

QUESTION TWO

- (a) Describe the FIVE threats contained within The Code of Ethics and Conduct and for each threat list TWO examples of a circumstance that may create the threat.

(15 marks)

- (b) You are the audit manager of Crown & Co and you are planning the audit of Owl Financials Ltd (Owl), who specialise in the provision of loans and financial advice to individuals and companies. Crown & Co has audited Owl for many years.

The directors are planning to list Owl on the London stock exchange within the next few months and have asked if the engagement partner can attend the meetings with potential investors. In addition, as the finance director of Owl is likely to be quite busy with the listing, he has asked if Crown & Co can produce the financial statements for the current year.

During the year, the assistant finance director of Owl left and joined Crown & Co as a partner. It has been suggested that due to his familiarity with Owl, he should be appointed to provide an independent partner review for the audit.

Once Owl obtains its stock exchange listing it will require several assignments to be undertaken, for example, obtaining advice about corporate governance best practice. Crown & Co is very keen to be appointed to these engagements, however, Owl has implied that in order to gain this work Crown & Co needs to complete the external audit quickly and with minimal questions/issues.

The finance director has informed you that once the stock exchange listing has been completed, he would like the engagement team to attend a weekend away at a luxury hotel with his team, as a thank you for all their hard work.

In addition, he has offered a senior member of the engagement team a short-term loan at a significantly reduced interest rate.

Requirement:

- (i) Explain the ethical threats which may affect the independence of Crown & Co's audit of Owl Financials Ltd; and
- (ii) For each threat explain how it might be reduced to an acceptable level.

(25 marks)

(TOTAL 40 marks)

QUESTION TWO

Compliance with The Code of Ethics and Conduct's fundamental principles can be threatened by a number of areas. The five categories of threats, which may impact on ethical risk, are:

- Self-interest
- Self-review
- Advocacy
- Familiarity
- Intimidation.

Examples for each category (Only two examples required per threat):

Self-interest

- Undue dependence on fee income from one client
- Close personal or business relationships
- Financial interest in a client
- Incentive fee arrangements
- Concern over employment security
- Commercial pressure from outside the employing organisation
- Inappropriate personal use of corporate assets.

Self-review

- Member of assurance team being or recently having been employed by the client in a position to influence the subject matter being reviewed
- Involvement in implementation of financial system and subsequently reporting on the operation of said system
- Same person reviewing decisions or data that prepared them
- An analyst, or member of a board, audit committee or audit firm being in a position to exert a direct or significant influence over the financial reports
- The discovery of a significant error during a re-evaluation of the work undertaken by the member
- Performing a service for a client that directly affects the subject matter of an assurance engagement.

Advocacy

- Acting as an advocate on behalf of a client in litigation or disputes
- Promoting shares in a listed audit client
- Commenting publicly on future events in particular circumstances
- Where information is incomplete or advocating an argument which is unlawful.

Familiarity

- Long association with a client

- Acceptance of gifts or preferential treatment (significant value)
- Over familiarity with management
- Former partner of firm being employed by client
- A person in a position to influence financial or non-financial reporting or business decisions having an immediate or close family member who is in a position to benefit from that influence.

Intimidation

- Threat of litigation
- Threat of removal as assurance firm
- Dominant personality of client director attempting to influence decisions
- Pressure to reduce inappropriately the extent of work performed in order to reduce fees.

(b)

(1) Ethical threat

Owl Financials Ltd (Owl) has asked the engagement partner of Crown & Co to attend meetings with potential investors. This represents an advocacy threat as the audit firm may be perceived as promoting investment in Owl and this threatens objectivity

Managing risk

The engagement partner should politely decline this request from Owl, as it represents too great a threat to independence.

(2) Ethical threat

Due to the London stock exchange listing, Owl has requested that Crown & Co produce the financial statements. This represents a self-review threat. As Owl is currently not a listed company then Crown & Co are permitted to produce the financial statements and also audit them.

However, Owl is seeking a listing and therefore these financial statements will be critical to the potential investors and this increases audit risk.

Managing risk

Ideally, Crown & Co should not undertake the preparation of the financial statements. Due to the imminent listing, this would probably represent too high a risk.

If Crown & Co choose to produce the financial statements then separate teams should undertake each assignment and the audit team should not be part of the accounts preparation process.

(3) Ethical threat

The assistant finance director of Owl has joined Crown & Co as a partner and has been proposed as the review partner. This represents a self-review threat, as he was in a position to influence the financial statements whilst working at Owl; if he is the review partner there could be a risk of him reviewing his own work.

Managing risk

This partner must not be involved in the audit of Owl for a period of at least two years. An alternative review partner should be appointed.

(4) Ethical threat

Owl has several potential assurance assignments available and Crown & Co wish to be appointed to these. There is a potential self-interest threat as these assurance fees along with the external audit fee could represent a significant proportion of Crown & Co's fee income.

Managing risk

The firm should assess whether these assignments along with the audit fee would represent more than 15% of gross practice income for two consecutive years. These assurance assignments will only arise if the company obtains its listing and hence will be a public interest company. If the recurring fees are likely to exceed 15% of annual practice income then additional consideration should be given as to whether these assignments should be sought by the firm.

(5) Ethical threat

Owl has implied to Crown & Co that they must complete the audit quickly and with minimal questions/issues if they wish to obtain the assurance assignments. This creates an intimidation threat on the team as they may feel pressure to cut corners and not raise issues, and this could compromise the objectivity of the audit team.

Managing risk

The engagement partner should politely inform the finance director that the team will undertake the audit in accordance with all relevant ISAs and their own quality control procedures. This means that the audit will take as long as is necessary to obtain sufficient, appropriate evidence to form an opinion. If any residual concerns remain or the intimidation threat continues then Crown & Co may need to consider resigning from the engagement.

(6) Ethical threat

The finance director has offered the team a free weekend away at a luxury hotel. This represents a self-interest threat as the acceptance of goods and services, unless insignificant in value, is not permitted.

Managing risk

As it is unlikely that a weekend at a luxury hotel for the whole team has an insignificant value, then this offer should be politely declined.

(7) Ethical threat

The finance director has offered a senior team member a loan at discounted interest rates.

Managing risk

This loan must not be accepted by the audit senior due to the preferential terms.

(8) Ethical threat

Owl does provide loans and hence the provision of a loan is within the normal course of business. However, if the loan is on preferential rates, as this is, then it would represent a self-interest threat.

Managing risk

However, if the terms of the loan are amended so that the interest rate charged is in line with Owl's normal levels, then the provision of the loan is acceptable.