit customers and more efficient billing and collection procedures.

- Better treasury management with a view to minimising holdings in liquid assets such as cash and bank and better investment of temporary excess liquid funds.

- Better use of the credit facilities provided by suppliers or negotiating improved credit terms.

(1 mark per valid point up to a maximum of 3)

(c) Interest cover

This is a profit and loss account ratio which is calculated by taking profit before tax and interest and dividing it by interest charges for the year. For example, if profit before interest and tax is £750,000 and annual interest charges are £150,000 the interest cover is 5 times.

The interest cover is a measure of financial risk. It tells us the number of times that interest commitments could have been covered by operating profit. It enables lenders to assess the margin of safety attaching to interest payments due to them by the business.

An investor would generally prefer this ratio to be higher rather than lower. If this ratio falls then the income gearing of the business is increasing and the risk attaching to the lending is increasing. If it falls to near 1 to 1 lenders might become worried that future interest payments (and ultimately the repayment of their loans) might be in jeopardy.

(ii) Dividend yield

The dividend yield is the dividend paid on a share expressed as a percentage of the middle market price of the share. The middle market price is the average of the bid and offer price of the shares. For example, if a company paid dividends totalling 25 pence per share in its last financial year and the market value of the share is £1.50 the dividend yield is 17%.

The dividend yield enables the investor to look at how dividend yields have changed over time and how dividend yields compare between different companies.

Generally, speaking the higher the dividend yield the better and an investment in a company with a higher dividend yield would be a more attractive investment. As such the dividend yield might be a useful comparator for an investor interested in the cash flow returns from investments.

It is worthwhile noting two important limitations in using dividend yields. Firstly, they are based on past dividend levels and the investment decision should be based on expected future dividend levels. Secondly, dividends represent distributed profits only. The dividend yield does not allow for the retention policy of the company. So a company may have a relatively low dividend yield not because profits are low but because it is ploughing back a high proportion of profits into the business. This could augur well for future profits and distributions.

(iii) PE ratio

The PE ratio is the ratio of the current market price of a share to its last reported earnings per share. For example, if the last reported earnings per share figure for a company was 11 pence and the current share price was £1.65 the PE ratio would be 15.

The PE ratio gives some idea of the number of years' purchase of the latest known earnings that investors are willing to pay to acquire an interest in the company. A high ratio means that the market is bidding up the price beyond what the latest reported earnings would appear to justify; presumably, then, investors are expecting future earnings to rise enabling larger dividends to be paid.

The PE ratio reflects the market's confidence in a quoted company, so generally speaking, the higher the ratio the better. It depends not only on the company's perceived future prospects but also on the industry within which the company operates and economic confidence generally. 'The Financial Times' publishes PE ratios for each industry group and subsection. Individual company PE ratios can therefore be compared with the average PE ratio for companies in similar lines of business. If a company has a PE ratio significantly higher than the average for its sector the company is a leader in its sector. Unfortunately, it could also mean that the company's shares are merely overvalued.

(Definition of each ratio = 1, what it measures = 2, use and interpretation = 2 marks, total 5 per ratio = 5 x 3 = 15)