

1 Ethical issues for auditors – common problems (Lecture A689 – 23.52 minutes)

This section examines some of the more common ethical issues for auditors, but it does not consider the requirements for either listed audits or Public Interest Entities (PIEs).

1.1 Non-audit services – prohibited services

When auditing entities that are not (PIEs) or listed there are many non-audit services that auditors can provide which are not prohibited (although appropriate safeguards are often required).

When the FRC's *Ethical Standard* (ES) was introduced in 2016 it created two problem prohibitions which relate to providing tax advocacy services and certain tax services where contingency fees are charged.

Additionally, auditors providing valuation services has been problematic for a while. The ES makes the point that the auditor cannot undertake a valuation that is both material and involves significant subjective judgement.

1.2 Non-audit services – applying safeguards

Auditors, particularly of smaller entities, often provide non-audit services such as accountancy and corporation tax compliance. In addition VAT, PAYE and other similar services are also common.

These services tend not to be prohibited when provided to unlisted companies and non-PIEs, but there are certain conditions that must be met:

- The auditor has to identify and document the name(s) of informed management.
- The nature of the services provided need to be documented – note that some non-audit services will be prohibited such as accountancy services which involve creating originating documentation or that forms part of the entity's internal control environment.
- Threats to independence must be identified and documented – sometimes the threats might be so great that they cannot be managed with safeguards and either the service should not be provided or the auditor should withdraw from the engagement.
- Appropriate safeguards need to be applied – for certain non-audit services, safeguards are always required.

Question 1 – Ask the audience

Company A Ltd maintains good accounting records and prepares accurate and complete management accounts. It adjusts for accruals, prepayments, depreciation, stock, warranty provisions, bad debts, tax, deferred tax etc. Everything balances!

However, Company A does not have the expertise to put its financial statements in Companies Act format and draft the relevant disclosures and they ask the auditors to do this. Few adjustments are needed to the reported results in the management accounts.

What are the independence considerations that the auditor must consider?

Question 2 – Ask the audience

Company B Ltd needs significant assistance with the preparation of the financial statements, corporation tax returns, VAT and PAYE. Nothing balances!

What are the independence considerations that the auditor must consider?

Note: Neither of the above questions have a written answer, because different audit firms approach these issues in different ways and have different policies. A written answer might confuse people if it suggested a different approach to that adopted by a particular firm.

However, what these examples should illustrate is the need to document the nature of the non-audit services and identify the threats and appropriate safeguards on a case-by-case basis.

1.3 Long association and the 10-year rule

For listed audit clients there is a requirement for mandatory audit partner rotation. However, there is no equivalent requirement for unlisted audit engagements.

For unlisted clients, once an audit engagement partner has held this role for a continuous period of ten years, careful consideration must be given as to whether a reasonable and informed third party would consider the audit firm's objectivity and independence to be impaired. The ES does not demand rotation of the partner at this point but, in the absence of rotation, it requires either safeguards to be applied or, in the absence of safeguards, the audit firm must document the reasons why the partner continues to participate in the audit engagement without safeguards and these facts are communicated to those charged with governance of the client.

For example, the following documentation might be seen on an audit file.

Dover Transport Ltd – extract from audit file - example

The audit partner, Mr Georghegan, has been the audit engagement partner for 22 years for Dover Transport Ltd (DTL). DTL is a large client and the partner spends approximately 20 hours a year working on the audit, accounts, tax and other services for this client.

Long association has led to a familiarity threat and the safeguard applied is a second partner review by Mrs Coleman the compliance partner.

Rainbow Ltd – extract from audit file - example

Rainbow Ltd is a small charity and Mrs Ramillies has been the audit engagement partner for 10 years. It is a pure audit with a fee of £3,000 per annum and the partner's involvement is only three hours a year. The audit senior who does most of the audit work has only been doing the audit for the past two years

There is no significant threat to independence arising from long association, partly because long association has not caused any particular over-familiarity on the part of Mrs Ramillies and partly because the audit senior has only been doing this audit for two years. The client has been informed of this issue.

Note: In this example the new audit senior is seen as reducing the partner's long association threat. In practice the effect of this can sometimes be overstated and perhaps a second partner review is needed as a safeguard

1.4 Gifts and hospitality

The ES deals with the issue of gifts and hospitality in paragraphs 4.61D to 4.65. Paragraph 4.61D of the ES states:

A firm, its partners and any covered person, and persons closely associated with them, shall not solicit or accept pecuniary and non-pecuniary gifts or favours, including hospitality, from an entity relevant to the engagement, or any other entity related to that entity, unless an objective, reasonable and informed third party would consider the value thereof as trivial or inconsequential.

FRC Ethical
Standard
paragraph 4.61D

Paragraph 4.62 of the ES then goes on to confirm that when gifts, favours or hospitality are accepted from an audit client, or from others related to the audit client, a self-interest and familiarity threat to integrity, objectivity and independence are created. In addition, familiarity threats are also created where gifts, favours or hospitality are offered to an audit client, its partners or any other covered person.

What do you think about the following scenarios?

Scenario 1

The financial statements of North Co Ltd for the year ended 31 August 2019 have just been approved and the auditor's report thereon signed by the audit engagement partner. The chief executive officer of North Co has offered to take the audit engagement partner out for a business lunch at North Co's expense.

Scenario 2

An audit client has a staff canteen or a dining room, and the audit staff are invited to use these facilities at lunchtime, free of charge.

Scenario 3

The audit manager is invited to their audit client's staff Christmas party.

Paragraph 4.63 of the ES states:

The firm shall establish policies on the nature and value of gifts, favours and hospitality that may be accepted from and offered to an entity relevant to an engagement, or any other entity related to that entity, their directors, officers and employees, and shall issue guidance to assist partners and staff to comply with such policies.

*FRC Ethical
Standard
paragraph 4.63*

Where gifts and hospitality are accepted by the audit firm, or are offered more than once, the view of an objective, reasonable and informed third party of the **cumulative** effect is considered. Therefore, to comply with this requirement, a record of such gifts and hospitality (and offers thereof) should be retained by the audit firm.

When there is any doubt as to the acceptability of gifts, favours or hospitality by the audit team, the team must discuss the situation with the engagement partner. Where the audit engagement partner has any doubts as to the acceptability of gifts, favours or hospitality, he/she must refer the issue to the firm's ethics partner/ethics function. Whenever there are doubts in such cases, it would always be advisable to decline the offer as, in such cases, if there are doubts in the minds of the audit engagement team, it is usually the case that the view of an objective, reasonable and informed third party would be that an ethical threat has been created.