

## Solutions to Student Self Assessment Questions

### Chapter 3

#### **The meaning and importance of auditor independence, factors affecting independence and measures to attain it**

#### **Questions**

**3.1** Consider the following situations:

(a) Assume that you are a partner in a two partner practice with total practice income of £250,000. One of your clients (a private limited company with a turnover of £10 million and with some 80 employees) pays ongoing fees to you amounting in total to £35,000. Do you think that your independence might be threatened? What steps would you take in a situation like this?

(b) Assume that you are partner in charge of an office of your firm. You are engagement partner of a major client whose fees of £150 000, represent 2 per cent of the total gross practice income of your firm, but 20 per cent of the income of your office. Consider the implications in the light of the IFAC Code and APB Ethical Standards

(c) Assume that you are a partner with a number of clients for whom you are personally responsible. One of these clients is much larger than the others and you have to spend about 40 per cent of your time on the assignment. The fees receivable represent about 4 per cent of the gross practice income of your firm. Your own income is not based on fees receivable from this client. Consider the implications of this situation.

**3.2** Now that you have read the IFAC Code and the APB Ethical Standards do you think that they have been influenced by prior work on auditing theory? Justify a Yes or No answer.

**3.3** You have been asked by your audit partner to be senior in charge of the audit of a small public limited company. Unbeknown to the partner, you hold 1,000 of the 100,000 shares in the company. Do you think that you could remain unbiased in relation to this client?

**3.4** You have just been telephoned by the chief accountant of a listed company client – Randerston plc – to tell you that there has been a computer breakdown and that some parts of the data concerning construction contracts have been lost. He asks if two senior members of the firm's engagement team could be loaned to enable reconstruction of the data to be made on a timely basis. The deadline would be in 30 days time when the draft financial statements are due to be finalized. What issues would you consider and what would be your response?

#### **Solutions**

3.1 a) In this case, the fees are less than 15% of gross practice income, but they are far in excess of the 10% and you would no doubt not wish to lose this income. ES4 certainly suggests that this situation might threaten independence. You might feel yourself that you are professional person and could maintain your independence, but you should remember that it is the perception of independence that is just as important as actual independence. There are two important matters in relation to the scenario outlined, namely, that the audit client is not a small entity, but your firm has less than three partners and cannot fulfil the requirement that an ethics partner should perform a hot review of the audit procedures, documentation and conclusions before the audit report is finalized. However, you should certainly

discuss the key issues affecting the audit of your client with your fellow-partner, and perhaps even ask an outside firm to perform the hot review for you. You should also inform those charged with governance of the audit client of the significance of the fee issue, and you might even consider giving up some of the non-audit work, if any, particularly if the fees are likely to rise above 15% of your gross practice income

- b) The problem here is that losing this client might mean that the office would lose its viability and your objectivity might be threatened in consequence. The threat to your independence would be particularly grave if your remuneration was based, at least to some extent, on the fees generated by your office. This is clearly a situation where the matter should be referred to the ethics partner. However, as your remuneration is based to some extent on the fees of this client this looks as if your firm might have to consider resigning from the audit of this client, unless your firm can assign this client to another part of the firm. See paragraph 25 of ES4 in this connection.
- c) You are clearly spending a great deal of time with the client in question, and your objectivity might be threatened because of the closeness of the relationship, that is, there may well be a familiarity threat. Although the fee income is below the limits specified in ES4 and though your own remuneration is not affected specifically by the fees received from this client, your firm would have to have policies and procedures in force to ensure that the familiarity threat was countered. The matter should be referred to the ethics partner, who might perform a hot review of the audit procedures, documentation and conclusions, considering in particular the key inherent and control risks facing the client. Consideration should also be given to the period of time that you have been involved with the client and in the circumstances it might be wise to consider rotation even if your period of engagement does not exceed the limits specified in ES3 (5 years for a listed company client and 10 years for a non-listed client).

3.2 The first and indeed seminal academic work on auditing appeared in 1961 when Mautz and Sharaf published 'The Philosophy of Auditing' which included a considerable section on independence, some of which we have introduced in this chapter. Since then, there has been considerable academic interest in auditing and we have introduced you to some of their work in this chapter, that of Goldman and Barlev and of Shockley in particular. These writers identified some years ago the risks to independence that find a place in the Statement. Shockley even went so far as to say that his work would be an aid to legislators. By legislators we include not merely legislators in parliament but those members of the profession and others who are responsible for issuing guidance to members of the auditing profession, including the IFAC Code and the APB Ethical Standards. We discussed this matter in the text and believe therefore that the Statement has indeed been influenced by academic work in the past.

3.3 You might think that holding 1,000 shares from 100,000 would be a matter of little importance as it represents only 1% of the total. However, holding of shares in the auditee company is one particular risk to integrity, objectivity and independence that ES2 regards as an insurmountable self-interest threat. You might regard yourself as a fairly lowly member of staff and that, as your work is reviewed and controlled by others, there would be no threat as far as your audit firm is concerned. However, being senior in charge, you are likely to have an influence on the conduct and outcome of the audit and you should inform the audit partner of your holding. The likely action by your firm is concerned would be to remove you from the audit, and, if you have already been engaged in some audit work, to have this work subjected to independent review. This is because there are no safeguards to counter a financial interest of this nature (see paragraph 8 of ES2. You could, of course, dispose of your shares if you wish to

continue as senior on the assignment, but even then, you might be excluded temporarily (see paragraph 13 of ES2).

- 3.4 The general rule is that accounting services should not be provided to listed company clients (see paragraph 117 of ES 5). However, this is clearly an emergency as contemplated in paragraph 121 and one that might have unfortunate consequences for Randerston plc, if it meant that it missed filing financial statements on a timely basis, or if obtaining further lines of credit was dependant on timely preparation of those statements. In these circumstances you could accede to the request of Randerston's chief accountant, but you have to warn him that the two members of staff seconded to the company would not be able to take any part in the audit engagement. You might suggest that two other members of staff with IT and accounting backgrounds could perform the work instead. You should also say that the help that the audit firm's staff would be of a technical nature and that they should not take part in any activity which would be the province of management, such as making decisions on such matters as stage of completion and any profits or losses to be taken up.