Answers

1 (a) Briefing notes

To: Audit team
Regarding: Principal audit risks relating to the consolidated financial statements of the Grissom Group, for the year ending 30 June 2010.

Introduction
These briefing notes summarise the principal audit issues for the consolidated financial statements of the group. There are three subsidiaries in the group and several other investments. The notes consider the audit issues company by company, and other issues which are relevant to the whole group.

Grissom Ltd

Non-controlling interests
The first risk is an inherent risk that the investments have been inappropriately classified as associates. According to FRS 9 *Associates and joint ventures*, an investment should only be classified and accounted for as an associate if the reporting entity exercises significant influence over financial and operating policy decisions, in which case equity accounting should be used to measure the investments in the group balance sheet. The risk is that the investments have been classified and accounted for incorrectly. If Grissom Ltd cannot demonstrate the exercise of significant influence, then the investments should be treated as trade investments, and would not be consolidated. Alternatively, the substance of the interest in these companies could be a joint venture, if control is shared between Grissom Ltd and the other investors.

A second issue raised by the diversification away from the group's normal activities is that the group's finance team may not have sufficient experience in these two new areas, for example, there may be a risk that they have insufficient knowledge to know how to correctly recognise and defer the revenue for a travel agent.

In addition, a detection risk arises from the activities of the non-controlling interests. They represent a departure from the other activities of the group, and our firm may have little experience or knowledge of travel agencies and pet shops. This means that we may fail to identify risks of material misstatement relating to the amounts included from these investments in the consolidated financial statements.

Bonus and changes to accounting estimates
The directors receive a bonus based on group profit before tax. This leads to inherent risks of overstatement of income and/or understatement of expenses. The directors will want to maximise profits due to their financial interest in the group's results, which could lead to the manipulation of profits to achieve a desired bonus. The fact that the finance director left following a disagreement could indicate that the changes to accounting estimates were inappropriate. The estimates could have been changed as part of an earnings management strategy.

Changes to accounting estimates can represent a high risk of material misstatement. FRS 18 *Accounting policies* requires that changes to estimates are accounted for prospectively rather than retrospectively. There is a risk that management has confused changes to estimates with changes in policies, which require a retrospective accounting treatment.

No group finance director
The lack of a group finance director increases inherent risk and control risk. A group finance director should be in place, in order to ensure that group accounting policies are adhered to throughout the production of the consolidated financial statements. It is much more likely that a material misstatement could occur during the consolidation process if there is no one overseeing it. Errors are more likely to occur, and to remain undetected, as the group finance director should exercise a supervisory control over the whole consolidation process.

Willows Ltd

Dismantling costs
According to FRS 15 *Tangible fixed assets*, the cost of an asset should include the estimated costs of dismantling and removing the asset (also known as decommissioning costs) if there is an obligation to incur the cost at the end of the life of the asset. A provision should also be recognised as a creditor falling due after more than one year. FRS 12 *Provisions, contingent liabilities and contingent assets* contains criteria that must be met in order to recognise a provision. The requirement contained in the planning permission creates an obligation leading to a probable outflow of economic benefit, and the construction of the factory is a past event.

The risk is that the decommissioning cost has not been capitalised as part of the asset, in which case the asset is understated, and the other side of the entry will be missing, leading to incomplete provisions. In addition, the depreciation expense would be understated.

Even if the costs have been recognised, there are specific rules regarding the measurement of the amount recognised, which should be discounted to present value. There is risk that the calculation has not been carried out correctly, for example, using the incorrect discount factor. Furthermore, a finance charge should be recognised each year to reflect the unwinding of the discounted provision. The risk is that the charge has not been made, or has been measured incorrectly.

Hodges Ltd

Grant received
SSAP 4 *Accounting for government grants* states that grants should be recognised in profit over the useful life of the related asset. This means that the income should be deferred, and recognised as income over the estimated useful life of the packing lines, beginning in February 2010. The risk is that the income has been immediately recognised in full, overstating profit for the year, which would help the directors to maximise their bonus.

Tutorial note: Under SSAP 4 and the Companies Acts 1963 to 2009, the grant should be presented on the balance sheet as deferred income. Deducting the grant in arriving at the asset's carrying value is considered unlawful under UK & Irish GAAP.

Secondly, there is a condition attached to the grant. If Hodges Ltd fails to meet the environmental targets, the grant may have to be repaid, partly or in full. If this is the case, a provision should be recognised for the potential repayment (or a note should disclose a contingent liability in the case of a possible repayment). The risk is a potential understatement of provisions if the target has not been met.

Identifying whether the company has defaulted from the conditions of the grant poses a risk in itself, as it may be difficult for the audit firm to obtain sufficient evidence on this matter, other than a written management representation or reliance on third party reports.

Brass Co

Mid-year acquisition
Brass Co was acquired part way through the accounting period. Its results should be consolidated into the group profit and loss account from the date that control passed to Grissom Ltd. The risk is that results have been consolidated from the wrong point in time. Given the directors' incentive to maximise group profit, the results may have been consolidated from too early a point in time if Brass Co is profitable.

Goodwill on acquisition
The goodwill on acquisition should be calculated according to FRS 7 *Fair values in acquisition accounting*. The calculation is inherently risky due to the need for significant judgements over the fair value of assets and liabilities acquired. There is also risk that not all acquired assets and liabilities have been separately identified, measured and disclosed. Risks are heightened due to the overseas location of the company, meaning that estimations of fair value may be more complex and subjective.

Retranslation of Brass Co's financial statements
The company's functional and presentational currency is local, and different to the rest of the group. Prior to consolidation, the financial statements must be retranslated, using the rules in FRS 23 *The effects of changes in foreign exchange rates*. The assets and liabilities should be retranslated using the closing exchange rate, income and expenses at the average exchange rate, and exchange gains or losses on the retranslation should be recognised in group equity. This is a complex procedure, therefore inherently risky, and the determination of the average rate for the year can be subjective.

The goodwill intangible asset must also be calculated using the closing exchange rate, which is effectively treated as a revaluation. The risk is that this retranslation has not occurred, and that goodwill remains at historic cost.

Adjustments necessary to bring in line with group accounting policies
Brass Co does not use the same financial reporting framework as the rest of the group, as its accounts are prepared using the local accounting rules of Chocland. The company's financial statements must be adjusted to align them with group accounting policies. This will require considerable expertise and skill, and combined with the absence of a group finance director, the risk of errors is high.

Intra-group transactions
The trading transactions between Brass Co and Willows Ltd must be eliminated on consolidation. The risk is that the intra-group elimination is not performed, resulting in overstated revenue and operating expenses at group level (and debtors and creditors if any amounts are outstanding at the year end).

In addition, for any items remaining in stock which contain unrealised profit, a provision for unrealised profit must be made. If this adjustment is not carried out, stock and group profit will be overstated.

Conclusion
Due to the many factors described in these notes the audit of several material components of the consolidated financial statements is relatively high risk. However, the consolidation of Grissom Ltd, Willows Ltd and Hodges Ltd is relatively low risk, as our firm has audited the consolidated financial statements for several years, and those companies all use the same reporting framework, report in the same currency, and have the same year end.

(b) ISA 600 (UK and Ireland) *Special Considerations – Audits of group financial statements (including the work of component auditors)* provides guidance on the factors that should be considered in relation to the work of component auditors. Sidle & Co audit a significant component of the group. ISA 600 requires that the group engagement team obtains an understanding of the component auditor when it plans to request the component auditor to perform work on the financial information of a component for the group audit.

Tutorial note: 'Component' is defined as an entity or business activity for which financial information is included in the group financial statements. In this scenario, Brass Co is a wholly owned subsidiary, so meets the definition of a component. Sidle & Co, the auditors of Brass Co, are component auditors using the ISA 600 terminology.

Ethical status
The first factor to be considered is the ethical status of the firm, particularly independence. According to ISA 600, the component auditors are subject to the same ethical requirements that are relevant to the group audit. This means that because Vegas & Co, the group audit firm, is bound by IFAC's *Code of Ethics for Professional Accountants*, ACCA's *Code of Ethics and Conduct*, and the APB's *Ethical Standards*, then Sidle & Co is bound by the same ethical rules, irrespective of the ethical code that exists in Chocland.

If the ethical rules and principles are found to be less stringent in Chocland, then less reliance can be placed on the work of Sidle & Co. This is because there may be doubts over the objectivity and integrity of the audit firm, and also over its competence to conduct the audit.

Qualifications and professional competence
The professional competence of Sidle & Co must be considered. The auditors' qualifications may not be of the same standard as those of Vegas & Co. The quality of their work could therefore be questionable.

In addition, the auditors at Sidle & Co may not have the necessary skills or resources to be involved in a group audit. For example, the group audit team may instruct Sidle & Co to perform work necessary for the group audit, such as verification of related parties, or fair value measurements. The firm may not have previous experience in these matters, and indeed may not have been involved in a group audit before.

ISAs are not followed in Chocland, meaning that the audit work conducted may be less rigorous than expected. This means that audit evidence gathered may not be sufficient to support the group audit opinion.

Monitoring
There should be consideration of whether Sidle & Co operates in a regulatory environment that actively oversees and monitors auditors. This would enhance not only the firm's ethical status, but also adds credibility to its competence.

Audit Evidence
There should be an evaluation as to whether the group engagement team will be able to be involved in the work of the component auditor to the extent necessary to obtain sufficient appropriate audit evidence on material matters.

Procedures could include:

- Obtaining and reviewing the ethical code followed by audit firms in Chocland, and comparing it to codes used by Vegas & Co.
- Obtaining a statement from Sidle & Co that the firm has adhered to any local ethical code and the IFAC Code.
- Establishing through discussion or questionnaire whether Sidle & Co is a member of an auditing regulatory body, and the professional qualifications issued by that body.
- Obtaining confirmations from the professional body to which Sidle & Co belongs, or the authorities by which it is licensed.
- Determining through discussion or questionnaire whether Sidle & Co is a member of an affiliation or network of audit firms.
- Discussion of the audit methodology used by Sidle & Co in the audit of Brass Co, and compare it to those used under ISAs (e.g. how the risk of material misstatement is assessed, how materiality is calculated, the type of sampling procedures used).
- A questionnaire or checklist could be used to provide a summary of audit procedures used.
- Ascertaining the quality control policies and procedures used by Sidle & Co, both firm-wide and those applied to individual audit engagements.
- Requesting any results of monitoring or inspection visits conducted by the regulatory authority under which Sidle & Co operates.
- Communicating to Sidle & Co an understanding of the assurances that our firm will expect to receive, to avoid any subsequent misunderstandings.

(c) (i) Audit procedures on classification of non-controlling interests:

- Determine the percentage shareholding acquired, using purchase documentation, legal agreements, etc.
- Confirm that the percentage shareholding is within the normal range for an associate i.e. between 20% and 50% of equity shares.
- Obtain a list of directors (using published financial statements, or a Companies Registration Office Search) for the companies to confirm whether Grissom Ltd has appointed director(s) to the boards.
- Discuss with the directors of Grissom Ltd their level of involvement in policy decisions made at the companies.
- Obtain a written representation detailing the nature of involvement and influence exerted over the companies (for example a letter from the investee's board of directors confirming the voting power of Grissom Ltd).
- Consider the identity of the other shareholders and the relationship between them and Grissom Ltd. This may reveal that the situation is in substance a joint venture and would need to be accounted for as such.

Tutorial note: as the non-controlling interests are not audited by your firm, it is not appropriate to expect to see books and records maintained by those companies, such as minutes of directors' meetings.

(ii) Audit procedures on the condition attached to the grant received by Hodges Ltd:

- Obtain the grant document and review the terms, to verify that a 25% reduction is stated in the document.
- Determine over what period the 25% reduction must be demonstrated e.g. must it be achieved by a certain point in time and sustained for a certain period.

– Review the terms to establish the financial repercussions of breaching the condition – would the grant be repayable in full or in part, and when would repayment be made.
– Obtain documentation from management showing the monitoring procedures that have been put in place regarding energy use.
– Identify how the energy efficiency is monitored – internally, or through third party inspection and confirmation.
– Review the results and adequacy of any monitoring that has taken place before the year end to see if the condition has been breached (for example, compare electricity meter readings pre and post installation of the packing line to confirm reduced levels of electricity are being used).
– Discuss the energy efficiency of the packing lines with an appropriate employee to obtain their views on how well the assets are performing.

2 **(a)** Benefits to Mac Ltd of outsourcing the internal audit function

Quality

The service provider will have good quality staff with experience of financial reporting, auditing techniques and commercial and business awareness. This will enhance the credibility and efficiency of the work they are performing. Lindsay, being only recently qualified, may have limited experience, and the more junior members of her team who are studying for their professional examinations may not be technically competent in all of the areas that the internal audit team are responsible for.

Authority/status

Lindsay comments that many of her recommendations are ignored. This may be because she is seen to lack status and authority within the company, as she was a junior manager before heading the internal audit function, and because she is recently qualified. If the recommendations come from an independent source, which has authority and is supported by senior management, they are more likely to be followed. The current team lacks independence as they are employees who report to the finance director. The team may be reluctant to overly criticise the operations of the finance function.

Resources

It appears that Mac Ltd's internal audit function is currently under-resourced, as there are only three people to provide internal audit for a growing company, with multiple locations. Outsourcing the function will allow an immediate increase in the resource base, meaning that more work can be quickly performed e.g. the investigation into fraud can commence immediately.

Focus/range of work

From Lindsay's comments, it seems that the team currently lacks a consistent focus. They are directed by the finance director, who has changed the focus from financial reporting controls to operational controls, and it seems the team is too small to do both. Outsourcing the function will provide as many staff as necessary (cost permitting) to cover a range of activities. Also, the team will be better focused and be able to prioritise objectives from an independent point of view.

Reallocation of staff

Lindsay and the rest of her team can be reallocated to other parts of the business. The finance team may benefit from extra resources if the company continues to grow. Internal controls are more likely to become embedded in the organisation as the finance function will have more knowledge and experience of developing and implementing controls.

Tutorial note: Credit will be awarded for discussion of other, relevant benefits, e.g. Flack & Co employees may be more technically up-to-date, can bring new technology to the internal audit function, a stronger internal audit function may serve as a preventative and detective control to make frauds less likely in the future.

(b) Impact of outsourcing on the external audit

The external audit providers, Manhattan & Co should assess the impact of the outsourcing arrangement by reference to ISA 610 (UK and Ireland) *Using the work of internal auditors*, and ISA 402 (UK and Ireland) *Audit considerations relating to an entity using a service organisation*. The ISAs require that the auditor determines the significance of the service organisation's activities to the client, and the relevance to the audit.

Manhattan & Co should consider the extent of reliance they may wish to place on the work of Flack & Co. It is likely that more reliance will be placed on internal audit than previously, which should increase the efficiency of the external audit. The fees charged by Manhattan & Co could be affected by this. As Mac Ltd is short of cash, the fee could be an important consideration for the company.

The internal auditors may suggest changes to accounting systems and controls. When these changes occur, the external audit firm will need to document and evaluate the new procedures, which may be time consuming. (It could be argued that new systems and controls could reduce the reliance placed on them.)

The control environment is likely to be improved over time. This means that Manhattan & Co should reassess their audit strategy, which will probably mean a reduction in the extent of substantive procedures that need to be carried out.

Manhattan & Co will need to consider access to records and working papers held by Flack & Co, as information relevant to the external audit, especially in relation to the testing of controls are likely to be held by the service provider.

(c) Procedures to quantify the financial loss

– A review of the procedure for adding to the approved suppliers list, to help identify how many suppliers have been added by the account manager.

– A review of the payments approved by the manager, and a comparison of the suppliers paid on his approval to the list of approved suppliers. This will help to identify any unapproved suppliers paid, and the amounts paid to them.

– Computer-assisted audit techniques could be used to identify any suppliers with the same bank account details as the account manager, and then to trace payments made to them.

– Review the completeness of supplier statements compared to a list of suppliers paid, as fictitious suppliers will not have supplied a statement.

– For each supplier, an invoice received could be selected, and details traced back to a signed order/delivery note/service or time sheet for services provided. If none of these can be found, the invoice and supplier is likely to be fictitious.

– A review of the terms of any insurance cover that Mac Ltd has taken out to cover instances of fraud. Any potential reimbursement will reduce the loss suffered by the company.

– A discussion with management and the gardai and solicitors (assuming management has reported the fraud) to ascertain if any of the amount stolen could be reimbursed by the account manager, in the event that he is prosecuted successfully.

(d) Report to: Danny and Stella Hudson
Content: Responsibilities in respect of fraud
Audit committees: benefits and drawbacks

Introduction
This report has been requested by Danny and Stella Hudson. The objective of the report is to compare the responsibilities of the external auditor and of management in relation to the detection of fraud, and also to outline the benefits and drawbacks for Mac Ltd of establishing an audit committee. The company is not required under relevant regulations to establish an audit committee; however, we understand that disclosures pertaining to the existence of an audit committee are recommended to be included in the annual report.

(i) Responsibilities of external auditors and management in relation to the detection of fraud.
The external auditor must comply with the requirements of ISA 240 (UK and Ireland) *The auditors responsibilities relating to fraud in an audit of financial statements*. ISA 240 also comments on the responsibilities of those charged with governance and of management.

ISA 240 makes it clear that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance and management of an entity. By establishing a sound system of operational and financial controls, management should reduce opportunities for fraud to take place, and establish a culture which should persuade individuals not to commit fraud due to the likelihood of detection and punishment. In some jurisdictions, codes of corporate governance require specific actions to be taken in respect of internal controls by management. The external auditor may provide recommendations and advice on the improvement of internal controls, but it is not their responsibility to put the recommendations into practice.

The auditor's responsibility is to consider the risk of material misstatement in the financial statements due to fraud. This means that the auditor is more focused on fraud that impacts on the accounts than on operational fraud which may not cause a material misstatement. A fraud with an immaterial impact may not be detected by audit procedures. Because the external auditor will use sampling techniques based on a level of materiality, not all balances and transactions will be subject to detailed testing, so small frauds are not likely to be detected. This is possibly why the fraud relating to supplier payments has remained undetected.

A similarity is that both management and the external auditor should assess the strength of controls in place within the entity, and in doing so, evaluate the likelihood of a fraud occurring. The auditor will perform this evaluation while planning the audit. Corporate governance codes state that management should continually be monitoring the strength of the entity's control environment and systems.

(ii) Benefits and drawbacks of an audit committee
Improved credibility of the financial statements should result from the various activities of the audit committee, particularly from their impartial review of the financial statements, and their discussion of significant issues with the external auditors. The external auditor's opinion will also attract more confidence, as it will be transparent that the audit committee has monitored the independence of the auditors.

A stronger control environment will be encouraged by the presence and actions of an audit committee. The fact that the internal audit function would report to the committee, rather than to the finance director, as is currently the situation, strengthens their independence within the company, and should add weight to their recommendations, which currently are sometimes ignored. A stronger emphasis on controls will help the smooth running of the business and hopefully reduce business risks, as well as opportunity for fraud.

This improved credibility and control environment could be important for a large and growing private company like Mac Ltd for a number of reasons. Mac Ltd appears to be short of cash, and in the event of raising finance, it will be easier and possibly cheaper to raise finance if there is a perception of good governance created by the presence of an audit committee.

In addition, management may decide at some point in the future, to achieve listed company status. It is a component of the UK's listing requirements that a company has an audit committee, or at least evaluates the need for such a committee. If Mac Ltd already has an audit committee established, it will be easier to meet listing requirements in the future.

The audit committee should also bring valuable skills, knowledge and expertise to the company. The committee would comprise non-executive directors, who will have a variety of business backgrounds and will be independent. The executive directors should view the members of the committee as a sounding board, which can provide impartial advice and guidance to the executive directors. In a family-owned and managed company like Mac Ltd, this source of external experience could prove invaluable. Also it will enable the executive directors to devote their attention to management.

However, it can be difficult to recruit appropriate members to the committee. In practice, there are few people with the relevant skills and experience who are also independent of the company, who have the time to devote to their role as a member of the committee. This could be a problem for Mac Ltd, whose business activities are quite specialised. But, with appropriate advertising and by offering a reasonable fee, it should be possible to recruit some non-executive directors with experience in the hospitality business.

This then links to the final downside, which is expense. The audit committee members should expect to receive a fee commensurate with their level of experience and knowledge, so the fees may be significant. This could be an issue for Mac Ltd due to its cash flow problem.

Conclusion

This report has indicated that establishing an audit committee can bring valuable benefits to an organisation, as a result of the varied responsibilities of the members of the committee. Certainly for Mac Ltd, which appears to have a fairly weak control environment, the committee could help to establish some much-needed discipline. However, the difficulties and costs of setting up an audit committee should be assessed before a final decision is made.

3 (a) Should auditors be blamed when a company fails?

The recent economic crisis has led to a number of high profile company collapses. This usually results in an examination of the role of the company's auditors, and a discussion of whether the audit firm should have spotted the going concern problems, and warned stakeholders of the issues.

Looking at the first part of the statement, this asks whether auditors should accept some of the blame when their client firm fails. This suggests that the auditor is in some way at fault, and has helped to contribute to the failure of a business. It is the responsibility of management to ensure proper risk assessment and risk management is conducted in a business. Although in some jurisdictions the auditor performs an assessment of risk management procedures, this is not the fault of the auditor if such procedures are inadequate and contribute to the collapse of a company.

Tutorial note: Credit will be awarded here for discussion specific to jurisdictions where the auditor attests to risk management procedures, and also for discussions on the recent proposals that audit firms should specifically comment on this in their report.

However, it is fair to say that auditors have a responsibility to gain an in-depth understanding of their client's business, including the environment in which it is operating. This means that the auditor should at the very least be aware of going concern problems, and are in a position to alert management to problems that they may have overlooked. But it remains the responsibility of management to deal with such problems.

One of the features of the recent economic crisis, which has resulted in the failure of many companies, is the speed at which the crisis deepened. The auditor, when assessing going concern status, does not have a crystal ball, and cannot be expected to foresee situations in the future which may impact the survival of their client's business. Especially in a speedy economic downturn it is unfair to criticise the auditor's view of going concern status at a year end.

The issue may be one of misunderstanding – the so-called expectation gap. The general public perceive the role of the auditor to be much wider than just providing an opinion on the financial statements. The expectation is that auditors provide advice on business strategy, and so should take some of the responsibility when the business fails. This indicates that the public do not understand the importance of the independent status of the auditor, and that the auditor must not take on the role of management.

There may of course be situations in which an audit firm has not acted appropriately, for example, in not challenging the management on matters having a significant impact on the financial statements, or failing to detect frauds which have a material impact on the financial statements. In such cases the auditor may indeed be partly to blame if the company subsequently collapses.

The second part of the statement asks whether the auditor should do more to warn stakeholders about going concern issues. It could be argued that it is the responsibility of management to make such warnings, and in fact, financial reporting standards require a lot of disclosure about concentrations of risk. In particular FRS 29 *Financial instruments: disclosures* requires detailed notes to the accounts describing and providing details on concentrations of certain risks. So, a lack of disclosure may not be the critical issue. The problem is more likely to be that readers of financial statements do not have the financial awareness to understand these disclosures. The auditors cannot be blamed if users of financial statements are not sufficiently financially literate to be able to understand such disclosures.

Auditors highlight significant going concern problems using an emphasis of matter paragraph within the audit report. This means that problems should be clearly highlighted for users of the accounts. Perhaps more could be done to make any such disclosures as transparent as possible, which would aid users' understanding of going concern problems. In addition, shareholders' meetings could be used more often as a vehicle for the auditor to raise concerns with shareholders. Auditors, however, may be reluctant to voice concerns in such a forum, and may be put under pressure from management not to speak out.

To conclude, it would seem unfair to make auditors take some of the blame for the failure of a company, when it is explicitly the role of management to safeguard the company and manage its risk exposure. However, auditors could be more proactive in highlighting going concern problems through the various channels available to them, i.e. through highlighting matters within the audit report, and through contact with shareholders at general meetings of the company.

(b) **(i)** ISA 570 (UK and Ireland) *Going concern* states that an inability to obtain financing for essential new product development or other essential investments is an indicator which may cast doubt on an entity's ability to continue as a going concern.

The receipt of the loan is of huge significance for the financial statements and for the audit, as if it is not received, the company may not continue in operational existence. This will then impact on the fundamental basis of preparation of the financial statements using the going concern concept. The auditor must ensure that sufficient, appropriate evidence is sought regarding the finance.

If there is any doubt over the receipt of the loan and therefore the going concern status of Juliet Ltd, the financial statements should contain a note to explain the significant uncertainty over the future of the company. The audit report should contain an emphasis of matter paragraph (in accordance with ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report*), which discusses the uncertainty and refers to the note in the financial statements. If the note is not provided then a qualification of the audit opinion will be necessary due to lack of disclosure leading to a disagreement over the preparation of the financial statements.

However, the bank may be reluctant to provide confirmation that the loan will be advanced to Juliet Ltd. This could be due to the bank itself facing going concern threats, forcing it to severely restrict the amount and type of lending offered. Or, the bank may have a policy not to confirm to their customers or to auditors that lending facilities will be made available.

The fact that the company's assets are impaired in value may reduce the likelihood of the loan being advanced, as there is little for Juliet Ltd to offer as security for the amount advanced.

In the event of the bank not offering the loan to Juliet Ltd, alternative providers of finance could be approached. So it is not automatically the case that a refusal from the bank to offer the loan means that Juliet Ltd is unable to successfully restructure.

Even if the loan is received, Juliet Ltd may face significant threats to its going concern status, due to cancelled customer contracts and bad debts. The audit firm must be extremely thorough in its going concern review, and not just assume that the receipt of the loan would guarantee the future of the company.

Procedures:

– Obtain and review the forecasts and projections prepared by management and consider if the assumptions used are in line with business understanding.
– Obtain a written representation confirming that the assumptions used in the forecasts and projections are considered achievable in light of the economic recession and state of the automotive industry.
– Obtain and review the terms of the loan that has been requested to see if Juliet Ltd can make the repayments required.
– Consider the sufficiency of the loan requested to cover the costs of the intended restructuring.
– Review the repayment history of any current loans and overdrafts with the bank, to form an opinion as to whether Juliet Ltd has any history of defaulting on payments. (Any previous defaults or breach of loan conditions makes it less likely that the new loan would be advanced).
– Discuss the loan request with the company's bankers and attempt to receive confirmation of their intention to provide the finance, and the terms of the finance.
– Discuss the situation with management and those charged with governance, to ascertain if any alternative providers of finance have been considered, and if not, if any alternative strategies for the company have been discussed.
– Obtain a written representation from management stating management's opinion as to whether the necessary finance is likely to be obtained.

(ii) Ethical and other implications

In Juliet Ltd's case, the cash flow forecast will be used by the bank as part of its lending decision, so the forecast is crucial to the future existence of the company. Advising on the cash flow forecast is effectively a non-audit service that has been requested.

ISA 570 states that one of the procedures that should be performed when there is doubt over going concern status is analysis and discussion of cash flow, profit and other relevant forecasts with management. Further, when analysis of cash flow is a significant factor in considering the outcome of events, the auditor should consider the reliability of the company's information system for generating the cash flow information, and also whether there is adequate support for the assumptions underlying the figures.

The issue is that a self-review threat to independence and objectivity is likely to arise where the audit firm provides assistance to management in the preparation of the forecasts, but would then need to analyse and discuss the forecast for the reasons outlined above.

There could also be an advocacy and a management threat due to the audit firm advising on a matter significant to the company's operational existence, and promoting the company's position to the potential provider of finance.

Ethical Standard 5 (Revised) *Non-audit services provided to audit clients* requires that prior to accepting a non-audit service assignment, the audit firm must assess the threats and the availability of appropriate safeguards which should reduce the threats identified to an acceptable level.

The audit firm should consider carefully whether safeguards could be put in place to reduce the threats described above to an acceptable level. The forecasts could be reviewed by a separate team which would reduce the self-review threat, and management should provide written confirmation that they alone are responsible for the forecasts, which reduces the management threat. If such safeguards were considered satisfactory, then the audit firm can proceed with the work as requested by Juliet Ltd.

However, the firm may decide that it is unlikely that safeguards could be used to reduce these threats to an acceptable level because the non-audit service requested is so significant to the financial statements and the very existence of the company. In this case the review of forecasts should not be performed by the audit firm.

At the meeting with the bank, the audit firm must be careful to avoid assuming responsibility for the company's proposals and for the forecasts presented, or being regarded as negotiating on behalf of the entity, or advocating the appropriateness of the proposals. The situation could easily create an advocacy threat to objectivity.

In addition, from a legal perspective, the audit firm must be careful not to create the impression that they are responsible for the forecasts, or are in any way guaranteeing the future existence of the company. In legal terms, attending the meeting and promoting the interests of the client could create legal 'proximity', which increases the risk of legal action against the auditor in the event of Juliet Ltd defaulting on the loan.

4 (a) The provision of a valuation service is an example of providing a non-audit service. Guidance on this type of situation is provided in Ethical Standard 5 (Revised) *Non-audit services provided to audit clients*. The key issue is that if an audit firm provides a valuation service for an item which will be included in the financial statements, a self-review threat arises. The self-review threat exists because the audit firm will be auditing a balance on which they have themselves placed a valuation.

The significance of the risk depends on the level of materiality of the item in the financial statements. According to IFAC's *Code of Ethics for Professional Accountants*, if the valuation service involves the valuation of matters material to the financial statements, and the valuation involves a significant degree of subjectivity, the self-review threat created could not be reduced to an acceptable level by the application of any safeguards. If this were the case, the audit firm should not provide the valuation service. Alternatively, if the valuation service were provided, the firm should resign from providing the audit service.

Carter & Co must assess the degree of risk in valuing Fernwood Ltd's pension liability. If the amount is immaterial to the financial statements, or does not involve a significant degree of subjectivity, the valuation service can be provided, as long as safeguards are put in place, for example:

– Using separate personnel for the valuation service and the audit.
– Performing a second partner review.
– Confirming that the client understands the valuation method and the assumptions used.

The valuation of the pension balance recognised is likely to involve many judgments and assumptions, and so is likely to be a subjective exercise. It is therefore most likely that Carter & Co will assess the situation as creating a significant self-review threat which safeguards cannot reduce to an acceptable level, in which case the valuation service should not be provided as well as carrying out the audit.

If Carter & Co were to provide the valuation service, either because the self-review threat is assessed as low, or if they were to resign as auditor, then the firm should carefully consider whether it possesses sufficient skills and expertise to perform the valuation. This is a specialist area, and the firm would have to ensure that it could perform the work competently.

(b) Allocation of staff to an audit team should be the decision of the audit firm, and should not be influenced by the wishes of the client. This point should be made clear to the finance director of Hall Ltd.

Staff should be allocated to an audit team based on the needs of the audit. The team should comprise staff with a mix of skills, experience and technical knowledge as appropriate to the size and complexity of the audit, as well as logistical issues such as location and deadlines. Introducing an audit senior with no previous experience of the client may lead to ineffective leadership of the team, and could jeopardise the quality of the audit.

On the other hand, working on a new audit client will provide Kia with more experience and broaden her knowledge and expertise.

A further issue is that Kia is a relative of the financial controller of Hall Ltd. A family or personal relationship between a member of the audit team, and an officer or employee of the audit client can create threats to objectivity. Guidance on how the audit firm should consider the impact of close relationships on the audit is provided in Ethical Standard 2 (Revised) *Financial, business, employment and personal relationships*. The threats that arise are as follows:

– Familiarity – Kia may fail to approach the audit with professional scepticism
– Intimidation – the financial controller may be able to exert influence on Kia, for example, influence her conclusions on work performed

– Self-interest – Kia may be unwilling to challenge the financial controller about accounting matters for fear of causing problems for her relative.

The degree of threat depends on the level of seniority of the close family member. Where they are in a position to exert direct and significant influence over the financial statements then the threat is significant. In this case, Kia's relative is the financial controller, so is clearly in an influential position. Kia herself is also in a position of some influence over the audit, as she would take the position of audit senior, therefore responsible for the day-to-day supervision and direction of the junior members of the audit team.

The most appropriate course of action would be that Kia is not assigned to the audit of Hall Ltd. The reasons for this should be explained to the client.

(c) Usually documents such as title deeds or insurance certificates are held by the audit client or their legal advisors, but sometimes the service is provided by the accountant.

IFAC's *Code of Ethics* states that before agreeing to provide custodial services the audit firm must ensure that there is no legal restriction on holding assets (documents or tangible assets). A self-interest threat could be created as the firm receives a financial benefit from the fee charged for the service. There could also be a perception of a close relationship between the audit firm and the client, if one is holding documents on behalf of the other.

Appropriate safeguards to be used in the provision of a custodial service could include:

– Keeping the assets physically separate from the firm's assets,
– Keep orderly documentation regarding the assets and be ready to account for them to the client when requested,
– Establishing strict controls over the physical access to the assets, and
– Comply with all relevant laws and regulations in respect of holding the assets.

Confidentiality is also a key issue – the firm must ensure that documentation is only ever given to the client who has entrusted it to the firm. The reasons for this should be explained to the firm.

In addition Carter & Co should be vigilant in respect of money laundering regulations. The tangible assets could be purchased using the proceeds of crime and as such the firm in custody of such assets would be deemed to be involved with money laundering. The firm would have to be careful to ascertain the true origin of the assets in its custody.

A further issue is whether Carter & Co has sufficient security to offer such a service. Employment of extra security methods such as alarm systems, CCTV, security personnel could be costly, and might outweigh the revenue to be derived from offering the service.

In order to maximise the revenue from this source of income, Carter & Co could be tempted to concentrate on holding high value assets, as these would attract the highest fees. This would compound the security issues discussed above, especially the cost of extra insurance.

If there were ever a problem such as documents held in custody being lost or damaged, or assets being stolen, then Carter & Co would face major reputational risk. This risk, along with the extra costs discussed above, may outweigh the relatively small revenue stream that the custodial service would provide.

(d) Referral fees are not prohibited by IFAC's *Code of Ethics*. However, a self-interest threat can arise, as the audit firm gains a financial benefit for each audit client referred to Gates Ltd. The referrals and payments to Carter & Co can continue, provided that safeguards are put in place. Safeguards could include:

– Disclosing to the audit clients that a referral fee arrangement exists, and the details of the arrangement.
– Receiving confirmation from the audit clients that they are aware of the referral arrangement.
– Receiving confirmation from all employees of Carter & Co that they have no interest in Gates Ltd.

Carter & Co may also wish to consider the quality of the training provided by Gates Ltd. Any problems with the training provided could cause damage to the reputation of Carter & Co.

5 (a) (i) Accounting policy on revenue recognition

It appears that Grimes Ltd has recognised revenue earlier than allowed under its stated accounting policy. The audit partner must ensure that this matter is discussed with management, and with those charged with governance. The partner should make management aware that the financial statements, if not amended, do not show a true and fair view, which will lead to a qualification on the grounds of disagreement.

The partner should also discuss with management, and those charged with governance, whether they wish to change the stated accounting policy dealing with revenue recognition. ISA 260 (UK and Ireland) *Communication with those charged with governance* requires that selection of accounting policies and potential changes to accounting policies, be discussed where relevant.

However, the partner should emphasise that this is only permissible under FRS 18 *Accounting policies*, if the new accounting policy is either required due to a change in accounting standards (which is not the case here), or is a voluntary change resulting in fairer presentation of the financial statements. It would be hard to argue that the earlier recognition of revenue is necessary for fairer presentation, so it is unlikely that a change in accounting policy would be justified in this case.

In addition, the partner may wish to consider whether the early revenue recognition is an attempt to window-dress the financial statements, in other words, to inflate the profit and revenue by creative accounting. The audit partner should ensure that all areas of the audit file dealing with matters of subjectivity, especially those areas where evidence was provided by management, should be thoroughly reviewed for potential bias in accounting treatments. This is an important issue as the audited financial statements are to be used by the company's bank for a lending decision.

A second partner review is also recommended due to the contentious nature of the matter, and the possibility of management bias in the financial statements.

All of the issues and actions explained above should be carried out urgently, given the short space of time before the audit report and financial statements need to be issued.

Property development costs

The partner should consider if there is any source of audit evidence, other than the records kept by the project manager, to verify the costs included in the property valuations. The accounting system should be able to provide some evidence.

In addition, the partner should enquire with management as to whether any back up data exists, or if recovery of the data, which has been corrupted, could be attempted.

If the data cannot be recovered, then the matter should be raised with those charged with governance, as ISA 260 (UK and Ireland) *Communication with those charged with governance*, and ISA 265 (UK and Ireland) *Communicating deficiencies in internal control to those charged with management and governance*, both require that significant deficiencies in internal controls are discussed with the client. The communication should describe the deficiency and its potential impact on the financial statements, and a recommendation for improvement should be given.

Finally, as this situation could result in a qualification of the audit opinion due to limitation on scope, management and those charged with governance should be made aware of the potential qualification.

Possibly, given an extension to the deadline for completion of the audit, the company's records could be reconstructed, allowing audit evidence to be obtained.

(ii) **Accounting policy on revenue recognition**

According to ISA 705 (UK and Ireland) *Modifications to opinions in the independent auditor's report*, material misstatements may arise in the financial statements due to a misapplication of selected accounting policies. This arises when management has not applied the selected accounting policies consistently with the financial reporting framework, including when management has not applied the selected accounting policies consistently between periods or to similar transactions and events (consistency in application).

If the financial statements are not amended, this material disagreement due to misapplication of accounting policies will cause the audit opinion to be modified. This would be likely to be a material rather than pervasive disagreement, resulting in an 'except for' qualification.

ISA 705 (UK and Ireland) requires that in the case of a qualification, a clear description of the reasons for the qualification be provided in the report, and unless impracticable, a quantification of the potential effect on the financial statements should be provided. In this case, the audit report should state the amount of revenue, and profit that has not been recognised in accordance with the company's stated accounting policy. The effect on the balance sheet, in other words the de-recognition of properties from current assets, should also be referred to, and the impact on total assets quantified.

This description should be provided in a paragraph entitled 'Basis for Qualified Opinion', which should be placed immediately before the opinion paragraph in the auditor's report.

Property development costs

The lack of records maintained by Grimes Ltd in relation to the property development costs gives rise to a limitation on the scope of the work of the audit form. This is likely to lead to a qualification of the auditor's opinion because the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.

As described above, in the event of a qualification, the audit report should describe the reason for the qualification, in the 'Basis for Qualified Opinion' paragraph. In the case of Grimes Ltd there will be two separate qualifications which both should be described and quantified in this paragraph.

In addition, the Companies Act 1990 and the Company Law Enforcement Act 2001 requires that the auditor reports on various matters, including if a company has not maintained adequate accounting records. If Grimes Ltd cannot corroborate the development costs due to a failure of its accounting records to capture these costs, then a report of any indictable offence should be made by the auditor to the Director of Corporate Enforcement (ODCE).

(b) **(i)** All audit firms want to avoid litigation, due to the bad publicity that is likely to follow, the financial consequences, and the potential collapse of the audit firm. There are several ways that an audit firm can reduce its exposure to claims.

Client acceptance procedures

Firms should carefully assess the risk associated with potential audit clients. Screening procedures should be used to identify matters that create potential exposure for the audit firm. For example, it would be unwise to take on a new client with significant going concern problems. The issue is that a client should only be accepted if the associated risk can be managed to an acceptably low level given the skills and resources of the audit firm.

Proper use of engagement letters
The engagement letter should be used to clearly state the responsibilities of the auditor, and of management. As it forms a contract between the audit firm and the client, it should be updated on an annual basis, with care being taken to ensure the client is fully aware of any changes in the scope of the audit, or the reporting responsibilities of the audit firm.

Performance and documentation of audit work
Audit firms should ensure that professional standards are maintained, and that International Standards on Auditing (ISAs) (UK and Ireland) are adhered to. It is crucial that full documentation is maintained for all aspects of the audit, including planning, evaluation of evidence, and consideration of ethical issues. A claim of negligence is unlikely to be successful if the audit firm has documentary evidence that ISAs have been followed.

Quality control
Firms must ensure they have implemented firm-wide quality control procedures, as well as procedures applicable to the individual audit engagement. Quality control acts as an internal control for the audit firm, helping to ensure that ISAs and internal audit methods have been followed at all times.

External consultations
Firms should make use of external specialists when the need arises, for example obtaining legal advice where appropriate, to ensure that the auditor's actions are acceptable within the legal and regulatory framework.

Disclaimers
In recent years it has become common in some jurisdictions for audit firms to include a disclaimer paragraph in the audit report. This is an attempt to restrict the duty of care of the audit firm to the shareholders of the company, thereby attempting to restrict legal liability to that class of shareholders. Disclaimers, however, may not always be effective.

Tutorial note: More than the required number of points have been covered in the answer. Credit would be awarded for discussions of other, relevant means of limiting exposure to liability, such as the need for adequate Professional Indemnity Insurance.

(ii) **Limited Liability Partnerships (LLPs)**
Irish audit firms currently operate as either sole traders or partnerships. Members of ordinary audit firm partnerships are personally liable to an unlimited amount for any debts of their firm and can be sued individually or collectively for any damages from negligence or breach of contract. Currently if in an audit firm, one partner causes damage by giving advice negligently all other partners are obliged to contribute to the damages up to the extent of their personal assets.

In today's business environment, particulary for larger partnerships, irrespective of the application of internal quality control procedures as set out by ISQC1, it is not practically possible for individuals to know in detail the standard of work of their fellow partners. The personal assets of an individual partner can be put at risk by the action of others in their firm.

LLP audit firms can still be sued, but in the same way as a company the members' liability is limited to the amount of money they have invested. The rationale for an LLP firm is to provide individual partners within an audit firm with the security of carrying on business in common with limited liability, while at the same time providing safeguards for those with whom they deal. It will therefore assist auditors who operate as partnerships but fear putting their personal assets at risk. LLP safeguards will resemble those which apply to companies but without being bound by aspects of company law that relate not to limited liability but to separation of ownership and management.

Liability Limitation Agreement
A liability limitation agreement is a contractual limitation of the auditor's liability to a company. There are several possible implications for the audit profession which are discussed below.

Audit quality
One of the main arguments against the use of such agreements is that audit quality could suffer as a result. The argument is that auditors could become less concerned with the quality of their work, in the knowledge that if there was a claim against them, the financial consequences are limited.

Value of the audit opinion
As a consequence of the point above, many argue that users of the financial statements will place less reliance on the audit opinion, resulting in less credible financial statements.

Pressure on audit fees
It is considered that firms may be under pressure from clients to reduce their audit fees. This is a response to the fact that if the audit firm has reduced its risk exposure, then the fee for providing the audit service should be reduced.

Competition in the audit market
The ability to set a cap on auditor's liability could distort the audit market. Bigger audit firms may have the ability to set a high cap, which creates a disadvantage to smaller audit firms. However, it can be argued that the ability to set a cap actually helps the audit market, by protecting firms and making collapse less likely, and can promote competition between the larger firms.

	Marks
1 (a) Evaluation of audit risks and other matters to be considered	
½ mark for identification (to a maximum of 5 marks) and up to 1½ further marks for evaluation and ½ mark for correct reference to relevant SSAP/FRS (max 1 mark)	
– Classification of non-controlling interests (FRS 9)	
– Auditors lack knowledge of activities of non-controlling interests	
– Bonus and potential earnings management	
– Change in accounting estimates (FRS 18)	
– Lack of group finance director	
– Capitalisation of dismantling costs (FRS 15)	
– Provision – discounting and finance charge (FRS 12)	
– Deferral of grant income (SSAP 4)	
– Potential provision or contingent liability (FRS 12)	
– Mid-year acquisition	
– Goodwill on acquisition – subjective (FRS 7)	
– Retranslation of Brass Co financial statements (FRS 23)	
– Retranslation of goodwill	
– Adjustments necessary to bring in line with group accounting policies	
– Intra-group transactions	
Maximum marks	18
Professional marks for presentation of answer, clarity of explanations	2
(b) Matters to be considered and procedures – reliance on component auditor	
1 mark per comment on matters/procedure	
– Ethics	
– Competence/qualifications	
– Skills/resources	
– Quality control	
– Monitoring activities	
– ½ mark for ref to ISA 600	
Maximum marks	8
(c) (i) Principal audit procedures for non-controlling interests	
Generally 1 mark per procedure	
– Confirm % shareholding acquired	
– Confirm if Grissom Ltd appointed any board members	
– Consider relationship with other shareholders	
– Discussion of involvement	
– Written representation re involvement	
Maximum marks	4
(ii) Principal audit procedures for condition attached to grant	
Generally 1 mark per procedure	
– Confirm 25% to terms of grant	
– Ascertain from grant document:	
– the period required to demonstrate reduction	
– the amount that would be repaid if condition breached	
– Review results of monitoring performed	
Maximum marks	4
Maximum	**36**

Marks

2 (a) Benefits of outsourcing internal audit

Up to 1½ marks per point evaluated:

- Improved quality/experience
- Greater authority
- Bigger resource base
- Independent viewpoint
- Better ability to focus and prioritise issues
- Finance function benefits from staff reassigned

Maximum marks 6

(b) Impact of outsourcing on the external audit

Generally 1 mark per point:

- Assess extent of reliance per ISA 610/402
- Likely to place greater reliance than previously
- Impact on audit strategy – less substantive procedures
- More efficient audit/lower fees
- Need to document and evaluate changes to systems/controls
- Access to information and working papers

Maximum marks 4

(c) Procedures regarding fraud

Up to 1 mark per procedure:

- Review process for adding approved suppliers to list
- Review all payments authorised by the account manager
- Use CAATs to identify suppliers with same bank details
- Supplier statement review
- Select invoices and trace to supporting documentation
- Consider likelihood of insurance reimbursement
- Consider prosecution of account manager and recovery of funds

Maximum marks 4

(d) Report to client on audit committees

Professional marks to be awarded for format (heading, introduction, conclusion) – 1 mark, and clarity of explanation, use of language appropriate to client – 1 mark.

Generally 1 mark for each comment from list below:

(i) Responsibilities in relation to fraud:
- ½ mark ref ISA 240
- Management primary responsibility
- Management responsible for controls and culture of entity
- Auditor only responsible for detection of frauds with material financial statement impact
- Auditor not responsible for prevention but does make recommendations on controls
- Both review strength of systems and controls

(ii) Benefits and drawbacks
- Increase confidence/credibility
- Stronger control environment
- Bring external experience/expertise
- Provide impartial consultation
- Easier to raise finance/gain listed status
- Problems in recruitment
- Expense

Maximum marks – technical	8
Professional marks	2
Maximum	**24**

		Marks
3	**(a)** Discussion	

Up to 2 marks for comments discussed from ideas list

- Management responsibility for risk assessment
- Auditor should be aware of going concern issues
- Auditor must not take on management role
- Misunderstanding of roles of management and auditor
- Auditor may be to blame if overlooked a fraud/other matter
- Financial statements contain disclosure on risk assessment
- Users may not be financially literate
- Auditors could make problems more visible and understandable

Maximum marks — 8

(b) (i) Matters and procedures on funding

Up to 1 mark each point:
Matters:
- Area of critical importance to the audit
- Bank reluctant to confirm arrangements
- Assets impaired – little collateral to offer
- Have alternative providers been discussed?
- Potential impact on FS and audit report if significant doubt remains over going concern
- ½ mark ref ISA 570/ISA 706

Procedures:
- Review assumptions used in forecasts and projections
- Management representation on reasonableness of assumptions used
- Review potential finance for adequacy
- Consider if any previous defaults
- Consider terms of finance – can the company meet repayment terms?
- Written confirmation from bank
- Discuss with bank
- Discuss with management

Maximum marks — 6

(ii) Ethical and other implications

Up to 1 mark each point explained:
- Advice is a non-audit service
- Self-review threat
- ½ mark ref to ES 5
- Advocacy threat
- Management threat
- Safeguards should be used to reduce threats
- Firm may decide that no safeguards can reduce threats to an acceptable level
- Attending meeting could create legal proximity

Maximum marks — 6

Maximum — **20**

			Marks
4	(a)	**Fernwood Ltd**	

Up to 1 mark each point explained:
- Self-review threat (restrict to ½ mark if not explained)
- ½ mark ref to ES 5
- Provision of non-audit service
- Threat depends on materiality of balance
- Threat depends on degree of subjectivity
- Can only perform if low threat and safeguards used
- Pension very subjective so unlikely to be able to reduce threat to acceptable level
- If service provided assess skills and competence

Maximum marks 6

(b) Hall Ltd

Up to 1 mark each point explained:
- Client should not influence selection of audit team members
- Kia has no experience of the client
- Family relationship creates three objectivity threats (1 mark each explained)
- ½ mark ref to ES 2
- Degree of threat depends on level of influence
- Do not assign Kia to the team
- Explain to client why Kia has not been assigned

Maximum marks 6

(c) Collier Ltd

Up to 1 mark each point explained:
- Custodial service creates self-interest threat (½ mark if not explained)
- Safeguards to be applied (1 mark each)
- Money laundering consideration
- Consider security of offices/availability of space
- Extra costs e.g. insurance, more security measures
- Reputational risk in event of theft/loss of documents
- Confidentiality issues

Maximum marks 5

(d) Gates Ltd

Up to 1 mark each point explained:
- Referral fee creates self-interest threat
- Allowed if safeguards in place (1 mark for each safeguard)
- Consider quality of service provided

Maximum marks 3

Maximum **20**

				Marks
5	**(a)**	**(i)**	**Action to be taken**	
			Generally 1 mark each comment made:	
			Recommended actions: Revenue recognition: – Discuss with management/TCWG non-application of stated accounting policy – Discuss potential qualification of opinion on disagreement – Discuss relevance of FRS 18 and why change in policy not allowed (½ mark ref FRS 18) – Review audit files/consider other areas that could be subject to bias – Second partner review of files recommended	
			Property development costs: – Consider alternative sources of evidence are available – Enquire about back up data/recovery of corrupted files – Report control weakness under ISA 260 and ISA 265 (½ mark ref either ISA 260 or ISA 265) – Discuss potential qualification due to limitation on scope	
			Maximum marks	6
		(ii)	**Impact on auditor's report**	
			Generally 1 mark each comment made:	
			Revenue recognition: – Revenue recognition: Material disagreement on misapplication of accounting policies – must be explained and quantified – Property costs: Material limitation on scope – must be explained and quantified – Basis of opinion paragraph to precede the audit opinion	
			Property development costs: – Material limitation on scope – Indictable offence and potential reporting requirement to ODCE	
			Maximum marks	4
	(b)	**(i)**	**Methods of reducing exposure**	
			Up to 1 mark for each method – Client screening – Engagement letter – Adherence to ISAs and other regulation – Quality control – Disclaimer paragraphs	
			Maximum marks	4
		(ii)	**Implications of LLP Partnerships and liability limitation agreements**	
			Up to 1½ marks each: – Audit quality – Less confidence in financial statements – Pressure to reduce fees – Distort audit market	
			Maximum marks	6
			Maximum	**20**