

ACCA December 2013 (4): Chester & Co audit firm

You are an audit manager in Chester & Co (audit firm), and you are reviewing three situations which have recently arisen with respect to potential and existing audit clients of your firm.

Tetbury Co's managing director, Juan Stanton, has approached Chester & Co to invite the firm to tender for its audit. Tetbury Co is a small, owner-managed company providing financial services such as arranging mortgages and advising on pension plans. The company's previous auditors recently resigned. Juan Stanton states that this was due to '*a disagreement on the accounting treatment of commission earned, and because they thought our controls were not very good.*' You are aware that Tetbury Co has been investigated by the financial services authority for alleged non-compliance with its regulations. As well as performing the audit, Juan would like Chester & Co to give business development advice.

The audit of **Stratford Co's** financial statements for the year ended 30 November 2013 will commence shortly. You are aware that the company is in financial difficulties. Stratford Co's managing director, Colin Charlecote, has requested that the audit engagement partner accompanies him to a meeting with the bank where a new loan will be discussed, and the draft financial statements reviewed. Colin has hinted that if the partner does not accompany him to the meeting, he will put the audit out to tender. In addition, an invoice relating to interim audit work performed in August 2013 has not yet been paid.

Banbury Co is a listed entity, and its audit committee has asked Chester & Co to perform an actuarial valuation on the company's defined benefit pension plan. One of the audit partners is a qualified actuary and has the necessary skills and expertise to perform the service. Banbury Co has a year ending 28 February 2014, and the audit planning is due to commence next week. Its financial statements for the year ended 28 February 2013, in respect of which the audit report was unmodified, included total assets of \$35 million and a pension liability of \$105,000.

Required:

Identify and discuss the ethical and other professional issues raised, and recommend any actions that should be taken in respect of:

- (a) **Tetbury Co;**
- (b) **Stratford Co; and**
- (c) **Banbury Co.**

ANSWER

(a) Tetbury Co

Chester & Co needs to conduct customer due diligence (know your client) procedures to ensure that anti-money laundering requirements are adhered to. This is especially important given the highly regulated nature of Tetbury Co's business. Background checks will need to be made on Juan Stanton and other members of management, and the nature of the business including the sources of income must be fully understood before deciding on accepting the audit appointment.

The competence of the audit firm in relation to the audit of a financial services firm should be evaluated, as it is a relatively specialised area. This is an ethical matter, with IESBA's (IFAC) *Code of Ethics for Professional Accountants* Code stating that a self-interest threat to professional competence and due care is created if the engagement team does not possess, or cannot acquire, the competencies necessary to properly carry out the engagement.

Chester & Co should consider whether it is appropriate to be appointed as auditor to Tetbury Co from an ethical point of view. The IESBA Code states that before accepting a new client relationship, a professional accountant in public practice shall determine whether acceptance would create any threats to compliance with the fundamental principles. Threats to integrity may arise from questionable activities by management of the company or from inappropriate financial reporting.

It appears that Tetbury Co's management may lack integrity due to its past investigation by the financial services authority. Chester & Co should find out more about this matter, for example, reading press reports or contacting the financial services authority for more information.

In addition, the resignation of the previous auditors over a disagreement indicates a possible problem with

management's integrity. There may also be ethical issues, for example, management may have intimidated the previous auditors over the financial reporting issue which prompted their resignation.

Chester & Co should request permission to contact the previous audit firm to obtain further information on the reasons behind the resignation, and if there are any other matters which should be considered in deciding whether to take on the audit appointment. It is important that all relevant facts are known before an acceptance decision is made. A threat to professional competence and due care arises where the appointment is accepted without full knowledge of relevant information.

Juan's comment about deficient controls is also a cause for concern, as it indicates that the audit would be high risk. While this alone does not mean that the audit should not be taken on, Chester & Co should consider whether the audit risk can be reduced to an acceptable level, for example, by using an experienced audit team and a substantive audit approach. As part of its client acceptance decision, Chester & Co should consider whether the fee for the audit outweighs the risk involved.

The audit firm could apply a safeguard such as securing Juan's commitment to improve the company's control environment before accepting the client.

Tetbury Co is owner-managed. This means that management comes to rely on the auditor for advice and recommendations and the audit firm could be perceived to be taking on the responsibilities of management. This is especially relevant to Juan's suggestion that the audit firm can provide business advice.

According to the IESBA Code, this situation gives rise to potential self-review and self-interest threats to objectivity. If the audit firm were to assume management responsibilities, then no safeguards can reduce the threat to an acceptable level. However, providing advice and recommendations to assist management in discharging its responsibilities is not assuming a management responsibility.

If the audit appointment is accepted, Chester & Co may wish to obtain written confirmation from management that it acknowledges responsibility for business decisions taken.

(b) Stratford Co

The request to attend a meeting with the company's bank can give rise to an advocacy threat to objectivity. IESBA's Code defines an advocacy threat as the threat that a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised. In this case, the managing director may want the audit engagement partner to support a view that Stratford Co will be able to continue as a going concern and that the loan ultimately will be repaid. This means that the audit partner is promoting the client which leads to the creation of an advocacy threat.

In addition, from a legal perspective, the audit firm must be careful not to create the impression that they are in any way guaranteeing the future existence of the company or providing assurance on the draft financial statements. 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 Stratford Co defaulting on any loan provided by the bank.

It may be possible for a partner other than the audit engagement partner to attend the meeting with the bank, which would be a form of safeguard against the ethical threat. Chester & Co's partner responsible for ethics should consider the severity of the threat and whether this, or another safeguard, could reduce the threat to an acceptable level.

There is also an intimidation threat to objectivity caused by the managing director's hint at putting the audit out to tender. IESBA's Code states that an audit firm being threatened with dismissal from a client engagement represents an intimidation threat. The managing director's actions should also lead to questions over his integrity, and the audit firm may wish to consider resigning from the audit if the threat becomes too severe.

Overdue audit fees are a self-interest threat, according to IESBA's Code, which states that a self-interest threat may be created if fees due from an audit client remain unpaid for a long time, especially if a significant part is not paid before the issue of the audit report for the following year. The audit firm should determine the amount of fee that is unpaid, and whether it could be perceived to be a loan made to the client. It may be a relatively insignificant amount, and it may not be long overdue as it relates to work performed less than four months ago, in which case the threat to objectivity is not significant.

(c) Banbury Co

Providing an actuarial valuation service is an example of providing a non-assurance service. According to IESBA's Code, the provision of such services can create threats to objectivity of self-review and self-interest. The self-review

threat arises because the defined benefit pension plan on which Chester & Co has been asked to provide a valuation service is included in the statement of financial position, and the audit firm would need to audit the figure which has been generated by a member of the firm. The self-interest threat arises from the fee which would be paid to the firm.

Chester & Co needs to evaluate the significance of the threats and whether safeguards could be used to reduce the threats to an acceptable level. In assessing the self-review threat the following factors should be considered:

- Whether the valuation will have a material effect on the financial statements.
- The extent of the client's involvement in determining and approving the valuation methodology and other significant matters of judgement.
 - The availability of established methodologies and professional guidelines.
 - For valuations involving standard or established methodologies, the degree of subjectivity inherent in the item.
 - The reliability and extent of the underlying data.
 - The degree of dependence on future events of a nature that could create significant volatility inherent in the amounts involved.
 - The extent and clarity of the disclosures in the financial statements.

A key matter to be considered is the materiality of the pension plan to Banbury Co's financial statements. Banbury Co is a listed company, and therefore a public interest entity. The Code states that an audit firm shall not provide valuation services to an audit client which is a public interest entity if the valuations would have a material effect, separately or in the aggregate, on the financial statements on which the firm will express an opinion.

Based on the 2012 financial statements, the pension liability at the year end represented only 0.3% of total assets and was immaterial. Chester & Co should consider whether there are any indications that the pension deficit may have become more significant during the year, which may have caused the balance to become material. In which case the audit firm should not provide the valuation service to Banbury Co.

An actuarial valuation involves significant subjectivity, for example, in determining the appropriate discount rate, and in estimating key variables to be used in the calculations. It is also unlikely that Banbury Co's management will possess sufficient knowledge and experience to have much involvement, if any, in the valuation. However, it may be possible to use safeguards to reduce the threats to an acceptable level.

Examples of such safeguards include:

- Having a professional who was not involved in providing the valuation service review the audit or valuation work performed; or
- Making arrangements so that personnel providing such services do not participate in the audit engagement.