AUDIT AND ASSURANCE / FINANCIAL REPORTING

AAT Fast-Track examination

6 June 2008

MARKING SCHEME

AT THE HEART OF
YOUR CAREER

Question 1

(a) Comparison of the three "E's"

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 the output from any given activity is achieving the desired result- the measure of output and outcomes.

Any reasonable set of examples should be given and will be credited, provided they illustrate the differences between these three concepts.

1 mark for each correct definition and 1 mark for each properly explained example up to a maximum of (6)

(b) Resources required for an effective Internal Audit Service

Human Resources
This is the most important issue in respect of internal audit resources.

There must be an appropriate mix of staff, so that work is assigned to people of appropriate experience and expertise.

The mix of staff needed will become apparent during the planning process and will be determined by the size and complexity of the organisation being audited.

There should be a proper range of competencies for specialised areas such as IT audit.

Resource shortages can be met in a variety of ways, such as training, hiring temporary staff and consortia arrangements.

There should be enough flexibility in the staffing complement to allow for special and unforeseen circumstances: for example for fraud investigations.

Staff should have the necessary personal qualities required of auditors. Audit staff should be numerate, articulate and able to express themselves with confidence.

All audit staff should receive appropriate periodic training.

Training can include periods of secondment to other departments.

Other Resources
Adequate accommodation will be needed for the audit section, near the main sources of data to which they will require access.

Adequate, secure storage for files is a must.

Auditors must have access to up to date and relevant IT – both hardware and software.

Auditors need access to a full set of up to date reference materials, including procedure manuals for departments being audited.

1 mark for each correct point or any other relevant point up to a total of (8)

(c) Risk Factors in the Operational Audit of a Grants Payment System

If the aims of the grants are not clearly set out, then it will be difficult to tell whether they have been achieved.

If management does not set up adequate monitoring systems, then it will be unable to determine how well it is doing.

Particularly complex rules may make it difficult to establish whether or not an applicant is entitled.

Lack of awareness in the group of those entitled to the grant may lead to low take up rates.

A history of fraudulent claims for this type of grant could indicate an increased risk.

If there are limits on the amount of grant that can be given, then any breach of such limits, no matter how small, is significant.

Discretion in the value of grants provided can be abused where the value of the grants is high.

Devolved budgetary arrangements within an organisation may mean that no one is sure who is responsible for the authorisation of grants.

Fast changing rules may increase the risk that up-to-date rules are not being used by those giving grants.

1 mark for each correct point or any other relevant point up to a total of (9)

(d) The Four Elements of Control Risk Self Assessment

These are:

1. Risk analysis, agreement to and documentation of, consequent control objectives – normally in specially convened meetings.

2. Documentation of existing control systems.

3. Evaluation of the adequacy of existing controls and subsequent control changes.

4. A reporting and review structure which covers the whole organisation and provides management with the necessary information on business processes and control systems.

1 mark for a reasonable summary of each key stage in the process, up to an overall of (4)

(e) The three Categories of Business Risk

1. Financial Risks – these arise from the financial activities of the organisation and include fraud and financial loss.

2. Operational Risks - these are the risks arising from the operation of the business, such as loss of key staff and facilities.

3. Compliance Risks – these relate to non-compliance with statutory or regulatory requirements.

1 mark for a reasonable summary of each type of risk and ½ marks if only a list of risk types is given without any supplementary detail, up to an overall maximum of (3)

(30)

Question 2

Spartacus plc
Income statement for the year ended 31 May 2008

	£000	½	
Revenue	5,684	½	
Cost of sales	(4,324)	*4 ½*	w
Gross profit	1,360	½	
Other operating income	341	½	
Distribution costs	(646)	*1 ½*	w
Administrative expenses	(969)	*2*	w
Income from investments	27	½	
Surplus on revaluation of investment property	50	*1*	
Finance costs	(50)	½	
Profit before tax	113	½	
Income tax expense	(65)	*3*	w
Profit for the year	48	½	

Spartacus plc
Balance sheet as at 31 May 2008

ASSETS		
Non-current assets	**£000**	½
Property, plant and equipment	1,485	*5*
Investments	42	*1*
	1,527	
Current assets		
Inventories	391	*1*
Trade receivables	632	*2*
Cash and cash equivalents	143	½
	1,166	
Total assets	2,693	
EQUITY AND LIABILIITES		
Equity		
Issued ordinary share capital	900	½
Share premium account	250	½
Revaluation reserve	95	½
Retained earnings	533	*3 w*
Total equity	1,778	
Non-current liabilities		
10% Debenture	500	½
Deferred tax	46	*1*
Total non-current liabilities	546	
Current liabilities		
Trade payables	355	½
Taxation	14	*1*
Total current liabilities	369	
Total liabilities	915	
Total equity and liabilities	2,693	

Layout 1 ½

Allocation of expenses

	Cost of sales £000	Administrative expenses £000	Distribution costs £000
Per trial balance		892	625
Opening inventory	355		
Error in opening inventory	17		
Purchases	4,263		
	4,635		
Closing inventory	(391)		
	4,244		
Gain on disposal of assets	(19)		
Depreciation for the year			
Buildings	6	1	1
Equipment, at cost	93	20	20
Allowance for doubtful debts		56	
	4,324	969	646
Workings marks	*4.5*	*2*	*1.5*

Allowance for doubtful debts

	£000
Old allowance for doubtful debts	23
Increase in allowance for doubtful debts	56
New allowance for doubtful debts	79

Trade receivables

	£000
Trade receivables	711
Allowance for doubtful debts	(79)
	632

Retained earnings

	£000	
Balance b/f	603	
Error in opening inventory	17	*1*
Profit for the year	48	*1*
Dividends paid	(135)	*1*
	533	

Corporation tax

	£000	
Provision for the current year	14	*1*
Previous underprovision	40	*1*
Transfer to deferred taxation	11	*1*
Charge for the year	65	

Calculation of depreciation

Buildings	£000
Cost as at end of year	400
Depreciation rate	2%
	8

Equipment	***£000***	
Cost as at end of year	861	
Accumulated depreciation	197	*(295 - 98)*
	664	
Depreciation rate	20%	
	133	

Tangible non-current assets

Buildings	**£000**	
Cost	400	
Depreciation (2% of 400)	8	
Accumulated depreciation at start of year	88	
Accumulated depreciation at end of year	96	*2*

Equipment	**£000**	
Cost	984	
Less withdrawn on disposal	(123)	
Cost at the end of the year	861	*1*
Accumulated depreciation	295	
Less withdrawn on disposal	(98)	
Accumulated depreciation before charge for year	197	*1*
Depreciable amount	664	
Depreciation rate	20%	
Depreciation charge for the year	133	*1*
Accumulated depreciation at end of year (197 + 133)	330	

Property, plant and equipment	
Land	300
Buildings (400 – 96)	304
Equipment (861 – 330)	531
Investment property	350
	1,485

Gain on sale of equipment	
Book value (123,000 – 98,000)	25
Proceeds	44
Gain on sale	19

(35)

Question 3

(a) The information provided enables us to reconstruct the following:

	£
Fair value of asset	101,492
Initial rental paid 1 June 2007	(25,640)
	75,852
Interest for year to 31 May 2008	**10,058**
Balance outstanding at 31 May 2008	85,910
Rental paid 1 June 2008	(25,640)
	60,270
Interest for year to 31 May 2009	**7,992**
Balance outstanding at 31 May 2009	68,262

Income statements	for year ended 31 May		
	2008	2009	
	£	£	
Depreciation	20,298	20,298	*2*
Finance charge	10,058	7,992	*2*

Balance sheet	£	£	
Non-current assets			
Leased asset	101,492	101,492	*1*
less Accumulated depreciation	20,298	40,596	*2*
	81,194	60,896	

Balance sheets	as at 31 May		
	2008	2009	
Non-current liabilities	£	£	
Obligations under finance leases	60,270	42,622	*2*
Current liabilities			
Obligations under finance leases	25,640	25,640	*2*
	85,910	68,262	

(11)

(b)

Cash flows from operations	£		
Cash receipts from customers	10,766,860		
Cash paid to suppliers and employees	(8,939,349)		
Cash flows from operations	1,827,511	*Presentation*	*2*

Workings:

Cash receipts from customers	£	
Opening trade receivables	229,870	*1*
Sales	10,805,060	*1*
Discounts allowed	(31,200)	*1*
Closing trade receivables	(236,870)	*1*
	10,766,860	

Calculation of purchases	£	
Cost of sales	7,586,410	*1*
Add closing inventory	109,875	*1*
	7,696,285	
Less opening inventory	(122,650)	*1*
	7,573,635	

Cash paid to suppliers	£	
Opening trade payables	185,640	*1*
Purchases	7,573,635	*1*
Closing trade payables	(269,840)	*1*
	7,489,435	

Cash paid for operating expenses	£	
Operating expenses	1,897,300	*1*
Exclude depreciation	(389,550)	*1*
	1,507,750	
Exclude discounts allowed	(31,200)	*1*
	1,476,550	
Accrued at start of year	19,850	*1*
Accrued at end of year	(21,630)	*1*
Prepaid at start of year	(44,600)	*1*
Prepaid at end of year	19,744	*1*
	1,449,914	

Cash paid to suppliers and employees	£	
Paid to suppliers	7,489,435	
Paid for operating expenses	1,449,914	
	8,939,349	*1*
		(20)

(c) An asset will be recognised if:

- There is sufficient evidence that a new asset has been created or that there has been an addition to an existing asset (i.e. a new item meets the definition of an asset).
- The asset or addition to an existing asset can be measured in money terms with sufficient reliability.

An asset will be derecognised if:

- There is sufficient evidence that a transaction or other past event has eliminated a previously recognised asset (i.e. the item no longer meets the definition of an asset).
- An item no longer meets the recognition criteria even although the item may still meet the definition of an asset.

1 mark for each point made up to an overall of (4)

(35)

Question 4

Notes for meeting re. Loxlee Ltd:

- The best overall measure of Loxlee Ltd's performance is ratio 1 – profit after tax to total assets. This has shown significant and consistent rises over the past three years. This suggests that the overall efficiency of Loxlee Ltd has improved markedly. While the figures look good comparisons ought to be made with similar businesses or competitors and with the business's targets if these are available.

- The improved performance is due to both increases in profitability on trading (ratio 2) and the efficiency in generating sales revenue from assets (ratio 3).

- The improvement in profitability on trading is due to a combination of increased margins earned on sales (ratio 4) and decreasing administrative expenses relative to sales revenue (ratio 5). These improvements have been offset to some extent by persistent increases in distribution costs relative to sales revenue (ratio 6).

- Possible reasons for the increased gross profit to sales revenue may include: increased selling prices and/or efficiencies in buying or production costs. The decreasing administrative expenses may be because a significant core of administrative expenses may be at least partially fixed relative to sales revenue and sales revenue is increasing.

- Distribution costs are small relative to sales revenue. However, they have increased by almost a half over the past three years. This may be due to reasons outside the company's control e.g. increasing petrol costs or postages, or it may be due to changing distribution technologies and/or poorer cost control.

- The combined effect of these is to give an increasing net margin on sales revenue (ratio 7). This has shown a significant increase in the past year. However, again, comparisons need to be made with competitors and, if possible, internally set targets.

- The other reason for the improving overall performance of Loxlee Ltd is the efficiency with which assets are used to generate sales. Here there is a mixed picture. Sales revenue to non-current assets (ratio 8) has increased steadily and significantly over the past three years. However, the sales revenue generated per £ of current assets has fallen in the past year. This suggests that most of the efficiency gains in this area are due to the more efficient use of non-current assets. Perhaps redundant or inefficient assets were disposed of in 2007.

- The current ratio may be adequate, it's over 1:1, but we do not know what the ideal ratio would be for this type of business. It has remained fairly steady over the three year period.

- The quick/acid test ratio has also remained steady over the three years. Although it is sometimes said that this ratio should not be less than 1.1 benchmarks are likely to vary.

- Although the current and quick/acid test ratios seem stable there is a potential area for concern when we look at the components of current assets. Inventory to cost of sales is constant. However, the percentage of receivables to sales revenue is increasing and the percentage of cash to sales revenue is decreasing. This suggests that the credit extended to customers is increasing – at the expense of liquid funds. This may or may not be a cause for concern. It may be deliberate and planned with the intention of increasing sales revenue and profits. If this is so then it seems to be working given the improvement in the overall performance of the company. On the other hand it may not be intentional and the company's credit control is out of control. This would be worrying and would demand immediate attention.

- Interpretation of these ratios comes with all the usual caveats. We have very little idea of the size of the company or the sector it operates in. The ratios are not comprehensive and there is no information which is not in ratio form. We have no information about targets or the performance of competitors. The ratios available give a limited insight into the business's performance over the past three years but do not say much, by themselves, about the future prospects for the economy, sector or company.

2 marks for each substantive point to a maximum of (29)

Recommendations:

The following areas could be investigated further:

Credit control: the reasons for the increasing proportion of trade receivables should be looked at. Is this evidence of poor credit control? If so, the company needs to review this area looking at how credit is granted and administered.

Distribution costs: it would probably be worthwhile to investigate these further with a view to seeing whether the increases are worthwhile in terms of increased sales revenue and profits or whether these could be controlled more effectively.

2 marks for each substantive point to a maximum of (6)

(35)