2 Auditing – the legal framework

this chapter covers . . .

This chapter describes the legal framework which governs the work of auditors and directors of a company. It explains the duty of care owed by auditors to shareholders and the responsibility they have to third parties. It describes the principles which govern the professional behaviour and personal qualities that are expected of an auditor when dealing with client information and client staff.

The chapter covers:

- *the responsibility of directors in maintaining financial records and preparing financial accounts*
- *the responsibility of auditors to shareholders and third parties*
- *the legal framework governing the work of auditors*
  - *in statute law (particularly the Companies Act 2006)*
  - *International Standards on Auditing (ISAs)*
  - *Case law (court decisions relating to auditing)*
- *the issue of professional ethics - the responsible way in which auditors deal with clients and keep confidentiality*

PERFORMANCE CRITERIA COVERED

unit 17 IMPLEMENTING AUDITING PROCEDURES

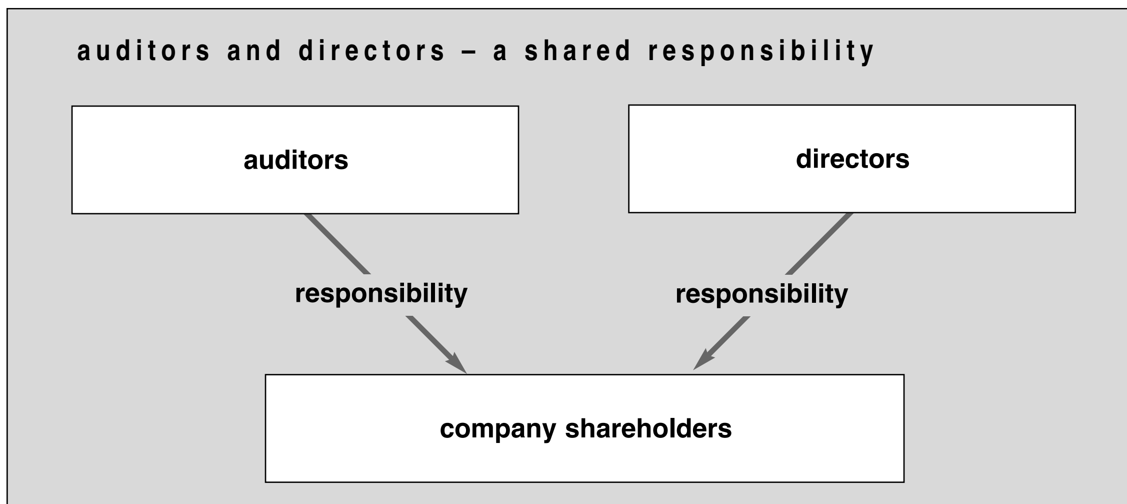
This chapter introduces the background to auditing and covers some of the underpinning Knowledge and Understanding that is common to all three elements of Unit 17. Specifically it covers the following items:

1. *A general understanding of the legal duties of auditors: the content of reports; the definition of proper records*
2. *A general understanding of the liability of auditors under contract and negligence including liability to third parties*
3. *Relevant legislation, relevant Statements of Auditing Standards**

**now replaced by the International Standards on Auditing*

OVERVIEW OF THE LEGAL FRAMEWORK

Companies are required by the Companies Act 2006 to prepare annual financial statements and to have these statements audited. The directors and auditors have separate responsibilities in the process. The fact that directors and auditors have an ultimate responsibility to the shareholders of the company means that these responsibilities will inevitably be linked.



a shared responsibility

Directors have a primary responsibility to prepare the accounts and report to the shareholders, who own the business, telling them how well the company has performed financially in the accounting period.

The **auditors**' responsibility follows on: they must check these accounts and report to the same shareholders whether or not the directors have accounted fairly and truthfully.

who is audited?

All companies that need to be audited, whether they are private limited companies or public limited companies are dealt with in the same way. Auditors have the same duty to the shareholders in a small family company as they do to the shareholders of a multinational public limited company.

Remember:

- companies that qualify as small companies will be exempt altogether from the requirement for an audit (see page 5)
- sole traders and partnerships do not require an audit

RESPONSIBILITIES OF DIRECTORS

The Companies Act 2006 states that the directors of the company are responsible for:

- maintaining proper financial records
- preparing financial statements in the prescribed format

We are now going to look at each of these responsibilities in turn.

maintaining proper financial records

An extract from the Companies Act 2006 is set out below. Whilst it is useful for you to read this, you don't have to remember it word for word and will not be required to refer to the section number.

Section 386 of the Companies Act 2006

(1) Every company must keep adequate accounting records.

(2) Adequate accounting records means records that are sufficient

(a) to show and explain the company's transactions

(b) to disclose with reasonable accuracy, at any time, the financial position of the company at that time, and

(c) to enable the directors to ensure that any accounts required to be prepared comply with the requirements of this Act.

To put this more simply, the directors of the company have a legal responsibility to keep the books of account of the business up-to-date and in sufficient detail so that reasonably accurate financial statements can be produced at any time. They must also make sure that the company keeps hold of all related information that was used to produce them.

In practice, this means that documentation relating to the day-to-day financial transactions of the business such as sales and purchase invoices, credits notes, bank statements etc, must be kept by the company even when they have been recorded in the accounts.

In addition, directors must ensure that they keep financial information in such a way that the requirements for disclosure of information in accounts as required by the Companies Act, can be met.

The Companies Act specifies the minimum requirement for accounting records that it expects a business to keep. Set out on the next page is an interpretation of what this means in real terms for a company.

Companies Act requirement	Books and records required
A record of payments and receipts:	Cashbook Petty cash book
A record of assets and liabilities:	Asset register Debtors ledger Creditors ledger
If the company deals in goods:	A record of stock Stock lists at the period end All statements of stock taking from which the stock listings have been prepared, ie the stock count sheets

Note that where the company is not engaged in a normal retail trade it must also keep records of goods sold and purchased in enough detail so that sellers and buyers can be identified.

The records must be kept at the office registered with the Registrar of Companies, known as the Registered Office, or at some other location the directors consider to be suitable. Smaller businesses often choose to have their accountant's office as their Registered Office but keep all the accounting records at their business premises.

These regulations must be complied with – if the directors of a company are found to have failed to keep records in sufficient detail they are guilty of an offence under the Companies Act and can be imprisoned or fined.

preparing financial statements

We will now examine the legal requirement to prepare financial statements. This may touch on some of the points you cover in Unit 11 (Drafting Financial Statements) which deals with the formats for preparing annual accounts. You should be aware from your studies that these formats are now increasingly regulated by International Accounting Standards (IAS).

So what do we mean by the term 'financial statements'? The Companies Act specifically refers to the preparation of:

- the balance sheet
- the profit and loss account or other form of income statement
- a directors' report

- a directors' remuneration report
- the notes to these statements and notes of the accounting policies adopted
- the auditors' report

The Companies Act also sets out some specific duties for the directors when preparing the financial statements. These should be familiar to you from your Financial Accounting studies. The directors must:

- prepare the financial statements on a going concern basis, unless they consider that the business will not be able to continue for the foreseeable future
- select suitable accounting policies and apply them consistently
- make judgements and estimates that are reasonable and prudent where revenues and potential costs or losses are not known with certainty
- state whether the relevant accounting standards have been followed
- explain any reasons why accounting standards have not been followed

As you can see from the points above, the legal requirements of the directors regarding the maintenance of financial records and the preparation of financial statements are both strict and detailed.

In addition to all of this the directors have a responsibility to allow the auditors access at all times to the books and records of the business. This leads us into the next section on the rights and responsibilities of the auditors.

AUDITORS' RESPONSIBILITIES

the legal framework

Over the years the rights and responsibilities of auditors have been established in three different ways:

- **statute law** – particularly the Companies Act 2006
- **International Standards on Auditing** (ISAs)
- **case law** – where decisions relating to auditing have been decided in court

These three legal influences have created a framework of rights and responsibilities within which auditors operate. They work broadly along the lines of the flowchart shown at the top of the next page.

Statute law: the legal rights of auditors and their basic responsibilities are defined in the Companies Act.

The auditors' rights and responsibilities are then further defined in the **International Standards on Auditing** (ISAs), which are issued by the Auditing Practices Board (visit www.apb.org.uk). The two main functions of ISAs are:

1. they expand on the wording of auditing legislation and set out in detail what is expected of auditors and what rights and duties they have
2. they tell auditors how to deal with specific sets of circumstances and give examples and guidance on how audit work should be carried out

Case law gives auditors guidance as to how the court decisions have interpreted the law and the ISAs under certain circumstances. It also helps to define the extent of auditors' responsibilities.

AUDITORS' RESPONSIBILITIES TO SHAREHOLDERS

Auditors' primary responsibilities, set out by the Companies Act, can be summarised as:

- to give an opinion to the shareholders as to the truth and fairness of the financial statements
- to give an opinion as to whether the financial statements have been properly prepared in accordance with the Companies Act

They must also include in their report reference to:

- whether proper books and records have been kept
- whether proper information has been supplied to them from any branches of the business they have not visited
- whether the accounts agree to the underlying financial records and supporting information
- whether the contents of the Directors Report is consistent with the accounts
- a statement of the separate responsibilities of auditors and directors

This is obviously a comprehensive list of requirements regarding the content of the audit report. We will look in more detail at the form and content of these reports in Chapter 7.

Fundamentally, the auditors' role is to report to the shareholders, who are the owners of the business, on the truth and fairness of the financial statements prepared by the directors and to confirm that proper records have been kept and full explanations received where necessary. It is important to appreciate that the auditors act for the shareholders collectively – as one body. They are not responsible to any one individual shareholder.

auditors' responsibilities to third parties

As we have seen, the primary responsibility of the auditors is to report to the shareholders. But what about other readers of the accounts?

Because they are appointed by the shareholders the law says that auditors owe a duty of care to shareholders to carry out their work in a professional and thorough way.

This duty of care means that, if auditors fail to do their work properly, the shareholders have the right to take them to court to recover any losses that the auditors' negligence has caused them.

Is this same duty of care extended to other users of the accounts? In short, can the auditors be held liable to any one at all if they get it wrong?

If any person decided to sue the auditors in court because they had suffered some loss, they would have to show that the auditors:

- owed a duty of care to the person who suffered the loss and
- failed to carry out their audit work using reasonable skill and care

Once this had been established, the person bringing the court action against the auditors would have to prove:

- the auditors were negligent in the way they carried out their work (ie they failed in their duty of care)
- the person bringing the action suffered a loss
- the loss arose as a result of the auditors' negligence

If all of this can be proved then the auditors are likely to be found guilty by the court of negligence and ordered to pay damages and compensation.

This could amount to a considerable sum – in the past, such claims have resulted in audit partners being made bankrupt and the audit firms ceasing to exist. It is no surprise that the partners in audit firms are naturally very interested in the law on responsibility to third parties!

One court case that has become very important in clarifying the extent of the duty of care of auditors is the Caparo decision, which is explained below. You do not have to remember all the facts of this case for your studies, but it is important that you understand how the principle it established affects the auditing profession.

the Caparo case

the facts . . .

In 1990 Caparo Industries sued audit firm Touche Ross for negligence in their audit of Fidelity plc, a company that Caparo had subsequently purchased.

Caparo stated that they had relied on the audited accounts to value Fidelity plc. It emerged that the asset value of Fidelity was substantially less than the audited accounts had shown. Caparo said that had they known the true position they would not have bought Fidelity.

the decision . . .

The judge in this case decided:

- that the auditors did not have a duty of care to third parties, unless
- they knew that these accounts were going to be relied upon for the purposes of making an investment.

Much to the relief of the auditors, Touche Ross, this was not found to be the case here.

WHAT GOVERNS THE AUDIT?

So far we have covered the responsibilities of the directors and the responsibilities of the auditors. We will now examine the legal rights that the auditors have which allow them to carry out their audit work effectively.

As we have seen, the work of the auditors is regulated in three ways:

- through the Companies Act 2006
- through International Standards on Auditing (ISAs)
- through legal decisions made in individual cases in the courts

We will now look at these three areas in turn.

auditors' rights under the Companies Act 2006

Just as the Companies Act establishes the responsibilities of the directors, it also sets out the legal framework within which auditors function. In order to help the auditors carry out their audit work the Companies Act gives them certain specific rights, which are set out in the table below.

Auditors have the right to . . .	
the records	Auditors have a right of access at all times to the company's books, accounting records and vouchers.
information and explanations	The auditors have the right to all explanations and information from the company's officers that they consider necessary for their audit.
attend meetings	The auditors have the right to receive notice of all meetings which a shareholder can attend, and the right to attend those meetings.
speak at general meetings	The auditors have a right to speak at any general meeting of the company on any part of it which concerns them as auditors.
written resolutions	The auditors must be sent copies of any written resolution proposed.
require presentation of accounts	Auditors have the right to give notice in writing requiring that the company holds a general meeting for the purpose of laying the accounts before the shareholders.

In conclusion, the auditors basically have the right to access all the company's books and records and to ask any questions of the directors (and their staff) that they feel necessary to complete the audit. In addition to this they are entitled to attend company meetings and to speak to the shareholders at these meetings on any points that relate to their position as auditors.

It should be pointed out that in most cases the audit client is happy to provide the auditor with the information that is needed and will not obstruct them from addressing company meetings.

International Standards on Auditing (ISAs)

Accounting and auditing within the UK is regulated by the Financial Reporting Council. Within this body the **Auditing Practices Board (APB)** is responsible for issuing auditing standards, which set out, in detail, the role and conduct of auditors in certain circumstances. All auditors carrying out statutory audits in the UK are governed by these standards. Visit www.frc.org.uk/apb for further information.

As auditing standards are being harmonised worldwide the APB is adopting the **International Standards on Auditing** (ISAs) which have been developed by the International Auditing and Assurance Standards Board (IAASB).

To put this into the context of your financial accounting studies, the work of the auditor is governed by ISAs in the same way as the financial statements prepared by the directors are governed by SSAPs, FRSs and, more recently, by International Accounting Standards (IASs). ISAs exist to support, advise and regulate auditors and to give guidance on specific situations.

AAT 'core' ISAs

The AAT has issued guidance stating which of these international standards it considers to be relevant to Unit 17. It has stated that it considers some of these ISAs to be 'core' statements, fundamental to carrying out a proper audit. You must be aware of these statements, although you will not be asked to quote them in your assessments. The 'core' ISAs are:

ISA 240	The auditors' responsibility to consider fraud in an audit of financial statements.
ISA 300	Planning the audit.
ISA 315	Obtaining an understanding of the entity and its environment and assessing the risks of a material misstatement.
ISA 330	The auditors' procedures in response to assessed risk.
ISA 500	Audit evidence.

In addition to these, the AAT also stresses the importance of an International Standard on Quality Control (ISQC) 'Quality control for firms that perform audits and reviews of historical financial information and other assurance and related service engagements'.

ISAs affecting the way audits are carried out

The ISAs that have the greatest impact on the way audits are carried out are shown below.

key regulations affecting audit implementation

ISA 220	Quality control for audits of historical financial information.
ISA 240	The auditors' responsibility to consider fraud in an audit of financial statements.
ISA 300	Planning an audit of financial statements.
ISA 315	Obtaining an understanding of the entity and its environment and assessing the risks of a material misstatement.
ISA 330	The auditors' procedures in response to assessed risk.
ISA 500	Audit evidence.

Under the ISAs, the issues of risk assessment and fraud have become central to the planning of the audit, thus the evidence requirements are increased and audit planning has to take account of this.

There is also a new requirement for audit firms to introduce quality control procedures into their own firm's working practices to ensure that audit work is carried out to the highest standard.

Throughout this book we will refer to relevant ISAs as we cover the different topics. Although we may quote some of the relevant paragraphs so that you can be aware of the precise wording of the key ISA, you are not expected to remember either the precise wording or the ISA number.

case law

A ruling in a previous decision made in the courts forms an important element of the legal framework affecting the work of auditors. The outcome of these cases and the comments of the judges have provided valuable guidance for auditors as to how to carry out their work (or in some cases how not to!). An example relating to auditors' responsibility to third parties has already been given on page 23. Over the years many firms of auditors have been sued for negligence – ie where a 'duty of care' has been neglected.

You are not expected to remember the names of cases or the exact words used by judges. They are quoted in this text to help to give you an impression of what is expected of auditors and how they should approach their work and dealing with clients.

PROFESSIONAL ETHICS

As we have seen, the rights and responsibilities of auditors are set out in several ways – by statute law, through ISAs and by case law. In addition to adopting the ISAs, the Auditing Practices Board (APB) also sets the standards expected of auditors with regard to their personal behaviour. This is known as the **ethical framework**.

Rather than setting out a large number of detailed rules on the behaviour of the auditors, the professional bodies have decided that it would be simpler to list the personal qualities that they expect a professional auditor to have. These are set out in International Standard on Auditing 200 'Objectives and general principles governing an audit of financial statements'.

This states that two of the most important personal qualities an auditor should have are:

- **integrity** – this means honesty, truthfulness and openness in dealing with clients' affairs
- **objectivity** – this means that auditors must not get too closely involved with their client

In addition to these two key areas we will also examine other aspects of behaviour and professional capability expected of the auditors in relation to the points below:

- independence
- professional competence
- reasonable skill and judgement

independence

The role of the auditors is such that they must take great care to ensure that their independence is not compromised in any way. They must be independent and must be 'seen to be independent'. At no point must their opinion on the truth and fairness of the client's financial statements be influenced either by their client or by anyone else.

Guidelines have been issued by the Recognised Supervisory Bodies (RSBs) as to what might compromise an auditor's independence. A summary of these guidelines is detailed here.

Auditors are not allowed to:

- have one single client that represents a high proportion of an auditor's total business – this is usually defined as having one client whose fee is more than 15% of the auditors' total fee income
- have family or close relatives working in the senior management of the client – for example, it would be unacceptable for the audit manager to be married to the financial controller of one of his clients
- hold shares in the client, either directly or indirectly
- accept loans from clients or lend clients money
- accept gifts or corporate hospitality – unless this is quite minimal
- provide accountancy services other than audit services to the client

Professional judgement must be exercised in all of these cases. If the audit is being performed on a major UK bank, for example, it is acceptable for members of the audit team to have mortgages with this bank. It is not, however, acceptable for the audit partner to have a substantial personal loan from the bank at a preferential rate. On the other hand no one would be very concerned if the audit client provided all the audit team with a free diary. However, it would be inappropriate for members of the audit team to be taken by the client on an all expenses paid trip to Aintree for the Grand National weekend.

professional competence

We have now established that the auditors must maintain independence at all times. We will now discuss the area of professional competence. It sounds obvious, but the auditors need to know what they are doing. This means that auditors should:

- be familiar with the principles of auditing which we have described in this book
- be aware of what the Companies Act 2006 says about how financial statements should be prepared and the disclosure requirements

You will already be familiar with this from your studies 'Drafting Financial Statements'. The fact that auditors must be members of Recognised Supervisory Bodies (RSBs) should ensure that they are also fully aware of these requirements.

In the area of professional competence case law goes some way to giving us a definition. Specifically, the judge in the **Kingston Cotton Mill** case defined what 'professional competence' actually means. The judge said:

> *'It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case.'*

What the judge meant in this case was that the auditors had to use 'reasonable skill and care' in carrying out their audit work and that, as long as they did this, their duty to their client was fulfilled.

To summarise:

- the auditors owe a duty of care to the shareholders who appoint them
- as professionals, auditors are expected to carry out the work they have to do in a professionally competent way; but they are not expected to be all seeing and all knowing

During the course of their audit work the auditors have a professional duty to:

- make reasonable enquiries
- carry out sufficient work to support the audit opinion they are signing as to the truth and fairness of the accounts

DEALING WITH CLIENTS

This section of this chapter will examine the manner in which auditors approach their audit work.

Auditors are expected to behave in a professional manner at all times. This is particularly relevant when, at various points during the audit, they spend time at clients' premises and come into daily contact with management and staff. A well-briefed client team will appreciate that they must assist the auditors in any way that they can to ensure a smooth audit visit. However, in addition to providing the auditors with all the necessary information that they require, they still have to carry out their day-to-day duties as usual.

With this in mind the audit staff are expected to be:

- courteous and polite
- discreet – not getting involved in gossip or office politics
- aware of the time commitments of clients' staff – they may have deadlines to meet
- aware of the rule of confidentiality (see below)

In practical terms when dealing with client staff the auditors should:

- avoid making unreasonable requests for information
- deal with several queries at a meeting rather than pestering staff with a continuous stream of questions when they are trying to work
- bear in mind client deadlines – for example, month-end routines should not be disturbed by demands from the auditors

For example, an audit junior may be very keen to obtain answers to all her queries on a particular audit test and in her enthusiasm she may bombard the client's finance staff with questions every time she finds an error. The audit supervisor, however, should encourage the junior to gather up a number of questions and arrange a meeting with client staff members to discuss the issues on a single occasion.

Although the auditors have a significant level of legal authority, insisting on exercising this authority should be avoided if at all possible. It should only be resorted to in exceptional circumstances when the auditors feel that they are being deliberately prevented from accessing information.

The auditors must remember that it is in their interest to maintain a good working relationship with a client's staff at all times and at all levels to allow for the smooth running of the audit and ensure minimal disruption to the client's day-to-day operations.

CONFIDENTIALITY

Finally we will look at the importance of **confidentiality**. During the course of their audit work the auditors discover a great deal of information about their client, some of which might be commercially sensitive and much of which will be confidential.

Confidentiality is, therefore, seen as being a very important aspect of auditors' responsibilities.

The fundamental rule is that auditors must not reveal any information that they have learned about a client to unauthorised third parties except in the most exceptional circumstances.

confidentiality – the exceptions

The Recognised Supervisory Bodies (RSBs) have established certain circumstances in which auditors are permitted to reveal information about their client to a third party.

These circumstances are:

- when the **client gives permission**
- when **required to by law** – for example, under money laundering regulations, if the auditor suspects the client's involvement in this kind of activity they have a duty to disclose this; similarly if they suspect the client is involved in treason or terrorist activities this should be reported to the relevant authorities
- when there is a **professional duty to disclose** – for example if the auditor is giving evidence at a trial
- when it is **in the public interest** – for example if the client is guilty of serious environmental pollution or is selling a product which might prove to be a danger to the general public the auditor is permitted to give relevant information to third parties

In all instances the auditors must think carefully before revealing any information about their clients' affairs to a third party. If in doubt they should obtain legal advice or the advice of their professional body.

confidentiality – security of information

A final practical issue regarding client confidentiality is in relation to security of information. The auditor will hold a substantial amount of client information in their audit files. Auditors must ensure the security of this information at all times:

- audit files should be kept locked away whenever they are left unattended
- audit files should never be left in vulnerable locations, for example in the boot of your car
- audit working papers should not be taken away from the auditor's office or the client premises unless absolutely necessary
- auditors should not discuss confidential client details in public places or with any unrelated third party even if it is a 'trustworthy family member'!

Chapter Summary

- The responsibilities of directors and auditors of limited companies are set out in the Companies Act 2006.
- It is the responsibility of the directors of a company to prepare the accounts and to provide all the information and explanations the auditors need.
- The content of the financial statements of a limited company is defined in the Companies Act 2006.
- The Companies Act 2006 sets out specific requirements for the books and records which have to be maintained by a limited company and it is the specific responsibility of the directors to ensure that proper books and records are maintained.
- The accounting records must be sufficient to be able to show the company's financial position at any time – they must be sufficient to enable the directors to prepare a profit and loss account and balance sheet in accordance with the Companies Act.
- Auditors are also regulated by International Standards on Auditing (ISAs) which set out detailed rules as to how audits should be conducted.
- Auditors owe a duty of care to the shareholders as a body not to individual shareholders.
- Auditors should use reasonable skill and care in carrying out their work.
- The Caparo case decided that auditors are not liable to third parties (outsiders) unless the auditors were aware of their interest in the client (eg buying the client) at the time of the audit.
- Auditors must ensure that they maintain their independence from their client.
- Auditors should behave in a professional manner at all times and treat clients' staff with courtesy and consideration.
- Auditors must treat all the information they discover about their client as confidential except in certain specific circumstances.

Key Terms

Companies Act 2006	the statute which sets out the responsibilities of directors and auditors and governs the conduct of company affairs
Registrar of Companies	the Government official with whom annual accounts and other statutory documents must be filed – documents kept by the Registrar (at Companies House) are available to the general public
Auditing Practices Board (APB)	a body responsible for developing and issuing professional standards for auditors in the UK
International Standards on Auditing (ISAs)	internationally accepted auditing standards which influence the conduct of auditors and audits within the UK; they are issued by the Auditing Practices Board (APB)
auditing case law	court decisions and judgements relating to auditing which establish rulings for the conduct of auditors and audits
duty of care	an obligation on auditors to act with reasonable skill and judgement in all circumstances; where there is a direct relationship the auditors owe more than a general duty and must act specifically in the best interest of their client
ethical framework	a set of principles, set out in Auditing Standards, which define the skills an auditor should have and the standard of behaviour expected of them in dealing with clients and their financial affairs
confidentiality	the principle that auditors must not reveal any information that they have learned about a client to unauthorised third parties except in exceptional circumstances

2.1* Which of the following statements are not correct, and why?

(a) Auditors can be sued by a client if the client has suffered a loss.

(b) Auditors owe a duty of care to all the shareholders collectively.

(c) The Caparo decision means that auditors cannot be sued by third parties.

(d) Directors have to ensure that their company keeps proper books and records.

(e) If auditors work for a client who has been money laundering they must tell the authorities.

(f) Auditors can own shares in client companies.

(g) If a firm of auditors receives a bottle of whisky from a client during the festive season, they must return it.

2.2* Your firm are the auditors of Guzzlers Ltd who own a chain of cafes and restaurants. You have acted for them for many years.

Describe the ethical issues raised by the following two situations and explain how you would deal with them.

(a) A local bank lending officer contacts you and says the directors of Guzzlers Limited have approached the bank for a loan. The directors have sent her a copy of the accounts and suggests that she contacts you if there are any queries or if she needs more information.

(b) Andy Nose is employed by your firm and has been the manager of the audit for several years. He comes to you and says that he has been asked by Guzzlers Limited to carry out some financial consultancy work for them.

2.3* The directors of Bigboy.com, a new start-up hi-tech company, have approached your accounting firm Columbus & Co, asking you to become their financial advisor and auditor.

The directors own 20% of Bigboy.com, the remainder of the shares being held by an investment company which provided start-up funding.

Bigboy.com has been operating for about a year in a totally computerised environment using the Internet. The company does not have much in the way of paper-based systems.

The attitude of the directors is that they consider administration to be a nuisance and do not want to have to spend much time on book-keeping. Most of their financial transactions are processed electronically and their view is that all they need is access to their bank account so they can see how much money they have – that is all that they have time for.

You are due to meet the directors tomorrow. Write a memo setting out the key points you want to make to them regarding:

(a) the problems this attitude might create for them as directors

(b) the problems this creates for your firm as auditors

2.4 You are the new auditor of Jojo Limited and have discovered that for the last three years the directors have deliberately overstated the valuation of stocks. Jojo is a family company but not all the directors are shareholders.

The directors have told you that they did it to keep the company trading in the short term as the bank would have called in the overdraft if the profits had not continued to rise. They ask you informally to turn a blind eye to this year's valuation as the company will cease to trade if the true position is revealed and as a result all the shareholders will lose their money.

If the company can carry on trading it stands a good chance of survival.

You are to write a letter to the managing director setting out your position as auditor.

2.5 You are the auditor of a business which comprises a small chain of supermarkets. The business has recently collapsed, owing the bank over £250,000. Investigations have revealed that one of the directors has been systematically defrauding the business over a number of years.

The director had access to the computerised accounting records and was able to take money from the business and alter stock and purchases records to cover the fraud. You have raised internal control concerns with the directors over the last few years and made several recommendations none of which were acted upon.

The bank have written to you as auditor alleging that as you were responsible for checking the transactions you should have discovered the fraud and therefore they intend suing you for recovery of their loss.

Write briefing notes for a meeting, setting out the main points relevant to the situation.