e.g

Illustration 2: Wimble & Co ethics

You are an audit manager in Wimble & Co, a large audit firm which specialises in providing audit and accountancy services to manufacturing companies. Murray Co has asked your firm to accept appointment as external auditor. Murray Co manufactures sports equipment. Your firm also audits Barker Co, another manufacturer of sports equipment, and therefore your firm is confident it has the experience to carry out the audit.

You have been asked to take on the role of audit manager for Murray Co, should your firm accept the engagement. You own a small number of shares in Murray Co, as you used to be an employee of the company. Don Henman, who has been the engagement partner for Barker Co for twelve years, will take the role of engagement partner for Murray Co. The audit senior will be Tim Andrews, as his sister is the Financial Controller at Murray Co and therefore he knows the business well.

Your firm recently purchased some bibs, footballs and other equipment from Murray Co for the firm's annual football tournament. Murray Co has offered to provide this equipment free of charge to the firm if they accept the role as auditor.

Murray Co would also like your firm to provide taxation and accounting services. Specifically, the company would like you to prepare the financial statements and represent the company in a dispute with the taxation authorities.

The fees for last year's audit of Barker Co have not yet been paid, and you have been asked by Don Henman to look into the matter.

Exercise:

Using the information provided, explain the ethical threats which may affect the independence of Wimble & Co in respect of the audit of Murray Co or Barker Co, and for each threat identify ways in which the threat might be reduced.

Solution: Wimble & Co ethics

Conflict of Interest

Wimble & Co also audits Barker Co, another manufacturer of sports equipment. The engagement partner for Barker Co will be the engagement partner for Murray Co.

Acting for directly competing clients is a threat to objectivity (and confidentiality). It is normal for firms to have clients that are in competition with each other; firms need relevant professional experience in the client's industry in order to comply with the fundamental principle of professional competence and accept appointment as auditor.

In order to manage such a conflict of interest, Wimble & Co should ensure that separate teams are used for each engagement – more detail is provided later in this chapter.

Financial interest

The audit manager owns shares in Murray Co.

The audit firm or a member of the assurance team (or their immediate family) are not allowed to own a direct financial interest in a client.

This creates a **self-interest threat**: the audit manager may be reluctant to identify misstatements or modify the audit opinion for fear of damaging the value of their shareholding.

The audit manager must be required to dispose of the shares, or another audit manager should be appointed to the engagement team instead.

Business relationship

Wimble & Co recently purchased some bibs, footballs and other equipment from Murray Co.

Purchasing goods and services from an audit client, does not generally create a threat to independence if the transaction is in the normal course of business and at arm's length.

However, a close business relationship between a firm or an audit team member (or their immediate family) and the client, such as a joint venture, creates a **self-interest threat**. Such relationships are not normally acceptable unless clearly insignificant.

Gifts and hospitality

Murray Co has offered free equipment to the auditor.

Accepting gifts or hospitality from an audit client may create **self-interest** and **familiarity** threats.

The partners of the firm should evaluate the gift offered and unless trivial and inconsequential, the audit team must not accept the equipment.

Long association

The engagement partner for Barker Co has been in place for twelve years.

Familiarity and **self-interest** threats are created by using the same senior personnel on an assurance engagement for a long period of time. Possible safeguards include:

- rotating the senior personnel off the assurance team
- independent review of the senior personnel's work
- independent quality control reviews of the engagement.

If it is a **listed company or another public interest entity**, individuals cannot act as **key audit partners** for more than **seven years** before being rotated off the audit for a minimum of **two years** (in exceptional circumstances in the interest of audit quality, an individual can act as key audit partner for eight years).

Personal relationship

The audit senior's sister is the Financial Controller at Murray Co.

Family and personal relationships between a member of an assurance team and a director of the client, or an employee of the client in a position to exert significant influence over the subject matter, may create **self-interest**, **familiarity** or **intimidation threats**.

Tim Andrew's sister is the Financial Controller at Murray Co and is therefore in a position to exert significant influence over the financial statements. Tim Andrews should not be on the audit team for Murray Co.

Provision of other services

The provision of other services may create threats to objectivity and independence. The threats, and significance of those threats is dependent on the services being provided.

However, there are some threats that may be created regardless of the type of service, such as:

- When the total fees from an audit client represent a large proportion of a firm's total income (or a specific partner or office's income), i.e. **fee dependence**, a **self-interest** or **intimidation** threat to objectivity may be created; the auditor may be reluctant to identify misstatements in the financial statements or to modify the audit opinion, for fear of losing the client. Possible safeguards include:
  - reducing dependence on the client
  - independent quality control reviews of the engagement.
- When the audit client is a **listed client or other public interest entity**, and the total fees represent **more than 15%** of the firm's total income for **two consecutive years**, the firm must:
  - disclose this to those charged with governance
  - arrange for an external quality control review of the engagement (either before or after issuing the audit report).
- Assuming management responsibilities for an assurance client may create threats to independence. The provision of other services may require the assurance firm to assume management responsibilities but an assurance firm **must not assume management responsibilities** as part of an assurance engagement or **for an audit client**.
  - Activities that are routine and administrative, or involve matters that are insignificant, generally are deemed not to be a management responsibility.
  - Providing advice and recommendations to assist management in discharging its responsibilities is not assuming management responsibilities.

In addition:

(1) **Murray Co would like the audit firm to prepare the financial statements.**

Preparing the financial statements and then auditing them creates a significant **self-review** threat to objectivity. However, audit firms may provide such services, as long as the client is not a listed or other public-interest entity, with adequate safeguards in place, including:

- Using staff who are not part of the audit team to prepare the financial statements or
- if performed by a member of the audit team, arranging an independent partner or senior staff member to review the work performed.

If an **audit client** is a **listed or other public-interest entity**, the firm **must not provide any accounting or bookkeeping services**, including payroll services or preparation of the financial statements.

(2) **Murray Co would like the audit firm to and represent the company in a dispute with the taxation authorities.**

This would create **advocacy** and **self-review** threats.

Firms must not represent audit clients in such disputes.

Overdue fees

The fee for last year's audit of Barker Co have not yet been paid.

Overdue fees create a **self-interest threat** where they remain unpaid for some time.

In addition, overdue fees could be perceived to be a loan. **An audit firm must not enter into any loan arrangement with a client.**

A firm should take steps to ensure audit fees are paid before the audit report is issued. If fees remain outstanding for any engagement, possible safeguards include an independent quality control review.

5 Confidentiality

External auditors are in a unique position of having a legal right of access to all information about their clients. The client must be able to trust the auditor not to disclose anything about their business to anyone as it could be detrimental to their operations.

Members of an assurance team should not disclose any information to anyone outside of the engagement team, whether or not they work for the same firm.