

Solutions to Student Self Assessment Questions

Chapter 1

Why are auditors needed?

Questions

1.1 Which of the following people do you think would be suitable to be the auditor of a limited company in your local town?

- (a) The chief accountant of the company, a member of ACCA.
- (b) A shareholder owning 10 per cent of the ordinary shares.
- (c) A shareholder owning 1 per cent of the ordinary shares.
- (d) A member of ICAS, who is employed by a local Building Society.
- (e) A member of ICAEW, a partner in a firm of Chartered Accountants.
- (f) The sales director of the company.
- (g) A German Wirtschaftsprüfer (a Wirtschaftsprüfer is empowered by German law to audit, among other things, public limited companies in Germany).

1.2 Which of the following people do you think would wish to be certain that the financial statements of a major public company had been properly prepared?

- (a) The ordinary shareholders.
- (b) The employees.
- (c) People thinking of buying shares in the company.
- (d) The Inspector of Taxes responsible for the tax affairs of the company.
- (e) A member of the public.
- (f) A supplier of goods to the company.
- (g) The government
- (h) The council of the local Stock Exchange.

1.3 If Andrew and James in our simple case had said that motor expenses amounted to £4 000, suggest:

- (a) What kinds of expenditure would probably be included in the heading 'motor expenses'.
- (b) How you would satisfy yourself that the amount of each expenditure heading was reasonably accurate.

1.4 Why do you consider that audit might be seen to be necessary in the case of an engineering company whose employees operate dangerous machinery? Suggest appropriate audit objectives, but do not restrict yourself just to financial audit.

Solutions

1.1 A number of people in the list would, on the face of it, be *competent* to carry out the audit of a small limited company in your local town - the members of ACCA, ICAEW and ICAS. Although the Wirtschaftsprüfer would be a competent auditor he or she might not possess the knowledge of local conditions to enable him or her to carry out the job properly. The ACCA member who is chief accountant of the company lacks independence and would, therefore, be rejected. The ICAS member is employed by a Building Society, does not appear to be in practice and may therefore lack recent audit experience. On the whole the best person (of the qualified accountants) to be the auditor would seem to be the member of ICAEW, a partner in the firm of Chartered Accountants.

All the other people (even if they were competent to carry out the work of an auditor) would seem to have an interest in the company in one way or another and would not be

suitable. You may have said in your answer that the independence of the ordinary shareholder owning 1% of the shares would not be threatened and that he or she could, therefore act as auditor. In this case, bear in mind that 1% might represent a large part of personal wealth and that he or she is likely therefore to lack sufficient independence.

1.2 The simple answer to this question is 'all of them'. Let us go through the list one by one and justify this answer:

- (a) The shareholders are the providers of capital and they are entitled to know how successfully the directors have been running the company. The accounts should also aid them to some extent in the decision to hold onto or to sell their shares, although in practice they would be wise to seek further advice before doing so.
- (b) The employees are intimately connected through their employment and rate of pay is likely to be dependent on the success of the company. It would seem, therefore, that they too have an interest in properly prepared accounts.
- (c) These people are potential shareholders and they want to make a decision as to whether to buy shares or not. One of the sources of information available to them will be the company's financial statement so they are clearly interested in those financial statements being properly prepared. Again, it would be wise to seek further information about the company before doing so.
- (d) The starting point of the tax computation of taxable income is the accounting profit before taxation. The inspector is clearly interested in properly prepared financial statements.
- (e) British Telecommunications plc is an important UK company. Its success or failure has a vital bearing on the success of the UK economy and in view of this, all residents of the UK are concerned in the proper preparation of financial statements by the company. (If you are not a resident of the UK, take an example from important companies in your own economy).
- (f) Suppliers of goods to a company are interested in the health of that company; in the short term they wish to be paid for goods supplied; in the longer term to know if the customer is a valuable long-term business partner. The same kind of considerations apply to customers and to competitors, all members of what the Corporate Report refers to as 'the business contact group').
- (g) The Government of any country is concerned with the success or failure of the component parts of the economy. In addition, in so far as governmental statistics are often based on accounting information, it will also be interested in the validity of that information.
- (h) BT is a public limited company and as published accounting information has a direct bearing on the quoted price of shares, the stock exchange has a very clear interest in valid accounting information.

Students should refer to the Corporate Report published by the Accounting Standards Steering Committee in 1975 for a discussion of these matters.

1.3 This is a question that is designed to start you thinking about the audit process. Andrew has stated that the motor expenses amount to £4,000; the duty of the auditor would be to prove that the assertion was a valid one. The first step would be to consider the types of expenditure that would be included under this heading. Suggestions are:

- (a) Vehicle licence fee
- (b) Insurance
- (c) Petrol
- (d) Servicing

Vehicle licence fee and insurance would be quite easily dealt with. An inspection of the relevant invoice, policy or tax disc would readily provide information about the charge to the profit and loss account and the amount of prepayment, if any. If there has been servicing of the lorry during the six-month period, an inspection of invoices would

reveal the amount. It is to be hoped that Andrew has kept the invoices, although his system for recording income would not give us much reason to suppose that he has done this in all instances. This may be particularly the case with regards to petrol. We would have to question Andrew about distances travelled and miles per gallon. Experienced auditors would probably be able to determine whether the figure appeared reasonable or not, although, without more information, it is difficult to say whether they would be able to report that the motor expenses figure was acceptable. However, the above suggestions do give an idea as to how auditors might proceed.

1.4 Companies whose employees operate dangerous machinery are required by law to have proper safety procedures in force. In this case the audit helps to ensure compliance with the law and identifies hazards that aid the protection of employees.

Audit objectives would include:

- ensuring that the company has proper rules concerning the use of the dangerous machinery
- ensuring that the company has training schemes for employees in the operation of the machinery and in the understanding of safety measures, such as protective screens
- ensuring that staff are aware of the procedures to be adopted in the case of accident
- being satisfied that the incidence of accidents is at a minimum.