ACCA June 2013 (2.a): Kennel & Co audit firm

Kennel & Co, a firm of Chartered Certified Accountants, is the external audit provider for the Retriever Group (the Group), a manufacturer of mobile phones and laptop computers. The Group obtained a stock exchange listing in July 2012. The audit of the consolidated financial statements for the year ended 28 February 2013 is nearing completion.

You are a manager in the audit department of Kennel & Co, responsible for conducting engagement quality control reviews on listed audit clients. You have discussed the Group audit with some of the junior members of the audit team, one of whom made the following comments about how it was planned and carried out:

«The audit has been quite time-pressured. The audit manager told the juniors not to perform some of the planned audit procedures on items such as directors' emoluments and share capital as they are considered to be low risk. He also instructed us not to use the firm's statistical sampling methods in selecting trade receivables balances for testing, as it would be quicker to pick the sample based on our own judgement».

«Two of the juniors were given the tasks of auditing trade payables and going concern. The audit manager asked us to review each other's work as it would be good training for us, and he didn't have time to review everything».

«I was discussing the Group's tax position with the financial controller, when she said that she was struggling to calculate the deferred tax asset that should be recognised. The deferred tax asset has arisen because several of the Group's subsidiaries have been loss making this year, creating unutilised tax losses. As I had just studied deferred tax at college I did the calculation of the Group's deferred tax position for her. The audit manager said this saved time as we now would not have to audit the deferred tax figure».

«The financial controller also asked for my advice as to how the tax losses could be utilised by the Group in the future. I provided her with some tax planning recommendations, for which she was very grateful».

Required:

In relation to the audit of the Retriever Group, evaluate the quality control, ethical and other professional matters arising in respect of the planning and performance of the Group audit.

ANSWER

There are many concerns raised regarding quality control. Audits should be conducted with adherence to ISA 220 *Quality Control for an Audit of Financial Statements* and it seems that this has not happened in relation to the audit of the Retriever Group, which is especially concerning, given the Group obtaining a listing during the year. It would seem that the level of staffing on this assignment is insufficient, and that tasks have been delegated inappropriately to junior members of staff.

Time pressure

The junior's first comment is that the audit was time pressured. All audits should be planned to ensure that adequate time can be spent to obtain sufficient appropriate audit evidence to support the audit opinion. It seems that the audit is being rushed and the juniors instructed not to perform work properly, and that review procedures are not being conducted appropriately. All of this increases the detection risk of the audit and, ultimately, could lead to an inappropriate opinion being given.

Procedures not performed

The juniors have been told not to carry out some planned procedures on allegedly low risk areas of the audit because of time pressure. It is not acceptable to cut corners by leaving out audit procedures. Even if the balances are considered to be low risk, they could still contain misstatements. Directors' emoluments are related party transactions and are material by their nature and so should not be ignored. Any modifications to the planned audit procedures should be discussed with, and approved by, senior members of the audit team and should only occur for genuine reasons.

Method of selecting sample

ISA 530 *Audit Sampling* requires that the auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. The audit manager favours non-statistical sampling as a quick way to select a sample, instead of the firm's usual statistical sampling method. There is a risk that changing the way that items are selected for testing will not provide sufficient, reliable audit evidence as the sample selected may no longer be representative of the population as a whole. Or that an insufficient number of items may be selected for testing. The juniors may not understand how to pick a sample without the use of the audit firm's statistical selection method, and there is a risk that the sample may be biased towards items that appear 'easy to audit'. Again, this instruction from the audit manager is a departure from planned audit procedures, made worse by deviating from the audit firm's standard auditing methods, and likely to increase detection risk.

Audit of going concern

Going concern can be a difficult area to audit, and given the Group's listed status and the fact that losses appear to have been made this year, it seems unwise to delegate such an important area of the audit to an audit junior. The audit of going concern involves many subjective areas, such as evaluating assumptions made by management, analysing profit and cash flow forecasts and forming an overall opinion on the viability of the business. Therefore the going concern audit programme should be performed by a more senior and more experienced member of the audit team. This issue shows that the audit has not been well planned as appropriate delegation of work is a key part of direction and supervision, essential elements of good quality control.

Review of work

The juniors have been asked to review each other's work which is unacceptable. ISA 220 requires that the engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. Ideally, work should be reviewed by a person more senior and/or experienced than the person who conducted the work. Audit juniors reviewing each other's work are unlikely to spot mistakes, errors of judgement and inappropriate conclusions on work performed. The audit manager should be reviewing all of the work of the juniors, with the audit partner taking overall responsibility that all work has been appropriately reviewed.

Deferred tax

It is concerning that the client's financial controller is not able to calculate the deferred tax figure. This could indicate a lack of competence in the preparation of the financial statements, and the audit firm should consider if this impacts the overall assessment of audit risk.

The main issue is that the junior prepared the calculation for the client. IESBA's (IFAC) *Code of Ethics for Professional Accountants* states that providing an audit client with accounting and bookkeeping services, such as preparing accounting records or financial statements, creates a self-review threat when the firm subsequently audits the financial statements. The significance of the threat depends on the materiality of the balance and its level of subjectivity.

Clients often request technical assistance from the external auditor, and such services do not, generally, create threats to independence provided the firm does not assume a management responsibility for the client. However, the audit junior has gone beyond providing assistance and has calculated a figure to be included in the financial statements. The Group is listed and generally the provision of bookkeeping services is not allowed to listed clients.

IESBA's Code states that, except in emergency situations, in the case of an audit client that is a public interest entity, a firm shall not prepare tax calculations of current and deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the financial statements on which the firm will express an opinion.

The calculation of a deferred tax asset is not mechanical and involves judgements and assumptions in measuring the balance and evaluating its recoverability. The audit junior may be able to perform a calculation, but is unlikely to have sufficient detailed knowledge of the business and its projected future trading profits to be able to competently assess the deferred tax position. The calculation has not been reviewed and poses a high audit risk, as well as creating an ethical issue for the audit firm.

The deferred tax balance calculated by the junior should be assessed for materiality, carefully reviewed or re-performed, and discussed with management. It is unclear why the junior was discussing the Group's tax position with the financial controller, as this is not the type of task that should normally be given to an audit junior.

Tax planning

The audit junior should not be advising the client on tax planning matters. This is an example of a non-audit service, which can create self-review and advocacy threats to independence. As discussed above, the audit junior does not have the appropriate level of skill and knowledge to perform such work.

The junior's work on tax indicates that the audit has not been properly supervised, and that the junior does not seem to understand the ethical implications created. As part of a good quality control system, all members of the audit team should understand the objectives of the work they have been allocated and the limit to their responsibilities.