CIPFA

AUDIT AND ASSURANCE/ FINANCIAL REPORTING

AAT Fast-Track Examination

7 June 2006

MARKING SCHEME

AT THE HEART OF YOUR CAREER

Question 1

(a) (i) It is management's responsibility to ensure that:
- Financial Statements are prepared.
- Those statements are properly prepared in accordance with all relevant legislation and standards.
- The organisation operates within the law in general and within the body's specific legal powers.

It is the external auditors' responsibility for forming an opinion as to whether management has done these things or not.

External auditors must:
- Examine the financial statements.
- Express an opinion upon those statements.

1 mark for any of the above and any other relevant point up to a maximum of 6

(ii) Organisational management is responsible for delivering value for money, which is determined by political objectives in most of the public sector.

External audit involvement in value for money is to a large extent driven by statute.

The Audit Commission Act 1998 requires the Audit Commission to undertake or promote comparative and other studies designed to make recommendations for improving VFM in local authorities.

Audit Scotland has similar powers under the "Public Finance and Accountability Act (Scotland) 2000. Similar legislative provisions exist in Wales and Northern Ireland.

Within the NHS the responsibility for VFM work was transferred to the Commission for Healthcare Audit and Inspection in April 2004.

The National Audit Act 1983 gives the Comptroller and Auditor General discretionary power to conduct VFM auditing in government departments and many other public bodies.

The powers of internal audit to undertake VFM are determined by management in the organisations for which they work.

Management might well decide to have work done in areas, which the external auditor has not targeted.

Internal audit might well exchange information with colleagues in comparable organisations in order to generate comparative data.

Management need not commission internal audit to carry out such reviews, which could be carried out by internal managers or an external consultancy, but auditors often are good at this work because of their skills base.

1 mark for any of the above and any other relevant point up to a maximum of 5

(b) Risks:

- Failure to establish the requirements for vehicles may result in the wrong type or number of vehicles being acquired.
- Poor specification of vehicles may result in lack of ability to 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 might 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 organisation to legal liability.
- Inadequate insurance may result in 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 refund replacements.

Possible Controls:

- Clear organisational responsibility established for overall control of vehicle management strategy.
- Regular review of vehicle requirements by senior management to ensure they remain relevant to the organisation's changing needs.
- Decisions on procurement methods taken in consultation with specialist procurement managers to ensure all options are considered.
- Regular user survey by asset management team to identify unmet needs or lack of capacity.
- Separation of duties with regard to vehicle acquisition, management and disposal.
- Monthly monitoring against budget by asset managers of running costs, repairs and maintenance costs.
- Details on Fixed Asset Register regularly reviewed by fleet manager to ensure accuracy of details.
- Fixed Asset Register to hold information on next insurance and taxation dates.
- All vehicles not in use kept securely.
- All users issued with clear rules and conditions with regard to personal use of vehicles.
- Regular review by user managers of age and conditions of vehicles to ensure fitness for purpose.
- Fleet management to establish maintenance and replacement policy and ensure that acquisitions and disposals comply with it.

1 mark per point for any of the above or any other relevant point to a maximum of 12

(c) COSO

This is the Committee Of Sponsoring Organisations of the "Treadway Commission". It is a body, which has developed guidance on "integrated control frameworks".

Integrated control frameworks knit together all the different aspects of internal control into one system of internal control.

The five components of an integrated control system, according to COSO, are:

Control Environment: The foundation of all the other components of internal control. It includes factors such as the integrity, ethical values and competence of the people working in the organisation and the attention and direction of the board of directors to such matters.

Risk Assessment: The mechanisms for identification, assessment and management of risk are seen as essential to the internal control framework.

Control Activities: These are the policies and procedures that help ensure that management directives are carried out. It would include control procedures such as approval, authorisation, verification, reconciliation etc

Information and Communication: For any internal control process to function correctly it is essential that correct, timely information is provided to the correct recipient internally and that there are good communications with the outside world as well.

Monitoring: Internal control systems need to be monitored – a process that assesses the quality of the system's performance over time.

1 mark per point for any of the above or any other relevant point to a maximum of 7

(30)

Question 2

Wharf plc
Profit and loss account for the year ended 31 May 2006 *1*

	£000	*½*
Turnover	3,980	*1*
Cost of sales	(3,016)	*4*
Gross profit	964	
Distribution costs	(350)	*1 ½*
Administrative expenses	(370)	*1 ½*
Other operating income	90	*½*
Operating profit	334	
Income from fixed asset investments	30	*½*
Interest payable	(43)	*½*
Profit on ordinary activities before taxation	321	
Tax on profit on ordinary activities	(130)	*2*
Profit for the financial year	191	
		(13)

(per working)

Wharf plc
Balance sheet as at 31 May 2006 *½*

Fixed assets		£000	*½*
Tangible		840	*(see working) 3*
Investments		153	*2*
		993	
Current assets	£000		
Stock	271		*1*
Debtors	384		*2*
Cash at bank and in hand	74		*½*
	729		
Creditors: amounts falling due within one year			
Trade creditors	200		*½*
Taxation	110		*1*
Bank loan, repayable 1 April 2007	60		*1*
	370		
Net current assets		359	
Total assets less current liabilities		1,352	
Creditors: amounts falling due after more than one year			
Bank loans	(70)		*½*
11% Debentures	(180)	(250)	*½*
Net assets		1,102	

Capital and reserves		
Issued ordinary share capital	400	*1*
Share premium account	-	*1*
Revaluation reserve	120	*1*
Profit and loss account	582	*2*
	1,102	
		(18)
		Presentation 4
		(35)

Workings

Turnover	£000
Sales, per list of balances	4,080
Less On approval	100
	3,980

Allocation of expenses	Cost of sales £000	Administrative expenses £000	Distribution costs £000
Per trial balance	3,020	350	330
Goods on approval	(80)		
Write down of fixed asset investments not covered by previous revaluation surpluses	7		
Reduction in closing stock	9		
Depreciation for the year			
Buildings	6	2	2
Equipment	54	18	18
	3,016	370	350

Corporation tax	
Provision for the current year	110
Previous underprovision	20
Charge for the year	130

Calculation of depreciation

Buildings	£000
Cost as at end of year	400
Depreciation rate	2.5%
	10
Fixtures and fittings	
Cost as at end of year	650
Accumulated depreciation	350
	300
Depreciation rate	30%
	90

Fixed asset investments	£000
Carrying value of revalued investments	110
New valuation	83
Diminution in value	27
Written off Revaluation Reserve	20
Written off profit and loss account	7
	27

Fixed asset investments	£000
per list of balances	180
Written off	(27)
New balance	153

Tangible fixed assets	Land	Buildings	Equipment	Total	
	£000	£000	£000	£000	
Cost or valuation					
As at 31 May 2006	300	400	650	1,350	*1 ½*
Accumulated depreciation					
As at 1 June 2005	0	60	350	410	
Charge for the year	0	10	90	100	
As at 31 May 2006	0	70	440	510	*1 ½*
Net book value					
As at 31 May 2006	300	330	210	840	
					(3)

Closing stock	£000
per trial balance	200
Goods on approval at cost	80
Write off (19 - 10)	(9)
	271

Debtors	£000
per list of balances	510
less on approval	(100)
less provision for doubtful debts	(26)
	384

Share capital	
per list of balances	350
Bonus issue	50
New share capital	400

Share premium	
per list of balances	50
Bonus issue	(50)
Balance c/f	0

Revaluation reserve	£000
per trial balance	140
Written off	(20)
	120

Profit and loss account	£000
Balance b/f	615
Profit after tax	191
	806
Dividends paid	(224)
Balance c/f	582

Question 3

(a)

Annual rental is £4,500 plus £11,750 = £16,250

Interest for year 1 is 4/10	£4,500
Interest for year 2 is 3/10	£3,375
Rental for year 2 is	£16,250
Capital repayment is	£12,875

So, cash flow statement for year 2

Returns on investment and servicing of finance	
Interest element of finance lease rental payments	3,375
Financing	
Capital element of finance lease payments	12,875

3 marks for calculation of interest element and 2 marks for calculation of capital element up to a maximum of 5

(b) **(i)** FRS 12 requires a provision to recognised in the balance sheet as a liability if:

1. The entity has a present obligation (legal or constructive) as a result of a past event
2. It is probable that a transfer of economic benefits will be required to settle the obligation
3. A reliable estimate can be made of the obligation.

2 marks each up to a maximum of 6

(ii) *Guaranteed loan*

This meets all three requirements of FRS 12 and Biggles plc should therefore provide for a liability of £340,000.

Refurbishment

This does not satisfy the requirements of FRS 12. This is not a provision. Nor is it a contingency. Biggles plc has no obligation independent of its future actions. For example, it could sell the helicopter before the refurbishment is required. There is, of course, no reason why Biggles plc should not set aside £150,000 cash each year – but this is not a provision.

3 marks each up to a maximum of 6

(c) (i)

	£000	
Contract price	125	*1*
Costs to date	39	*1*
Estimated future costs	44	*1*
Estimated profit	42	*1*
		(4)

(ii)

Percentage complete:	56 / 125	= 45%	*2*
Attributable profit (45% of 42)	18.82	[or 19]	*2*
			(4)

(iii)

Profit and loss account figures:

	£000	
Turnover	56.00	*1*
Cost of Sales (balance)	37.18	*2*
Profit	18.82	*1*
		(4)

(iv)

Balance sheet figures:

	£000	
Work in progress:		
Costs to date	39.00	*1*
Transferred to Cost of Sales	37.18	*1*
	1.82	
Amounts recoverable on contracts:		
Turnover	56.00	*1*
Value of work invoiced	48.00	*1*
	8.00	
Trade debtors:		
Value of work invoiced	48.00	*1*
Payments received	44.00	*1*
	4.00	
		(6)

(35)

Question 4

REPORT

The performance of Mariner plc compared with three competitors

From:
To:
Date:

General

The following report is based on a number of performance ratios calculated from the most recent financial statements of Mariner plc and three of its competitors which, for the purposes of this report, are named companies X, Y and Z respectively. These ratios are available as an appendix to this report.

Profitability

Return on capital employed is perhaps the best single overall measure of the efficiency of a profit making entity. Here this has been measured by comparing net profit to total assets employed (ratio 1). The higher the value of this ratio the better. Here, the performance of Mariner plc impresses. Mariner plc's return on capital employed is the best of the group, and significantly so when compared with companies X and Y.

Mariner plc's excellent performance seems attributable to its high gross profit ratio (ratio 4). Mariner plc is earning nearly £32 profit for every £100 of sales. This is far better than the other three companies which are earning between £19 and £24 gross profit for every £100 of sales.

It is not possible to tell from the ratios why Mariner plc's gross profit ratio is so high. Mariner plc may be able to source or manufacture its products more cheaply than the other companies – while maintaining relatively high selling prices. Pilferage, theft and stock losses may be lower in Mariner plc than the other companies. Mariner plc may also have a more profitable sales mix than the other companies.

In terms of assets utilisation Mariner plc also does well (ratios 7 and 8) – better than the other three companies in using fixed assets, but not as good as Company Z when it comes to current assets utilisation. This will be looked at in greater detail later.

Mariner plc also achieves the highest net profit to sales of the four companies, although its advantage is not as pronounced as it was with gross profit. This is because administrative expenses (ratio 5) are no better managed than in the other three companies while distribution costs (ratio 6) are actually the highest of the four companies.

Assets utilisation and liquidity

The turnover to total assets ratio is not supplied. However this can be estimated by adding together ratios 7 and 8. Here Mariner plc appears to use its assets more efficiently than companies X and Y but not as well as company Z. Company Z's advantage seems to be to due to the high productivity of its current assets; Mariner plc is better in terms of fixed assets utilisation.

Mariner plc's current and acid test ratios appear to be comparable to the other three companies. However, Mariner plc's levels of stocks and debtors appear to be on the high side, with the result that cash holdings may be a bit on the low side. There may be scope here for Mariner plc to improve its management of working capital.

Recommendations

The above analysis suggests that while Mariner plc's performance is the best of the group of four companies there may be scope for further enhancement by focusing on certain key areas. It is suggested that Mariner plc should seek:

- Better control of distribution costs.

  Mariner plc could improve its return on capital employed by 2% or 3% if it could trim these overheads by seeking efficiencies which do not adversely affect performance elsewhere.

- Better control of working capital – in particular, better stock control and credit control

  Reducing stock levels would reduce storage and insurance costs as well as reducing the risk of losses through obsolescence. Tighter control of credit given to customers would reduce collection costs and the risk of bad debts. Both would increase cash holdings. However, it is important that the improvements in the control of working capital be achieved without reducing sales and profitability.

Reservations

- The available information is limited. Other financial indicators might be useful eg investors' ratios. It would also be useful to have additional information about the quality of each company's current management, its risk exposure and the prospects for the industry sector.

- The data is available for one year only. Accordingly, it has not been possible to consider trends within each company and the industry sector. Also, although the information used was from the most recent financial statements it may now be out of date.

- It has been assumed that all the data is comparable e.g. similar accounting policies have been used in the four companies, that the financial years are coterminous, etc.

- We know nothing about the status of the three comparator companies. Are these the three 'best' companies, or are they representative of the whole sector? This could have a very significant effect on the overall interpretation of Mariner's performance.

Report format and style – 5 marks
Discussion of ratios – 2 marks per valid point to a maximum of 18
Recommendations – 2 marks for each key area + 2 for development = 4
Reservations – 2 marks per key point = 8

(35)