

QUESTION TWO

- (a) A member of the auditing profession should strive for objectivity in all professional and business relationships.

Requirement

Explain, with reference to both external and internal auditors, the meaning of the term “objectivity” in the context of auditing.

Also explain the nature of the threats, giving examples, faced by an auditor who strives for objectivity.

(20 marks)

(b)

You are the audit manager in the audit firm of Dawson & Co. One of your audit clients is Native Co, a company specialising in the manufacture and supply of sporting equipment. Native have been an audit client for five years and you have been audit manager for the past three years while the audit partner has remained unchanged.

You are now planning the audit for the year ending 31 December 2012. Following an initial meeting with the directors of Native, you have obtained the following information.

- (i) Native is attempting to obtain a listing on the London stock exchange. The directors have established an audit committee, as required by corporate governance regulations, although no further action has been taken in this respect. Information on the listing is not yet public knowledge.
- (ii) You have been asked to continue to prepare the company’s financial statements as in previous years.
- (iii) As the company’s auditors, Native would like you and the audit partner to attend an evening reception in a hotel, where Native will present their listing arrangements to banks and existing major shareholders.
- (iv) Native has indicated that the fee for taxation services rendered in the year to 31 December 2010 will be paid as soon as the taxation authorities have agreed the company’s taxation liability. You have been advising Native regarding the legality of certain items as “allowable” for taxation purposes and the taxation authority is disputing these items. Finally, you have just acquired about 5% of Native’s share capital as an inheritance on the death of a distant relative.

Requirement:

Identify, and explain the relevance of, any factors which may threaten the independence of Dawson & Co's audit of Native Co's financial statements for the year ending 31 December 2012. Briefly explain how each threat should be managed.

(20 marks)

(TOTAL 40 MARKS)

QUESTION TWO

- (a) Objectivity is defined as being "a state of mind which has regard to all considerations relevant to the task in hand but no other. It pre-supposes intellectual honesty"

External Auditors

Objectivity is usually hallmarked by independence in the case of external auditors. The auditor must be, and be seen to be, independent. The professional accountancy bodies provide a number of ethical guidelines as to how an auditor should maintain his independence.

Internal auditors:

Internal auditors are usually employees of the people they report to, so independence is a more difficult issue to understand here. However, it is vital that they maintain objectivity towards their tasks within a company. They must ensure they avoid conflicts of interest and maintain integrity in their relationships with other staff members.

In particular, an internal auditor is bound by their professional body's Code of ethics and Conduct. Objectivity is a fundamental principle of this code.

Threats to Objectivity

- Self Interest
- Self Review
- Advocacy
- Familiarity
- Intimidation

(b)

Threats to independence

Rotation of audit partner

Native Co have had the same audit partner for the last five years. An audit partner's independence may be impaired where that position is retained for more than five years for a listed company. The reason being that the partner has become too close to the directors and staff in the firm and this may impair his judgement on the financial statements. However, Native is currently not listed so this requirement does not apply.

As Native is now being listed, Dawson & Co should rotate the audit partner this year to avoid any familiarity threat. However, given that Native was not a listed company up to this audit, may imply that the partner could continue this year, but would be recommended to be rotated before the 2008 audit.

Preparation of financial statements

Apparently Dawson have been preparing Native's financial statements as well as carrying out the audit in previous years. While this may not have been an independence issue in the past, it will now as audit firms are not allowed to prepare financial statements of listed companies. Preparing financial statements as well as auditing them would provide Dawson

with a self-review threat, that is they may not see any errors, or want to report errors in material that they have previously prepared.

Dawson should therefore decline from preparation of Native's financial statements.

Attendance at social event

Attending the social event with respect to the new listing may be inappropriate as Dawson may be seen as supporting Native in this venture. There is an advocacy threat to independence. Support for a client may imply that the audit firm are "too close" to that client and may therefore lose their independent view regarding the audit. There is also a familiarity threat.

Dawson should therefore politely decline the dinner invitation, clearly stating their reasons.

Unpaid taxation fee

The unpaid fee in respect of taxation services could be construed as a loan to the audit client. Audit firms should not make loans to or receive loans from audit clients. An outstanding loan will affect independence as closure of the loan may be seen as more important than providing an appropriate audit opinion.

Dawson needs to discuss the situation with Native again, suggesting that a payment on account could be made to show that the whole fee will be paid. Alternatively, audit work on the 2007 financial statements can be delayed until the taxation fee is paid.

Inheritance

Under Codes of Ethics and Conduct, audit partners may not hold beneficial shares in a client company. This provision includes audit staff where they are involved in the audit. The independence issue is simply that the shareholder (the auditor in this case) may be more interested in the value of the shares than providing a "correct" opinion on the financial statements.

The shares should be disposed of as soon as possible. However, given the inside knowledge of the listing, disposal now, or delaying disposal a few days to obtain a better price may be considered "insider dealing". It may be better that the audit manager resigns from the audit immediately to limit any real or potential independence problems. Professional advice may be needed on when to sell the shares.