

You are an audit manager of Kloser, a firm of Chartered Certified Accountants. You are assigning staff to the final audit of Isthmus plc for the year to 31 December 2002. You are aware of the following matters:

- (1) Isthmus has recently issued a profits warning. The company has announced that the significant synergies expected from the acquisition of Vanaka, a former competitor company, have not materialised. Moreover, it has emerged that certain of Vanaka's assets are significantly impaired. Your firm's corporate finance department, assisted by two audit trainees, carried out due diligence work on behalf of Isthmus before the purchase of Vanaka was completed in December 2001.
- (2) Mercedes, the assistant manager assigned to the interim audit of Isthmus, has since inherited 5,000 £1 shares in Isthmus. Mercedes has told you that she has no intention of selling the shares until the share price recovers from the fall to £1.95 which followed the profit warning.
- (3) Anthony, an audit senior, has been assigned to the audits of Isthmus since joining the firm nearly three years ago. He has confided to you that his father owned 1,001 shares in Isthmus but sold them only days before the profits warning at a share price of £7.95. You are assured that Anthony did not previously know that his father had the shares.

Required:

Comment on the ethical and other professional issues raised by the above matters and their implications, if any, for staffing the final audit of Isthmus for the year to 31 December 2002.

(1) Profits warning

Ethical and professional issues

- The profit warning increases the inherent risk of this assignment. As more work may be needed than for the prior year (e.g. on Vanaka's impaired assets), additional staff may need to be assigned to the audit.
- An 'advocacy threat' may occur if a dispute (potential legal action) arises between Isthmus and Kloser. For example, if the due diligence work should have recognised the significant impairments.
- Kloser should undertake a review of the due diligence work and audit for the year-ended 31 December 2001 to ensure there were no findings which should have alerted them to the problems in Vanaka which precipitated the profit warning.
- A 'self-review threat' may arise in that the prior year-end audit, which followed the purchase, may have lacked objectivity. For example, the involvement of the corporate finance department in due diligence may have resulted in less audit work being carried out on Vanaka's assets and operating results than would otherwise have been performed.
- If Kloser was negligent in undertaking the due diligence work (e.g. because assets were impaired at the time of acquisition and/or the assumptions underlying the expected synergies were unrealistic/hypothetical), to whom will Kloser be liable? To whom was the due diligence work reported? (Isthmus, Isthmus's shareholders, providers of finance for the acquisition?)

Tutorial note: To illustrate that these 'model' answers are not exhaustive consider, for example, that credit was given to candidates who argued that the trainees' involvement in the audit would be beneficial (to Kloser and/or Isthmus).

Implications for staffing

As a safeguard for the provision of the other service (due diligence) the audit personnel seconded to the corporate finance department may not have participated in the audit for the year ended 31 December 2001. Any such 'bar' should continue.

If the secondees are involved in the audit, appropriate safeguards would include not assigning them to the audit areas most closely associated with due diligence and close monitoring and review of their work.

More senior/better quality/experienced staff should be assigned to the audit (than would have been necessary had the profit warning not been issued).

(2) Shares inherited

Ethical and professional issues

- A 'self-interest threat' has arisen as Mercedes has a direct financial interest in Isthmus (i.e. she controls the shares). In particular, in wishing the share price to increase Mercedes might be in a position to overlook unrecorded liabilities and losses discovered during the conduct of the audit (say).
- Even though Mercedes may have independence of mind and be known to act with the utmost integrity, she cannot have independence in appearance.
- This inadvertent violation (i.e. through inheritance) of an independence principle does not impair the independence of Kloser or the audit team providing:
 - Kloser's established policies and procedures have resulted in Mercedes having reported promptly her inheritance of the shares;
 - Kloser promptly advises Mercedes that the shares should be disposed of; and
 - the disposal occurs at the earliest practical date, or she is removed.
- Mercedes does not intend to dispose of the shares quickly as she is waiting for the share price to recover.
- It is unlikely that Kloser would consider offering her adequate compensation for an earlier disposal (the loss in share value since the fall being $5,000 \times (£7.95 - £1.95) = £30,000$).
- Although IFAC's Independence statement requires Mercedes' removal from the audit team, Kloser may require stricter safeguards and prohibit all professional staff from holding direct financial interests. Mercedes may therefore be asked to choose between staying with the firm or disposing of the shares at the earliest practical date.
- If any work has been done by Mercedes on the audit of Isthmus since she inherited the shares (e.g. in reviewing interim audit work or planning the year-end or final audit visits) that work should be re-reviewed by another professional accountant.

Implications for staffing

This threat is so significant that Mercedes should be removed from the audit team unless she disposes of the shares before she undertakes any further tasks relating to the audit of Isthmus.

(3) Dealing in shares

Ethical and professional issues

- A self-interest threat would have arisen only if Anthony had known that a close family member (a parent) had shares in Isthmus (but he did not). A self-interest threat cannot now arise as his father has disposed of the shares.
- Providing Anthony did not knowingly prompt his father to sell the shares, he has not committed a criminal act (e.g. of insider dealing).

Tutorial note: If he committed such an act he should be instantly dismissed by the firm and any professional body under which he is registered (e.g. ACCA) notified for disciplinary action.

- However, if he in some way communicated (e.g. in a careless remark) something that prompted his father to sell the shares, he may be in breach of his duty of confidentiality. This should be investigated and appropriate action taken (e.g. he may be cautioned or given a written warning).
- If he unknowingly gave his father price sensitive information, then his father may be guilty of insider dealing (or similar) for having acted on it.

Implications for staffing

Unless there is any reason to suppose that Anthony has acted improperly (e.g. if he has delayed disclosing the matter) there is no reason why he should not continue his position in the audit team.

However, if his father were to come under suspicion of insider dealing then Anthony should be withdrawn from this assignment.

Overall

Given the high profile attaching to this listed client it would be timely to have all members assigned to the audit team renew their written declarations of independence and confidentiality.