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UNIVERSITY OF LONDON

279 0093 ZA

BSc degrees and Diplomas for Graduates in Economics, Management, Finance and the Social Sciences, the Diploma in Economics and Access Route for Students in the External Programme

Auditing

Thursday, 18 May 2006 : 10.00am – 1.00pm

Candidates should answer **FOUR** of the following **EIGHT** questions: **ONE** from Section A, **ONE** from Section B and **TWO** further questions from either section. All questions carry equal marks.

PLEASE TURN OVER

SECTION A

Answer **one** question from this section and **not more than** a further **two** questions. (You are reminded that four questions in total are to be attempted with at least **one** from Section B.)

1. 'Labels 4U' is a US-based manufacturing company producing adhesive labels. You are part of a team performing the audit of one of its major subsidiaries in the UK and have been asked to review the purchasing process:
- The manager of the purchasing department has four assistants.
 - Orders for stocks of paper rolls used for production of adhesive labels are dealt with by raising Purchase Orders through the Control System. Some orders are raised by phoning the supplier. Each member of the purchasing department can raise Purchase Orders. Only the purchasing manager has access to, and authority to set up new, or change existing, supplier information.
 - When stocks of paper rolls are received from suppliers, the warehouse team unload the truck and send the Goods Delivery Note to the purchasing department.
 - The purchasing department matches Goods Delivery Notes against open Purchase Orders. Matched deliveries are entered as 'received' electronically in the Control System which automatically closes the open Purchase Order.
 - If a Goods Delivery Note cannot be matched to an open Purchase Order, the purchasing department will investigate whether the error has been caused by the purchasing department or supplier. In the meantime, the warehouse team stores the paper rolls in an open-air holding area adjacent to the warehouse and marks the rolls "Not for production".
 - The purchasing department review suppliers' invoices prior to forwarding them to the Accounts Payable department which records the invoices in the Control System.
 - At month end Accounts Payable staff print a list of unmatched Goods Delivery Notes for an accrual to be set up.

Required:

- (a) Identify control weaknesses in the purchasing process and suggest improvements to the process to remove the weaknesses. **(15 marks)**
- (b) Given your assessment of the quality of the control system, suggest additional audit procedures that could be carried out. **(10 marks)**

2. You are part of an audit team performing the year-end audit for one of the larger subsidiaries (with around 1,000 employees) of Dogs Dinners Inc., a global company, producing pet food in 50 different countries. You note the following in relation to the company's payroll system:

- Once new employees have signed a contract of employment, the Human Resources department notifies the Payroll department by submitting a New Starter Form.
- The Payroll department updates the Payroll Master-File with the New Starter details.
- Only the Payroll Manager can enter employee bank details into the Payroll System.
- Bonus payments and salary increases must be approved by the various department heads and the Finance Director.
- At the month end the Payroll Manager produces a Payroll summary which is saved to a shared network drive. He reviews the total monthly payroll figures and compares these to the previous month's payroll totals looking for unusual variations or discrepancies. He then e-mails the Finance Manager that the Payroll figures are available on the network drive.
- The Finance Manager accesses the network drive and uses the information to make the relevant Payroll journal entries in the General Ledger.
- The Finance Manager reviews the total payroll figure in the General Ledger and compares it to the previous month's figure to ensure that it appears reasonable.
- Details of employees leaving the company are typically notified by line managers to the Human Resources department, but sometimes the employees directly inform the Human Resources of their departure from the company.
- The Human Resources Department completes Leavers forms and forwards them to the Payroll department, who in turn update the payroll system.
- Departmental managers should inform the IT department staff to remove the Leavers' user IDs from the IT system.

Required:

(a) Identify control weaknesses in the Payroll process and recommend controls to remedy these weaknesses.

(12 marks)

(b) Describe substantive tests appropriate for Dogs Dinners payroll.

(13 marks)

3. 'CorpLight' Management Consultants operates in a competitive and fast-changing industry in which it pays to be aggressive and to post continually improving profit figures. Until last year it was audited by a large audit firm but the company ended the engagement after a disagreement. Your audit firm has accepted CorpLight as a new client and the audit partner has asked you to review the **revenue recognition process**. You have found the following:
- New projects are negotiated by Client Managers who are essentially sales people given lucrative incentives to negotiate new projects.
 - Project costs are based on time spent on projects by the client teams. A time entry system is used to allocate time spent by the members of the client teams on client-specific projects.
 - Client Managers tells the Finance Department of each new contract they sign with a client so that a unique project code can be set up. They also tell Finance which of the following three methods of revenue recognition is to be used to account for the project:
 1. Percentage of Completion (POC) – for larger contracts where a fixed fee has been agreed with the client. Revenue is recognised on the basis of actual hours spent to date compared to the total budgeted hours for the whole project.
 2. Time – for open-ended contracts where the client has agreed to be billed based on time spent on the projects by the client teams. Revenue is recognised as time is recorded.
 3. At Completion – for typically smaller projects lasting no more than 2-3 months. Revenue is recognised when a project is completed.
 - At the end of each month, time records entered by Client Teams are uploaded into the General Ledger which calculates the relevant financial statement amounts.
 - The Finance Manager reviews revenue and time for reasonableness by comparing the current month's total revenue to the previous month's total.
 - Client Managers review time recorded on a project, note down any adjustments related to miscoded time, and invoice the client accordingly.

Required:

- (a) Identify the procedures which your firm should conduct both before accepting the engagement and, having accepted the engagement, before any audit work can be started.
- (10 marks)**
- (b) Identify general risk factors and control risks in its revenue process which you consider to be relevant in planning your audit of CorpLight.
- (15 marks)**

4. You are carrying out the external audit of Lanson Demolition Company Limited. The Audit Manager to whom you report has asked you to obtain a Letter of Representation from the management of Lanson Demolition.

Required:

- (a) Explain why auditors should obtain Letters of Representation from management and list the matters commonly included in Letters of Representation. **(12 marks)**
- (b) Explain why it is important to discuss the content of the Letter of Representation at an early stage during the audit and explain what actions an external auditor can take if management refuse to sign a Letter of Representation. **(13 marks)**

SECTION B

Answer **one** question from this section and **not more than** a further **two** questions. (You are reminded that four questions in total are to be attempted with at least **one** from Section A.)

- 5.
- (a) In relation to financial statements briefly describe the meaning of fraud and error. **(4 marks)**
- (b) “An auditor is responsible for detecting material errors, but has no responsibility to detect fraud that is concealed through employee collusion or management override of internal control”.
- Critically evaluate the validity of this comment. **(9 marks)**
- (c) Describe three types of management fraud and how they might be detected by external auditors. **(6 marks)**
- (d) Describe three types of employee fraud and how they might be detected by external auditors. **(6 marks)**
6. Provide a critical analysis of the main lessons which auditors should learn from decided cases involving alleged negligence.
7. “The audit report is the only visible sign that an audit has been conducted.” Discuss the various messages contained in a standard auditors’ report and any indications of the limitations of what may be expected of auditors.
- 8.
- (a) Explain the concept of materiality and how it impacts on the planning, conduct and reporting of an audit. **(10 marks)**
- (b) Consider the various matters to be taken into account by auditors when determining whether or not a misstatement in a company’s financial statements is material. **(10 marks)**
- (c) Explain the distinction between overall planning materiality and tolerable error. **(5 marks)**

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