

QUESTION TWO

a) Explain the concept of objectivity, with reference to

- i) External auditors
- ii) Internal auditors, who are members of one of the professional accountancy bodies

outlining any general threats to objectivity that exist in each case.

(16 marks)

b) *Scenario 1*

Bakers Ltd is an audit client of Hinkley Innes, a firm of Chartered Certified Accountants. The firm has had the audit of Bakers for 17 years and the fee represents 7% of firm income. Bakers is considering a major new project and has asked the firm if it would be happy to undertake some one-off consultancy work for the firm. It is possible that the fee income for this contract would represent 10% of that year's income for Hinkley Innes. The new business services partner, who heads up a new division of the firm, is keen to take on the work, as this would represent his best contract yet.

Scenario 2

Peter works in the purchasing department of Murphy Manufacturing plc. He has been instrumental in setting up control systems in the purchasing department as part of a recent risk management exercise. He has a poor relationship with his immediate supervisor, the Purchasing Director. Murphy Manufacturing has just advertised the post of trainee internal auditor. Peter is interested in the work that internal audit do, having liaised substantially with the department during the recent controls exercise. No formal accountancy qualifications are required for the post, because the successful candidate will be put through accountancy training. Peter has had a chat with the head of internal audit concerning the post and is seriously considering making an application.

Required

Discuss the threats and the safeguards to objectivity that could be implemented in the two situations given above.

(20 marks)

(Total 36 marks)

Question 2

- (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

- Personal interest (for example, fear of losing fees or a good relationship with a client/fellow staff member)
- Review of own work (for example, if an auditor audits financial statements he has compiled or an internal auditor monitors systems he has designed)
- Disputes (for example, with a client, or where an audit firm advocates for its client, or where an internal auditor has a personal issue with a staff member)

(b)

Scenario 1:

Threats

The situation raises 3 potential threats to objectivity:

The first is the issue that the firm has had a long association with the audit client. It is unclear whether the same engagement staff have been associated with the entity in that time.

The second is that the firm has been offered the opportunity to carry out work other than audit for the firm. Professional ethical guidance states that provision of other services can affect objectivity.

Connected to the previous point is the fact that a self-interest threat arises through the substantial fee income that this client may generate in the current year. Professional ethical guidance in respect of recurring income is that 15% of office income from one client is likely to adversely affect objectivity. The income in this year is likely to be 17%, but much of that is not recurring. However, the firm should consider that the result of the consultancy might be that the business expands and the audit fee might rise in the future. They should lay down contingency plans.

Safeguards

In relation to the other services, the key inherent safeguard is that it is a one-off project. It appears that it will be carried out by a department other than the audit department, which will help to maintain objectivity.

In terms of the audit, as the client has been associated with the audit firm for a number of years, the firm should consider laying out procedures for rotation of the engagement partner in relation to the client, so that the relationship cannot become too close over time.

If this is considered inappropriate, it might consider instituting a second partner review as another measure to maintain objectivity

Scenario 2

Threats

If Peter was to get the job in the internal audit department, there would be a considerable threat of self-review, as he would have to monitor the system which he has set up in the purchasing department.

As Peter is a current employee of the company, there is also a risk that his objectivity towards an internal audit role would be affected by his relationships with fellow employees.

This is particularly the case with regard to his relationship with his current boss, the Purchasing Director, as he has a poor relationship with him. As a member of the internal audit department, Peter would in all likelihood have to report directly on matters relating to this director.

Safeguards

If Peter gets the job, an important safeguard would be that he did not work on matters relating to the purchasing department for a period of time, or perhaps until the systems have been reviewed again and/or the Purchasing Director moves on.

It would also be important to address the issue of objectivity as part of the recruitment process. The issue of relationships with staff would have to be disclosed and understood.

Lastly, it is important to have objectivity in the recruitment process. As Peter has had an informal discussion with the head of Internal Audit, the head of Internal Audit should ensure that other staff members are also included in the recruitment process.