



AUDIT AND ASSURANCE/FINANCIAL REPORTING

AAT Fast-Track Examination

6 June 2007

MARKING SCHEME



Question 1

(a) Audit Commission

Financial Audit

- The Audit Commission Act 1998 gives the Audit Commission the right to determine the financial audit arrangements for the NHS and Local Government in England and Wales.
- Audit provision in Wales has now passed to the Wales Audit Office.
- The Audit Commission appoints auditors to all NHS and Local Government bodies after consultation with the bodies.
- The Commission appoints either the staff of the District Audit Service (part of the Commission) or a private firm to do the audit.
- A private firm must satisfy certain requirements for appointment by the Commission including membership of professional accounting bodies.
- A scale of fees for the audits is set by the Commission after consultation with relevant bodies and all those doing the work must accept this scale of fees.
- The Commission prepares a Code of Audit Practice which all those undertaking the work must adhere to.
- Auditors are required to ensure that accounts are prepared in accordance with statutory requirements.

Value for Money Audit

- The Audit Commission is required by statute to undertake to improve economy, efficiency and effectiveness in local government.
- This work is now carried out by another part of the Audit Commission, the Best Value Inspectorate (BVI).
- The BVI examines and comments upon the Best Value Reviews carried out by individual local authorities as part of the authorities' requirements under the Best Value legislation.
- The Audit Commission no longer has power to carry out value for money reviews in NHS bodies in England and Wales. This responsibility has now passed to the Commission for Health Audit Inspection (CHAI).
- The Commission's auditors are required to satisfy themselves that the body has made proper arrangements for economy, efficiency and effectiveness.
- Where bodies are required to publish performance information under the Act the auditors are required to satisfy themselves that it has made appropriate arrangements for collecting and recording the information.

National Audit Office

Financial Audit

- The Comptroller and Auditor General (C&AG) is charged with auditing the accounts of central government by the Government Resources and Accounts Act 2000. He audits over 600 bodies, some of which have multi-billion pound turnovers.
- The C&AG is appointed by the Crown on the advice of the Prime Minister and the Chair of the Public Accounts Committee. He can only be removed from office by a similar formal procedure.
- The C&AG heads the National Audit Office (NAO). This body conducts financial audits of all government departments and agencies and other public bodies. The auditors of the NAO present their work on the financial audit of accounts to him/her to enable him/her to certify the accounts.
- All accounts certified by the C & AG are submitted to Parliament after scrutiny by the Public Accounts Committee (PAC).
- Before certification the C&AG must form an opinion that there are no material misstatements in the accounts. He must also confirm that the transactions in the accounts have appropriate parliamentary authority.
- Material misstatements in the accounts or other major financial problems encountered during an audit will normally result in a hearing before the PAC.
- Less significant issues will be raised in a management letter to which the management of the body concerned are required to reply explaining the reasons for the problems and the steps being taken to prevent a recurrence.

Value for Money Audit

- Section 9 of the National Audit Act 1983 gives the NAO the power to examine and report upon the economy, efficiency and effectiveness of public spending.
- The NAO publishes around 50 reports each year into value for money in the bodies it audits.
- The NAO decides on topics for examination from a careful analysis of risks to value for money across the bodies for which it is responsible.
- In addition to the bodies for which the C&AG carries out VFM audits, he also has the power to examine any body which receives more than 50% of its funds in any one year from moneys voted by Parliament.

Up to 5 marks for these and other relevant points on each body. No more than 3 marks to be awarded per body if either financial or value for money work is not mentioned

(10)

(b) Print Unit

Risks

Client needs and Quality of Output

- Technically demanding jobs may result in low quality or cost overruns.
- Failure to meet quality standards or time deadlines may result in loss of customers.
- Specialist skills may be lost if key staff leave and are not replaced.

Costing and Pricing

- Poor costing may lead to under or over charging.
- Changes in costs outside the unit's control may result in cost overruns.
- Excess wastage on certain jobs may mean increased materials cost.

Stock and Machinery

- Over reliance on one source may lead to problems if they are no longer able to supply the unit.
- Excess stockholding ties up working capital and incurs holding costs.
- Deterioration or theft of materials such as paper may mean that stock-outs occur.
- Old and out of date machinery and technology will have impacts on the quality and quantity of output.

Controls

Client needs and Quality of Output

- Unit management meets on regular basis with key customers to discuss needs and requirements.
- Regular customer survey on quality and speed of service.
- Training of staff in use of new machinery in order to maximize quality and efficiency of operation.

Costing and Pricing

- Unit management prepares detailed budget including overall profitability and individual job costing.
- Regular review by management of pricing levels to ensure consistency with costs.
- Monthly monitoring by job managers and unit manager to ensure that actual costs and income are in line with budget.

Stock and Machinery.

- Separate responsibilities for stock ordering / handling and so on from print job management.
- Stock system to record all issues, deliveries, returns of stock and allow for identifying current levels of different stock types.
- Regular review by stock manager of age of stock items to ensure quality and disposal of unneeded lines.
- Regular review by stock manager of holding of high-value or perishable lines.
- Management to establish replacement and maintenance policy on machinery.
- Unit manager regularly to attend trade shows to keep up to date on technological developments.

*1 mark per point for these and any other relevant points up to 5 marks
for both risks and controls*

(10)

(c) Turnbull Report

Recommendations

- The Board is responsible for internal control and ensuring that its system is effective in managing risk.
- Internal control should be embedded in the company and be capable of reporting quickly.
- Internal control is seen as necessary to business not an optional extra.
- Internal control effectiveness should be monitored and subject to regular review by the board.
- This function will often be a major function of the Audit Committee, who will need to report the results of its work to the board.
- Companies which do not have an internal audit function should from time to time review the need for one.
- Where there is an internal audit function, the Board should annually review the resources devoted to it and the quality of its work.

Translation to the Public Sector

- Many reviews of government projects which have gone wrong is the recognition that risk was not adequately assessed at the start.
- Many public sector organizations have undertaken work on risk over the years since Turnbull

- There is of course a need to translate some of the terminology. For example, few public sector organizations have a board in the same way that a company has.
- All sectors now prepare a statement of internal control in their annual reports.
- The public sector does also now embed internal control into management processes.
- In central government the document “Risk: Improving Government’s Capability to handle Risk and Uncertainty” has been produced. This aims to ensure that good risk management is embedded in government.
- The government is also implementing a two year risk programme.
- Risk management is also being embedded in management systems through initiatives in local government, health and other parts of the public sector.

1 mark per point for these and any other relevant points up to 7 marks for the recommendations and 3 marks for the translation to the public sector

(10)

(30)

Question 2

(a) Calculation of inventory as at 31 May 2007

	£m	
Valuation as at 5 June 2007	38	½
Add back cost of sales		
Sales	10	½
less Average margin	<u>2</u>	1
	8	
	<u>46</u>	
Exclude purchases	14	½
less returns outwards	<u>3</u>	½
Cost of inventory as at end of financial year	<u><u>35</u></u>	

(3)

(b) Gross profit for the year ended 31 May 2007

Calculation of cost of sales

	£m
Per trial balance	
Opening inventory	37
Purchases	<u>155</u>
	192
Closing inventory	<u>(35)</u>
	157
Depreciation for the year charged to cost of sales	
Buildings	1
Equipment, at cost	<u>4</u>
	<u><u>162</u></u>

Calculation of gross profit

	£m
Revenue	246
Cost of sales	<u>(162)</u>
Gross profit	<u><u>84</u></u>

*Opening inventory, purchases, closing inventory ½ mark each up to 1 ½,
 depreciation, 2 X ½ up to 1, turnover less cost of sales ½*

(3)

(c)

Molitor plc
Balance sheet as at 31 May 2007

ASSETS		
Non-current assets	£m	
Tangible	53	4
Investments	21	1
	74	
Current assets		
Inventory	35	1
Trade receivables	22	1
Cash and cash equivalents	24	1
	81	
Total assets	155	
EQUITY AND LIABILITIES		
Equity		
Issued ordinary share capital	48	1
Share premium	9	1
Revaluation reserve	9	1
Retained earnings	21	1
Total equity	87	
Non-current liabilities		
Deferred taxation	20	1
9% Loan notes	18	1
Total non-current liabilities	38	
Current liabilities		
Trade payables	16	1
Current tax payable	14	1
Total current liabilities	30	
Total liabilities	68	
Total equity and liabilities	155	

Presentation 2

(18)

Workings

Calculation of depreciation for the year

Buildings	£m
Cost as at end of year	24
Depreciation rate	5%
	1.2
Charged to cost of sales (70%)	0.84
Rounded to	1
Equipment	
Cost as at end of year	38
Accumulated depreciation	18
	20
Depreciation rate	30%
	6
Charged to cost of sales (70%)	4.2
Rounded to	4

Non-current assets		11
Land		
Buildings	24	
Depreciation on buildings (7 + 1)	<u>8</u>	16
Equipment	38	
Depreciation on buildings (18 + 6)	<u>24</u>	14
Investment property	<u>12</u>	
	<u>53</u>	
Allowance for doubtful debts		£m
Old allowance	5	
Decrease	<u>(2)</u>	
New allowance	<u>3</u>	
Trade receivables		£m
Trade receivables	25	
Allowance for doubtful debts	<u>(3)</u>	
	<u>22</u>	

(d) Molitor plc
Statement of changes in equity for the year ended 31 May 2007

	Share capital	Share premium	Revaluation reserve	Retained earnings	Total	
	£m	£m	£m	£m	£m	
As at 1 June 2006	40	17	6	14	77	4
Changes in equity for the year:						
Surplus on revaluation of investment property			3		3	1
Profit for the financial year				20	20	1
Dividends paid				(13)	(13)	1
Bonus issue of shares	8	(8)				2
As at 31 May 2007	<u>48</u>	<u>9</u>	<u>9</u>	<u>21</u>	<u>87</u>	<u>2</u>
						(11)
						(35)

Question 3

(a) Edesch plc

- (i) The purchase consideration is £985,000 and the net assets taken over total £885,000 (285,000 + 400,000 + 12,000 + 188,000). So there is goodwill of £100,000. 2

(ii) **Franchise**

This is an intangible asset and should be treated in accordance with IAS 38 *Intangible Assets*. It should initially be recorded at cost and written off over its estimated economic life of 10 years. It will also be subject to impairment review.

Goodwill

The goodwill should be recognised initially at cost as an intangible non-current asset. It should not be depreciated – but should be assessed annually (or more often if necessary) for impairment. Goodwill should be reported at cost less any impairment losses.

Goodwill should be separately reported in non-current assets. 6

(iii) **Revaluation**

IAS 38 allows for the subsequent revaluation of intangible assets (which it calls the 'revaluation model') to their fair value – determined by reference to an active market. This would apply to the franchise. The carrying value would therefore be fair value as at the date of revaluation less any subsequent accumulated amortisation and impairment losses. The company would need to revalue the asset sufficiently regularly to ensure that the carrying value of the assets is not materially different from its fair value.

It would not be possible to revalue the goodwill upwards after initial recognition because this would mean recognising additional goodwill which has been inherently generated. Inherent goodwill does not meet recognition rules. 6

(iv) **Negative goodwill**

The guidance of IFRS 3 is first of all to question whether or not a mistake might have been made in identifying and valuing the net assets taken over. So, first of all Edesch plc should review whether all the assets (and possible liabilities) taken over have been correctly identified and valued.

Any negative goodwill remaining should be regarded as the result of a bargain purchase and included in the profit or loss for the period. 3

(17)

(b) Preece plc

(a)

(i) Historical cost accounting

Cost of the machine	155,890		½
Less Accumulated depreciation	<u>93,534</u>	155,890 times 6/10	1
	<u>£62,356</u>		½

(ii) Current purchasing power equivalent

Net book value	62,356		1
General price index as at end of March	194	193 + 195 / 2	1
General price index as at date of purchase	<u>173</u>		1
Current purchasing power equivalent	<u>£69,925</u>	62,356 times 194 / 173	1

(iii) Replacement cost

Cost of new replacement	295,400		1
Equivalent service potential	236,320	295,400 times 1/1.25	1
Depreciation	<u>141,792</u>	236,320 times 6/10	1
Replacement cost	<u>£94,528</u>		1

(iv) Net realisable value	<u>£93,500</u>		1
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(b)

Fair value can be defined as 'the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction'.

Source: IFRS 1

Other definitions are acceptable, e.g.

'the price that would be received for an asset or paid to transfer a liability in a transaction between market participants at the measurement date' (an exit price).

Source: IASB Fair Value Measurements Project Report March 2006

The net realisable value of £93,500 is probably the **closest** value here to fair value.

2 marks for definition 2, 1 mark for conclusion to an overall 3

(14)

(c) Tribbin plc

The question must be whether or not Tribbin plc should create a provision for the costs of complying, or not complying, with the legislation.

As far as the costs of acquiring and installing the safety equipment are concerned there is no obligation because no obligating event has happened – the equipment has not been purchased or installed. However, there may be an obligation to pay fines because of non-compliance (non-compliance is itself an obligating event).

An assessment would need to be made of the probability of incurring fines under the legislation. This will depend on the wording of the legislation and the severity with which the legislation will be enforced.

Therefore, no provision should be made for the costs of fitting the new equipment. A provision should be recognised for the best estimate of any fines that are probable.

1 mark per valid point to a maximum of (4)

(35)

Question 4

- (a) (i) A permanent difference is a one-off difference between reported net profit and taxable profit. For example, an item may have been reported as an expense in the income statement but the expenditure is not allowable for tax purposes e.g. some entertainment expenses. This would cause taxable profit to be higher than reported profit. Permanent differences affect one year only.

Temporary differences cause differences between reported net profit and taxable profit but affect more than one financial year. Temporary differences originate in one or more financial years and reverse in one or more following financial years. A common example is the difference between the depreciation charged on the carrying value of a non-current asset in the financial statements and the capital allowances charged for tax purposes.

Up to 2 marks for descriptions, up to 2 marks for examples up to a maximum of (4)

(ii)

Statement of profit or loss – extract

		£
Profit before tax		31,566,800
Tax expense:		
Corporation tax	8,829,600	
Transfer to deferred taxation	<u>800,550</u>	
		<u>9,630,150</u>
Profit for the year		21,936,650

Workings

Net profit – given

Corporation tax – 30% of taxable profit of £29,432,000 = £8,829,600

Transfer to deferred taxation = 30% of the timing differences of £2,668,500 = £800,550

Net profit ½ mark, corporation tax 2 marks, deferred taxation transfer 2 marks, profit after tax ½ mark up to a maximum of 5

(iii)

Balance sheet extract

	£
Non-current liabilities	
Deferred taxation	1,774,850
Current liabilities	
Current tax payable	8,829,600

Workings

Corporation tax: as provided for in the income statement

Deferred taxation = balance b/f of £974,300 + transfer for the year of £800,550 = £1,774,850

Accurate headings up to 2 marks, corporation tax 1 mark, deferred taxation 1 mark up to a maximum of 4

(13)

(b) (i) 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 totaling 20 pence per share in its last financial year and the market value of the share is £1.60 the dividend yield is 12.5%.

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 is the better and, other things being equal, an investment in a company with a higher dividend yield would be more attractive than an investment in an equivalent company with a lower yield. However, it should be borne in mind that the motivations of investors may vary. For example, some investors might be happy to forego a high dividend yield in the short term in return for long-term growth prospects. Nevertheless, 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 reinvesting a high proportion of profits into the business. This could augur well for future profits and distributions.

(ii) Dividend cover

The dividend cover states the number of times that the total dividends paid to shareholders in a financial year was covered by the profit after tax for the year. It enables an investor to assess the margin of safety attaching to dividends payments to them by the business. It may also give an insight into the dividend policy of the company i.e. the way in which the company balances the distribution of profits and their retention within the business to maintain and expand the business.

A high dividend cover suggests a degree of safety in so far as the business might be able to maintain its dividend payments even if profits were to fall. If the dividend cover is low or falling investors might become worried that future dividend payments might be in jeopardy. However, a low dividend cover might be acceptable in a company with very stable profits, but the same cover at a company with volatile profits would indicate that dividends are at risk. An investor interested in the safety of dividend payments should also look at the net cash position of the company.

A low dividend cover might also mean that the business is not retaining sufficient funds within the business to maintain and expand its operating capability. The danger then might be that the business can only finance expansion through borrowing, or even be forced to reduce its level of operations.

(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 for a company were 15 pence and the current share price was £1.50 the PE ratio would be 10.

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 2 mark, what it measures 2 marks, use and interpretation 2 marks, up to 6 marks per ratio, up to an overall maximum of (14)

- (c)**
- (i)** The market price per share is the market capitalisation divided by the number of shares in issue i.e. $507.61 / 1,460.76 = 34.7497 = 35$ pence. 2
 - (ii)** Earnings per share is the market price per share divided by the PE ratio i.e. $34.7497 / 49.64 = 0.7$ pence. 3
 - (iii)** The dividend per share is the market price per share times the dividend yield i.e. 34.7497 pence * 5.04% = 1.75139 = 1.75 pence. 3
- (8)*
- (35)**