

AUDIT AND ASSURANCE/ FINANCIAL REPORTING

AAT Fast-Track examination 13 June 2005

From 10.00am to 12.00pm
plus ten minutes reading time from 9.50am to 10.00am

Instructions to candidates

Answer **three** questions in total: **Two** questions in **Section A** and **one** question in **Section B**. The marks available for each question are shown in italics in the right hand margin.

All workings should be shown. Where calculations are required using formulae, calculators may be used but steps in the workings must be shown. Calculations with no evidence of this (for example, using the scientific functions of calculators) will receive no credit. Programmable calculators are not permitted in the examinations room.

Formula sheets, statistical tables, graph paper and cash analysis paper are available from the invigilator, where applicable.

Where a question asks for a specific format or style, such as a letter, report or layout of accounts, marks will be awarded for presentation and written communication.

Candidates may use the proforma sheets provided and submit them as part of their answer.



SECTION A – (Compulsory)

1

AAT Fast Track Module Syllabus

Audit Question : June 2005

You are an audit supervisor in a firm of accountants, Walker, Harrison and Wilding, who are undertaking the external audit of a Registered Social Landlord (-RSL). The RSL has recently completed the conversion of a former factory into a block of flats. This was a large capital project with an initial budget of £5 million and a final cost of £8m.

Mrs Harrison, the partner in your firm who has responsibility for the RSL's audit, has recently received a letter from a tenant of the block of flats. Part of the letter reads as follows:-

“You will need to look very carefully at the way the RSL handled the conversion of the flats. The building work is really shoddy. They must really have skimmed on the costs. The RSL's internal auditors did what they call a “value for money” review of the project, but the tenants have not heard what the findings were. I hope you can help. I always found I got good answers from the external auditors of the local authority, when I was one of their tenants.”

Mrs Harrison has asked you to help her draft a response to the tenant. She needs answers to the following questions.

• **Requirement for Question 1XX**

(a)(a) Explain the factors, which determine whether an external auditor can rely upon the work of an internal auditor. (6 marks)

(a)

(b)(b) Define the terms “value for money audit” and “the 3 E's”. (4 marks)

(b)

(c)(c) Explain the differences in the external audit arrangements for Registered Social Landlords and Local Authorities. (6 marks)

(d)(d) Outline the main controls you would expect:-

(i) At the pre-award contract stage 4

(ii) During the currency of the contract (10 marks, 5 for each stage) 4

(e)(e) Explain the role of external audit in respect of internal control systems and audit risk. (4 marks) 6

(30 ~~Marks~~)

2

The following list of balances comes from the records of Quiktrak plc as at 31 May 2005, the end of its most recent financial year.

	<u>Notes</u>	<u>£000</u>
Sales		3,550
Cost of sales	1	2,556
Stock, 31 May 2005	2	128
Administrative expenses		445
Distribution costs		185
Interim dividend		56
Other operating income		88
Overprovision for corporation tax for 2003/2004		12
Fixed asset investments	3	230
Investment income		38
Interest payable		32
Freehold properties at valuation	4	
Land		240
Buildings		310
Fixtures and fittings	4	445
Accumulated depreciation	4	
Buildings		46
Fixtures and fittings		223
Goodwill	5	60
Trade debtors	6	444
Trade creditors		170
Provision for bad debts, 1 June 2004	6	22
Cash at bank and in hand		74
Bank loans		
Due for repayment 1 February 2006		40
Due for repayment 1 February 2007		50
11% Debentures, repayable 2008		140
Issued share capital	7	400
Share premium account		85
Revaluation reserve		68
Profit and loss account, 1 June 2004		273

The following additional information is available:

- 1 Cost of sales includes development expenditure of £25,000 which the directors would like to defer. This expenditure meets the criteria for deferment in SSAP 13 Accounting for research and development.
- 2 Included in stock as at 31 May 2005 are some items valued at their cost of £27,000. The directors now feel that these items were obsolete as at 31 May 2005 and had a net realisable value of £20,000.
- 3 Fixed asset investments include equity investments valued at £105,000. These investments originally cost £25,000. The directors have decided to adjust the carrying value of these investments to £98,000 because of a permanent diminution in the recoverable amount of these investments during the year ended 31 May 2005. None of the holdings of equity shares gives rise to a participating interest.

4 Quiktrak plc's depreciation policies are:

- Land: no depreciation charged
- Buildings: 2% per year using the straight line method
- Fixtures and fittings: 25% per year using the diminishing balance method

Depreciation is charged for a full year in the year of acquisition and no depreciation is charged in the year of disposal.

Depreciation is to be allocated 60% to cost of sales, 20% to administrative expenses and 20% to distribution costs.

5 Goodwill of £100,000 arose on the acquisition of an unincorporated business on 1 June 2000. The goodwill is being written off equally over its total estimated economic life of 10 years. Goodwill has not yet been amortised for the year ended 31 May 2005.

6 The provision for bad debts is to be adjusted to 4.5% of trade debtors.

7 The issued share capital of Quiktrak plc consists of ordinary shares of 50 pence each.

8 The following are to be provided for the year ended 31 May 2005:

- corporation tax of £122,000 on the profits for 2004/2005
- a proposed ordinary dividend of 9 pence per share

• **Requirement for question 2**

Prepare Quiktrak plc's profit and loss account for the year ended 31 May 2005 and its balance sheet as at 31 May 2005 in so far as the above information permits.

Note

- Additional notes and disclosures are not required.
- Disclosure of earnings per share is not required.
- Round all figures to the nearest £000.

(35)

SECTION B – (Answer one question from this section)

3

You have been asked to help with a number of issues which have arisen in connection with the preparation of the financial statements for Tropex plc for the financial year ended 31 May 2005.

(a) Cash flow from operating activities – indirect method

A temporary member of staff has prepared the following draft (but incorrect) calculation of the cash flow from operations using the indirect method:

	£
<u>Net profit before tax</u>	<u>638,830</u>
<u>Interest paid</u>	<u>(14,610)</u>
<u>Depreciation charges</u>	<u>(363,480)</u>
<u>Profit on sale of tangible fixed assets</u>	<u>2,500</u>
<u>Operating profit</u>	<u>263,240</u>
<u>Increase in stocks</u>	<u>5,000</u>
<u>Increase in debtors</u>	<u>36,000</u>
<u>Decrease in prepaid expenses</u>	<u>1,020</u>
<u>Increase in creditors</u>	<u>50,500</u>
<u>Increase in accrued expenses</u>	<u>2,050</u>
	<u><u>357,810</u></u>

You have the following additional information:

- (i) The interest paid figure of £14,610 is the actual amount paid during the financial year and includes prepaid interest of £1,020 as at 31 May 2005.
- (ii) The figures are arithmetically correct and increases and decreases have been correctly identified but the member of staff is not sure whether the figures should be added or subtracted.

(b) Government grant

During the year ended 31 May 2005 Tropex plc received a government grant of 40% towards the cost of installing a more environmentally friendly waste disposal system. The new system cost £300,000 (before the grant) and is to be written off over its estimated economic life of 10 years.

(c) Finance lease

Tropex plc has been leasing an asset since 1 June 2004. The lease is a finance lease and Tropex plc is committed to making 5 rental payments of £14,500 annually in advance from 1 June 2004. The only record which has been made in the accounts has been to debit lease rental payments account and credit bank account with the payment made on 1 June 2004. The cash price of the asset is £66,400.

(d) Revaluation of building

Tropex plc reports all its fixed assets at cost less accumulated depreciation. One of the company's buildings was worth considerably more than its carrying value as at 31 May 2005. The directors would like to include the building in its balance sheet at its current value but are not sure what the basis of valuation should be or what the implications are for the company's other fixed assets.

• Requirement for question 3

(a) Cash flow from operating activities – indirect method.

Using the figures given in (a) above prepare a corrected calculation of the cash flow from operating activities using the indirect method.

9

(b) Government grant.

Advise the company how the government grant (see (b) above) should be treated in the accounts and financial statements.

6

(c) Finance lease.

Advise the company how the finance lease (see (c) above) should be reported in the profit and loss account for the year ended 31 May 2005 and the balance sheet as at 31 May 2005. Illustrate your answer with appropriate figures using the rule of 78.

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(d) Revaluation of building.

With reference to (d) above advise the directors of Tropex plc:

- (i) what basis of valuation should be used for the building
- (ii) how the revaluation should be recorded in the financial statements
- (iii) how the depreciation of the building will be affected by the revaluation
- (iv) the implications for the carrying value of the other buildings owned and used by the company

7

(35)

4

Return on capital employed is one of the most important performance indicators for profit making enterprises.

• Requirement for question 4

(a) Identify and describe three limitations in calculating and interpreting this ratio using conventional financial statements.

9

(b) The following ratios have been calculated from the published financial statements of two companies which operate similar businesses.

	Rose Ltd		Lynn Ltd	
	2003	2004	2003	2004
Profit to turnover	13%	10%	13%	13%
Turnover to net assets	2.7	2.7	2.7	2.0
Return on capital employed	33%	26%	33%	26%

(i) Compare and contrast the performance of these two companies over the two years 2003 and 2004 as evidenced by these ratios.

5

(ii) Make recommendations on how each company could restore its performance in the future.

6

(c) The following ratios are sometimes used by investors in a company:

- (i) Interest cover
- (ii) Dividend yield
- (iii) PE ratio

For each ratio:

- (i) Define how the ratio is calculated.
- (ii) Describe what the ratio measures.
- (iii) Describe how an investor might interpret the ratio.

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(35)

Marking Scheme: Audit Question

~~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 candidate 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 associate 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 an auditor 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.~~

~~Auditor must satisfy themselves that accounts have been prepared according to the relevant statutory requirements.~~

~~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 5 marks for each subsection, a maximum of 10 marks in total)~~

~~(e)~~

~~Role of Internal 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 to 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" 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 4 marks)~~