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UNIVERSITY OF LONDON **279 0093 ZB**

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.

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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. Firenz PLC is an old, established family-owned company which for many years operated solely as a builders' merchant. Three years ago a new chief executive officer was appointed. Under his direction, Firenz branched into other fields by acquiring other companies in the property development, building and estate agency businesses. The expansion was financed largely through extensive bank borrowing secured on company property and other assets. Various banks were willing to lend money on the strength of apparently ever-increasing profits and prospects.

   Firenz is the biggest audit client of Confrere and Partners, Chartered Accountants, whose senior partner, Stella Mathison, has ordered a review of the audits of all companies in the Firenz Group as part of a quality control exercise. The review reveals:

   - In one subsidiary, a builders' merchant, the stock take was held two months prior to the year-end. Confrere's staff attended that stock take but has relied on management representations and a basic review of gross profit margins and stock turnover ratios as audit evidence.
   - In one construction company, the auditors noted that the manager in charge of ordering supplies never put work out to competitive tender and always used the same few suppliers of building materials. This contravened Firenz group instructions and had been brought to the attention of the subsidiary's board in the annual management letter. Nothing seems to have been done as a result. The auditors also noted that the manager appeared to own more than one luxury car; in answer to discreet enquiries, he explained that his cars were financed through his luck on betting on horse races.
   - One subsidiary holds land for development. This company is highly geared. The audit team had asked to see the title deeds of certain properties but were informed that the deeds were held by a related company, the estate agent arm of the group. The audit team requested and received confirmation of the other company's possession of the title deeds.
   - One subsidiary had been set up to lend to house purchasers who could not get mortgages from High Street lenders. This company makes unsecured loans to customers at high interest rates. The audit team noted that a number of customers were several months in arrears but that the company had made no provision for doubtful debts. The audit partner had discussed this issue with Mathison and together they had devised a form of wording for qualifying the auditors' report. The wording included the phrase "The performance of certain finance debts will become clearer with the passage of time".

   Required:
   Based on your knowledge of auditors' liability, consider the likely legal position of Confrere and Partners in relation to each of the above situations.

2. Expo plc is an established manufacturer of hand-held computers. In 2004, the company was taken over and a new management team installed with an aggressive profits-based bonus scheme. The new management pursued an expansion plan financed partly through new share issues leading to the introduction of a new state-of-the-art model in December 2005. Supported by a major advertising campaign and a one-year money-back guarantee, the model quickly became very popular. Expo sub-contracts production to overseas manufacturers. The company accounts for sales on the date they are delivered to retailers. No provision is made for returns because a very small number of claims have been made under the guarantee. The company no longer monitors the number of machines being returned for refund. A summary of Expo plc's financial statements:

Profit and loss accounts for the year ended 31 March

	Audited 2003 £m	Audited 2004 £m	Audited 2005 £m	Draft 2006 £m
Sales	60	75	110	130
Opening Stock	10	15	20	25
Purchases	45	55	90	105
Closing Stock	(15)	(20)	(25)	(50)
Cost of Sales	40	50	85	80
Gross Profit	20	25	25	50
Salaries	10	12	12	24
Other overheads	7	8	8	16
Net profit before dividends	3	5	5	10

Balance sheets at 31 March

	Audited 2003 £m	Audited 2004 £m	Audited 2005 £m	Draft 2006 £m
Fixed Assets	20	20	30	40
Stock	15	20	25	50
Debtors	10	12	40	70
Cash/(Overdraft)	2	0	(25)	(50)
Creditors	(17)	(19)	(25)	(35)
Net Assets	30	33	45	75
Capital	25	25	35	60
Retained Profit	5	8	10	15
	30	33	45	75

Required:

From the information given, identify factors which may influence the auditors in planning their audit of the financial statements for the year ended March 31, 2006.

3. Hazer Ltd. is a family-owned, manufacturing company that produces transformers for the electronics industry. The company has expanded considerably over the past few years. The directors are major shareholders and are seeking a public flotation in two years' time. They have appointed your firm in place of the small audit firm which had done the audit for the last twenty years. You are currently conducting a systems review process, documenting the company's systems and conducting walk-through tests. During the year ended 31 March 2006, Hazer Ltd. purchased over £2 million of equipment under a 'special fixed asset ordering system' described below.

Budgets
Each year the directors allocate to department heads a budget to which they are expected to adhere. Orders in excess of £30,000 must be approved by a director. Department heads complete a purchase requisition form which is forwarded to the purchasing department.

Purchasing Department
When a purchase requisition form is received, a buyer selects an appropriate supplier by searching supplier catalogues on file and then telephones the supplier to request a price. A verbal order is then placed. A pre-numbered purchase order is raised. One copy is sent to the supplier, one to the requisitioning department, one to the goods inwards department and one to accounts payable. The original document is then filed by the purchasing department in the open requisition file. When the goods inwards department informs the buyer that their item has been received, the buyer transfers the purchase order from the open requisition file to the filled orders file.

Goods Inwards
When goods are received, the receiving clerk stamps the purchase order with the date received and notes on the order any differences between the quantity ordered and quantity received. The receiving clerk files the purchase order and verbally notifies the head of the requisitioning department and purchasing department that the goods have been received.

Accounts Payable
On receipt of a purchase order, the accounts payable clerk files it in an open orders file. Suppliers' invoices are matched with the relevant purchase order and approved for payment by the clerk. Invoices so approved are filed in order of due date; at the due date a cheque is raised and forwarded to the Finance Director for signing.

Finance Director
Cheques in excess of £10,000 must be signed by two directors (all directors are bank signatories), otherwise they are signed by the Finance Director or Chief Accountant.

Required:

(a) Identify and describe the internal control weaknesses relating to purchases and payments of 'special fixed asset orders'.

(13 marks)

(b) Suggest appropriate controls to address weaknesses identified in part a) above.

(6 marks)

(c) Identify any other factors that the auditors should take into consideration when planning the audit for 2006.

(6 marks)

4. You are the auditor of Green Goddess Ltd. a company formed to make the most of consumers' growing awareness of environmental issues. The company manufactures soaps and detergents using only environmentally-friendly ingredients. This has become the major selling-point of the products and it appears to have been paying off in terms of winning market share. However, the company has started to attract some unwelcome attention from an investigative journalist who is looking behind the company's product and into the way the company operates generally.

The directors have been aware for some time that they could be doing more to make the company itself more environmentally-friendly but have been focussed on promoting their new products. They now feel that they will have to start to change other aspects of the company's operations.

The company operates from a factory built in the 1960s on the outskirts of a provincial city. The location was ideal, although the factory is not purpose-built, because it is near a river into which the waste is pumped once it has been cleaned to meet the minimum standards of the Environment Protection Agency. In addition there is a large vacant lot nearby which the company rents and uses as a car park for employees' cars and its fleet of 10 delivery trucks. Nearly all 100 employees drive to work as there is no bus route.

The administrative functions, such as personnel, accounts and sales departments, are based in the same premises and, although there is a strong corporate culture concerning environmental awareness, most of the attention has been focussed on the physical manufacture of the company's products. However, each room has a sticker near the door encouraging the last one to leave to turn out the light.

The directors, worried about the financial impact of bad publicity, have instructed the accounts department to organise an environmental audit covering all the company's operations.

Required:

(a) Outline the main elements of an approach to an environmental audit. **(8 marks)**

(b) Identify the extent (including limitations) to which the skills and experience of financial statements auditors may be useful in performing an environmental audit. **(7 marks)**

(c) From the brief details given above, suggest areas of the company's operations where the company might be able to reduce its impact on the environment. **(10 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. "Auditors should not be held liable for tracking down ingenious schemes of fraud committed by trusted servants of the company."

   Critically evaluate the extent to which you consider that this view corresponds with the public's perceptions of the role of the company auditor and assess whether such a view is justified in the modern context.

6. Discuss the extent to which external auditors may rely on the work of internal auditors during the course of an audit of financial statements.

7. Consider the various issues to be considered in formulating the auditors' report on financial statements and provide an analysis of the key elements of the auditors' unqualified report.

8. Explain the extent to which you consider that it is important for auditors not only to be independent but also to appear to be independent and critically evaluate the likely effectiveness of the methods proposed by the profession's critics for improving both real and apparent independence.

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