

Question 7

Described below are situations which have arisen in three audit clients of your firm. The year end in each case is 31 January 2006.

Hale plc

Hale plc is a company in the telecoms sector which builds and operates national fibre optic networks. During the year, the company incurred costs of £8.5 million in respect of repairs and maintenance to its networks. These costs have been capitalised and included in fixed assets. The directors refuse to make any adjustments in respect of this matter. The pre-tax profit of Hale plc for the year ended 31 January 2006 is £7.2 million.

Simpson Ltd

The stock at the year end includes £240,000 in respect of the cost of items which had been returned by a customer because they were not in accordance with the customer's specification. The directors insist on including the items at cost as the company has an agreement to sell them to another customer for £320,000, following the modification of the items at an additional cost of £140,000. The pre-tax profit of Simpson Ltd for the year ended 31 January 2006 is £2.4 million.

Whale Ltd

In September 2005, Mary Benton was paid £60,000 for services in respect of interior design work at Whale Ltd's head office. Mary Benton is the wife of the managing director (and majority shareholder) of Whale Ltd. The managing director refuses to disclose details of the transaction in the notes to the accounts because of its sensitive nature. The pre-tax profit of Whale Ltd for the year ended 31 January 2006 is £10.4 million.

Required

- (a) Explain why an auditor only offers an "opinion" on the truth and fairness of the financial statements.
(6 marks)
- (b) In respect of the situations outlined above, reach a conclusion on whether or not you would qualify each audit report. Give reasons for your conclusions and describe the nature of the audit qualification (if applicable).
(14 marks)

Total: 20 marks

Question 7

(a) Explain why an auditor only offers an “opinion” on the truth and fairness of the financial statements.

- There are large areas of subjectivity, rather than certainty, within financial statements
 - Where estimates are used e.g.
 - Where there is uncertainty about future events
 - Where there is a choice within accounting policies
 - As to the incidence of fraud or error since internal control systems have limitations
 - Concerning materiality
- The audit is a cost benefit exercise only designed to obtain reasonable assurance
- Thus there is a large amount of judgement involved

1 mark for each bullet point = 8 (max 6)

(b) In respect of the situations outlined, reach a conclusion on whether or not you would qualify each audit report. Give reasons for your conclusions and describe the potential effect, if any, on each audit report

Hale plc

Qualified/adverse 1

Disagreement over accounting treatment 1

£8.5m exceeds pre-tax profits, therefore material 1

Likely to be considered pervasive as capitalisation of repairs and maintenance costs results in reported profit instead of loss

1

Probably an adverse opinion as accounts as a whole may be considered misleading (pervasive)

1

Financial statements do not give a true and fair view ½

Reason and amount stated in opinion paragraph ½

5 marks max (6 possible)

Simpson Ltd

Unqualified 1

Difference between cost and NRV = (£240K - £180K) = £60K 1

Represents 2.5% of pre-tax profits and unlikely to be considered material 1

Unless there are other uncorrected errors 1

4 marks

Whale Ltd

Qualified 1

Disagreement over lack of disclosure 1

Size is irrelevant as related party transaction 1

Except for still give a true and fair view 1

Reason and amount involved stated in opinion paragraph 1

5 marks