

You are a manager in Depeche, a firm of Chartered Certified Accountants. You have specific responsibility for undertaking annual reviews of existing clients and advising whether an engagement can be properly continued. The following matters arose in connection with the audit of Duran plc for the year to 31 December 2002:

- (1) The audit team included a manager, two supervisors, two qualified seniors and six trainees. The final audit, which lasted approximately five weeks, was very time-pressured and the team worked late into the night towards the end of the audit. Duran's staff were very supportive throughout and paid for evening meals that were brought in so that the audit team could work with minimum disruption.
- (2) Duran's chief finance officer, Frankie Sharkey, was so impressed with the commitment of the audit staff that he asked that Depeche pay them all a bonus through an increase in the audit fee. In April 2003, Depeche paid all the members of the team below manager status a bonus amounting to a week's salary. The bonus was processed through Depeche's payroll, in the same way as overtime payments, and recharged to Duran as part of audit expenses.
- (3) One of the points initially drafted for possible inclusion in the report to the company's audit committee concerned the illegal dumping of drums, containing used machine oil, on nearby wasteland. Notes of discussions between the audit manager and Frankie show that it is the company's unwritten policy to disregard the local environmental regulations and risk incurring the fines, which are only small, as it would be costly to use the nearest licensed disposal unit. The matter is not referred to in the final report.

Required:

- (a) Comment on the ethical and other professional issues raised by each of the above matters. (10 marks)
 - (b) Discuss the appropriateness of available safeguards and advise whether or not Depeche should continue as the auditor to Duran plc. (5 marks)
- (15 marks)**

DURAN

(a) Ethical and professional issues

- The review, on an ongoing basis, of existing clients is a safeguard. For example, Duran is a listed company which should not be retained if recurring fees from it exceed 10% of Depeche's gross practice income. Annual review is a safeguard if Duran's fees exceed 5% (but are less than 10%).
- In making a decision to retain a client, Depeche must consider:
 - its independence and ability to serve Duran properly; and
 - the integrity of Duran's management.

(1) Hospitality

- Depeche's objectivity may be threatened, or appear to be threatened, by acceptance of goods, services or hospitality from Duran, unless the value of any benefit is modest.
- The audit staff have already accepted the hospitality. Their objectivity should not have been impaired provided that the meals were appropriate to the normal courtesies of social life.
- However, undue hospitality is likely to be regarded as a corrupt practice, which could be indicative of fraudulent activities having taken place.
- As the staff needed to work late to meet the deadlines, an alternative to Duran buying in the refreshments would have been for the audit team to make their own arrangement and for Duran to have been re-charged the expense.

(2) Financial reward

- Professional accountants in public practice should be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity, objectivity and independence.
- The bonus was not accepted in respect of the audit manager's involvement. Therefore there is no obvious threat to his objectivity.
- The bonus may be perceived to be a reward (or 'bribe') for having not detected or reported on a matter and acceptance of it may cast aspersions on the audit team's integrity.
- The bonus has been processed by Depeche in such a way as to account for PAYE, social security contributions, etc and recovered through the recharge of expenses associated with the audit. It represents an increase in the audit fee and the gross cost to Duran should be included in the amount disclosed in the note to the financial statements as auditors' remuneration.
- The bonus should be excluded from the fee when considering the 'recurring element'.
- Has this situation arisen in respect of previous Duran audits? Was the subject of such bonuses mentioned before the audit fieldwork was completed? If the audit team had any expectation that a bonus might be awarded to them it is likely that there will be a perception that their objectivity could have been impaired.
- Has the situation created an expectation that such bonuses could be a feature of this audit? Acceptance of the bonuses may have created problems for Depeche's practice management as it may be more difficult to allocate audit staff to other assignments if they have a preference for the Duran audit.
- That the bonus was not accepted at the manager level suggests that this was considered to be a threat to objectivity. This consideration and the decision to accept the bonus for other staff should have been documented.

(3) Client/auditor integrity

- Frankie Sharkey's apparent disregard for environmental legislation should have been taken into account when making a risk assessment of Duran's control environment. It may cast doubt on his integrity.
- The audit of Duran should have been carried out with due regard to:
 - SAS 120 'Consideration of law and regulations'; and
 - SAS 610 'Communication of audit matters to those charged with governance'.
- For example, if the illegal dumping became apparent during the audit but was not known at the planning stage, consideration should have been given to:
 - the frequency of the illegal act, how long it has been going on and what measures, if any, had been taken to conceal it from the auditors;
 - the potential financial consequences (e.g. fines, penalties, enforced discontinuation of operations and litigation);
 - whether the potential consequences require disclosure;
 - whether risk assessments made at the planning stage need now to be revised;
 - the validity of management representations.

- Matters to be communicated to those charged with corporate governance (i.e. the audit committee) include:
 - the potential effect on the financial statements of any significant risks and exposures, such as pending litigation, that are required to be disclosed in the financial statements (this could arise from the illegal dumping); and
 - other matters warranting the attention of those charged with governance, such as questions regarding management integrity.

Tutorial note: *Although the fines are 'only small', the boycotting of Duran's products or other adverse publicity could have a detrimental effect on the company's operations.*

- It is of potential concern that the matters have not been included in the final report unless the engagement partner knows, for example, that the matter has already been brought to the audit committee's attention (e.g. in an internal auditors' report).
- Does the draft report constitute an audit working paper? If it is retained on file it should clearly explain why it was not incorporated into the final report (and whose decision it was to exclude – the manager's or partner's). If there is no apparent justification for its exclusion, the integrity of the audit manager and/or engagement partner may be questioned.

(b) Available safeguards

Tutorial note: *Available safeguards will be appropriate if they eliminate the threats or reduce them to an acceptable level.*

- The firm's guidance on receiving hospitality should be reviewed and amended as necessary. It may be that 'on-going' hospitality is refused, if construable as excessive.
- Review of the engagement partner's decision to accept the bonus on behalf of the staff. For example, whether the firm's quality assurance policies and procedures required him to consult with other partners.
- Audit staff and the client should be advised that the bonus was a 'one-off' and not to be repeated.
- Senior staff (the two qualified seniors and two supervisors) should not be assigned to the audit for the year to 31 December 2003.
- Involving a second partner to review the conduct of the audit and advise staff involved of any concerns they have about their independence from Duran and the integrity of Duran's management.
- If the engagement partner has been involved in the audit for a number of years (say seven), it may be time to rotate the assignment.
- Discuss issues of independence with Duran's audit committee and obtain written confirmation that they are aware of the potential threats posed by public interest, fees, hospitality, etc and that they are satisfied that the firm's safeguards are adequate.

Advice whether or not the audit of Duran should continue

The Duran audit should be retained only if a partner of Depeche unconnected with Duran independently reviews the safeguards available and considers them to be adequate.

Alternatively: *If the safeguards available are not adequate to maintain independence, Depeche should withdraw from the audit.*