CIPFA

AUDIT AND ASSURANCE/FINANCIAL REPORTING

AAT Fast-track Examination

10 December 2007

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

Question 1

(a) The advantages of an internal audit consortium are:

- Direct control over the service
- Continuity of staff
- Costs are restricted to the direct costs of the service provision (there is no profit element)
- Independence from individual members of the consortium
- An ability to share good and bad practice with other member organizations.

The disadvantages are:

- Possible divided loyalties of audit staff
- Control of resource - one member might get a better service than others
- Ancillary services (for example VAT and IT audits) might still have to be bought in
- Lack of flexibility during very busy/quiet periods
- Quality of service might deteriorate over time without fresh input
- Inflexible pricing once budgets have been agreed.

1 mark for any of the above points or any other relevant point up to a maximum of (8)

(b) The financial statement assertions relating to transactions can be summarised as follows:

Occurrence: Transaction and events that have been recorded have occurred and pertain to the entity.

Completeness: All transactions and events that should have been recorded have been recorded.

Accuracy: Amounts and other data relating to recorded transactions and events have been recorded appropriately.

Cut-off: Transactions and events have been recorded in the correct accounting period.

Classifications: Transactions and events have been recorded in the proper accounts.

Regularity: Is expenditure in accordance with authorising legislation and has money been applied for the purposes intended?

1 mark for any of the above points in full up to a maximum of (6)
(½ mark only if the correct name of an assertion or a correct description without a name is given)

(c) Possible risks for consideration are:

- Failure to establish vehicle requirements may result in the wrong type or number of vehicles being acquired
- Poor specification of the vehicles may mean that they do not meet users' needs
- Not considering alternatives to purchasing may result in delay, for example if capital funds are not available
- Poor evaluation of procurement methods may mean paying more than is necessary
- Users of vehicles may not have budgetary /managerial responsibility for vehicles
- Lack of maintenance may lead to avoidable replacement
- Failure to tax and insure vehicles may expose the organization to legal liability
- Inadequate insurance may lead to financial loss
- Poor security may lead to loss of, or damage to, vehicles
- Excessive personal use of vehicles may lead to non-availability for official use
- Lack of replacement policy may lead to using vehicles beyond their optimum lifespan
- Poor disposal procedure may mean loss of revenue which could fund replacements.

1 mark for any of the above points or any other relevant point up to a maximum of (8)

(d) The four broad courses of action to be taken to deal with risks can be described as follows:

1. Control the risk: develop appropriate controls to deal with the risk. For example, auditors often draw attention to the need for separation of duties to deter fraud.
2. Live with the risk: some risks cannot be eliminated entirely and it is thus necessary to accept them as a way of life in the business concerned. Sometimes the costs of controls will be greater than the cost of the risk materializing and so the risk will be lived with. One example is sports injuries. These are an inherent risk in many sports and precautions will be taken in the event of them happening (first aid kits being handy), but eliminating the possibility entirely would mean not playing the sport.
3. Insure against the risk: this can be done internally or externally and is often the best way of dealing with high impact and low likelihood risks.
4. Don't do it: this is sometimes the conclusion of a risk assessment, that the risks are so high that it is no longer worth pursuing the activity concerned.

Other formulations of the four courses will also be accepted, such as the "Four T's"- take, treat etc.

1 mark for each of the above courses of action (however classified) and 1 mark for a relevant example of each up to a maximum of (8)

(30)

Question 2

Baldrick plc
Income statement for the year ended 31 October 2007 *½*

	£000	*½*
Revenue	12,908	*½*
Cost of sales	(9,277)	*½ + 5(W)*
Gross profit	3,631	*½*
Distribution costs	(1,561)	*1 ½*
Administrative expenses	(787)	*1*
Other operating income	330	*½*
Operating profit	1,613	*½*
Investment income	110	*½*
Finance costs	(72)	*½*
Profit before taxation	1,651	*½*
Taxation	(600)	*1*
Profit for the year	1,051	*½*

(14)

Baldrick plc
Balance sheet as at 31 October 2007 *½*

ASSETS			
Non-current assets		£000	*½*
Property, plant and equipment		4,078	*3 ½*
Goodwill		250	*1*
Investments		1,229	*1 ½*
		5,557	*½*
Current assets	£000		
Inventory	779		*1 ½*
Trade receivables	1,368		*1 ½*
Cash and cash equivalents	220		*½*
		2,367	*½*
Total assets		7,924	*½*
EQUITY AND LIABILITIES			
Equity			
Issued ordinary share capital		2,000	*½*
Share premium account		300	*½*
Revaluation reserve		350	*1*
Retained earnings		1,263	*2 ½*
		3,913	
Non-current liabilities			
Deferred taxation		200	*1*
Bank loan, 2011		900	*½*
9% Debentures 2012		800	*½*
		1,900	

Current liabilities		
Trade payables	1,250	½
Other payables	36	½
Current tax payable	525	*1*
Bank loan, 2008	300	½
	2,111	
Total equity	3,913	
Total liabilities	4,011	
	7,924	

(21)

(35)

Workings

Property, plant and equipment	Land	Buildings	Equipment	Total
Cost or valuation	£000	£000	£000	£000
As at 1 November 2006	500	2,500	2,550	5,550
Additions			750	750
Disposals			(410)	(410)
As at 31 October 2007	500	2,500	2,890	5,890
Accumulated depreciation	£000	£000	£000	£000
As at 1 November 2006		300	1,200	1,500
Charge for the year		50	612	662
Withdrawn on disposals			(350)	(350)
As at 31 October 2007		350	1,462	1,812
Net book value	500	2,150	1,428	4,078

Surplus on equipment disposal

	£000
Proceeds from sale of equipment	66
Book value of equipment sold	60
	6

Allocation of expenses

	Cost of sales	Administrative expenses	Distribution costs
	£000	£000	£000
Per trial balance	8,750	770	1,230
Reduction in closing inventory	21		
Surplus on disposal of equipment	(6)		
Depreciation for the year			
Buildings	25		25
Equipment	306		306
Impairment of goodwill	150		
Written off non-current asset investments	31		
Increase in allowance for receivables		17	
	9,277	787	1,561

Allowance for receivables	£000
Old allowance for receivables	40
New allowance for receivables	57
Increase	17

Receivables	£000
Trade receivables	1,425
Allowance for receivables	(57)
	1,368

Retained earnings	£000
Balance b/f	532
Profit for the financial year	1,051
Dividends paid	(320)
Balance c/f	1,263

Non-current asset investments	£000
Carrying value	226
New valuation	145
Diminution in value	81
Written off to Revaluation Reserve	50
Charged to income statement (cost of sales)	31

Question 3

(a) Indirect method

	£		
Net profit before taxation	553,550	453,550 + 100,000	*2*
Adjustments for:			
Depreciation	346,450		*1*
Surplus on sale of non-current assets	(2,500)		*1*
Interest expense	15,615	16,365 - 750	*2*
Operating profit before working capital changes	913,115		
Increase in inventories	(3,000)		*1*
Decrease in receivables	271,800		*1*
Increase in payables	21,150	19,100 + 2,050	*2*
Cash generated from operations	1,203,065		
Interest paid	(16,365)		*1*
Corporation tax paid	(80,000)		*1*
Net cash from operating activities	(1,106,700)		

(12)

(b) Direct method

	£		
Receipts from customers	10,841,215	*3 ½*	(W)
Payments to suppliers and employees	(9,638,150)	*6 ½*	(W)
Cash generated from operations	1,203,065		
Interest paid	(16,365)	*2*	
Corporation tax paid	(80,000)	*2*	
Cash generated by operating activities	1,106,700		

(14)

Workings

Receipts from customers		
Sales	10,590,615	*1*
Discounts allowed	(21,200)	*1*
Decrease in trade receivables	271,800	*1 ½*
	10,841,215	

Cash to suppliers		
Purchases	7,803,000	*1*
Discounts received	(20,000)	*1*
Increase in trade payables	(19,100)	*1 ½*
	7,763,900	

Cash paid to employees		
Wages and salaries	982,500	*1*
Increase in accrued wages	(2,050)	*1*
	980,450	

Other cash payments		
Other expenses	893,800	*1*

Payments to suppliers and employees	
Suppliers	7,763,900
Employees	980,450
Expenses	893,800
	9,638,150

Corporation tax

	£		£
c/f	130,000	b/f	110,000
Cash paid	80,000	Income statement	100,000
	210,000		210,000

(c)

		£
Sales		10,590,615
Cost of sales		
Purchases	7,803,000	
Increase in inventories	(3,000)	
		7,800,000
		2,790,615
Gross profit percentage		26.35%

(3)

(d) Increasing prices would increase the gross profit percentage, other things being equal. Profitability on operations would therefore increase if there is no increase in operating expenses.

The effect on profit would depend on how customers react to the increase in selling prices. If demand remains at least the same, then the figure for profit would increase, other things being equal. However, if the products sold by the company are price elastic, demand could fall if prices are increased. If the fall in demand is not offset by the increase in prices, then profit would decrease.

(6)

(35)

Question 4

(a) (i) The profit on sale is £6.5 million [£10m - £3.5m]. IAS17 requires this to be recognised over the period of the lease, i.e. 10 years. The airliner would continue at its carrying value of £3.5 million and be amortised over the 10 years. *4*

(ii) If the period of the leaseback is only two years it would be classified as an operating lease, and the whole of the profit of £6.5 million could be included in the financial statements for the year ended 31 December 2007. *2*

(6)

(b) (i) The enterprise has transferred the significant risks and rewards of ownership of the goods to the buyer.

(ii) The enterprise has no continuing managerial involvement to the degree usually associated with ownership, and no longer has effective control over the goods sold.

(iii) The amount of revenue can be measured reliably.

(iv) It is probable that the economic benefits associated with the transaction will flow to the enterprise.

(v) The costs incurred in respect of the transaction can be measured reliably.

2 marks each up to an overall maximum of (10)

(c) (i) In a defined contribution scheme the employer pays a regular contribution, usually based on a percentage of employees' pay, into a pension scheme. The contributions are invested in a pension fund and pensions are then paid to employees based on the contributions made and the performance of the fund. *3*

(ii) In a defined benefit scheme the employer undertakes to provide employees with a pension calculated as a percentage of their remuneration at the time of retirement. A typical defined benefit scheme might provide a pension of 1/80th of terminal salary for each year of service. Many of the problems and issues surrounding accounting for pension costs are in respect of defined benefit schemes and this is the type of scheme that IAS19 is primarily concerned with. *3*

(iii) The pension liability in a pension scheme should be determined by an actuarial valuation at each balance sheet date. Factors that the actuarial valuation will take into account include:

(a) Estimated future rates of inflation and pay increases.
(b) The estimated number of employees joining the scheme.
(c) The age profile of employees in the scheme.
(d) The probability that employees will die or cease employment before reaching pension age.
(e) The expected rate of return on the pension fund assets.

The pension liability should be discounted at a rate corresponding to the current rate of return on a high quality corporate bond of equivalent term to the scheme liabilities. This liability is reported in the balance sheet under the heading of non-current liabilities.

Assets held in the scheme must be measured at their fair value at the balance sheet date and any difference between that and the actuarial valuation will result in an actuarial gain or loss. *7*

(13)

(d) According to IAS20 the government grant should be treated as a deferred credit or deducted from the cost of the asset (as this is a depreciable asset). However, the UK Companies Act does not allow the grant to be deducted from the cost of the asset, so this option is not available. The deferred credit will be shown in the balance sheet as deferred income – but not as part of shareholders' funds.

The asset will be written off over 20 years, so depreciation will be £14,000 a year.

The deferred income will be written off to the income statement as deferred income of £5,600 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
Or as a deduction from asset – 1
Balance sheet treatment of deferred credit – 1
Depreciation of asset £14,000 a year – 1
Deferred income written off to income statement as deferred income, £5,600 a year – 1
No offset – 1
Disclosure requirements – 1

Up to an overall maximum of (6)

(35)