

QUESTION TWO

You are an audit manager in Church & Co, responsible for the audit of Christian Ltd, a large company which provides information technology services to business customers. The finance director of Christian Ltd, John Jones, contacted you this morning, saying:

‘I was alerted yesterday to a fraud being conducted by members of our sales team. It appears that several sales representatives have been claiming reimbursement for fictitious travel and client entertaining expenses and inflating actual expenses incurred. Specifically, it has been alleged that the sales representatives have claimed on expenses for items such as gifts for clients and office supplies which were never actually purchased, claimed for business-class airline tickets but in reality had purchased economy tickets, claimed for non-existent business mileage and used the company credit card to purchase items for personal use.

I am very worried about the scale of this fraud, as travel and client entertainment is one of our biggest expenses. All of the alleged fraudsters have been suspended pending an investigation, which I would like your firm to conduct. We will prosecute these employees to attempt to recoup our losses if evidence shows that a fraud has indeed occurred, so your firm would need to provide an expert witness in the event of a court case. Can we meet tomorrow to discuss this potential assignment?’

Christian Ltd has a small internal audit department and in previous years the evidence obtained by Church & Co as part of the external audit has indicated that the control environment of the company is generally good. The audit opinion on the financial statements for the year ended 31 March 2012 was unmodified.

Requirement:

- (a) Assess the ethical and professional issues raised by the request for your firm to investigate the alleged fraudulent activity.

(25 marks)

The Auditing Practices Board’s Consultation paper *The provision of non-audit services by auditors* summarise differing views as to whether there should be an outright prohibition on the provision of non-audit services to audit clients.

Requirement:

- (b) Evaluate the arguments for and against the prohibition of auditors providing non-audit services to audit clients which are listed entities.

(15 marks)

(TOTAL 40 marks)

QUESTION TWO

(a)

An investigation into the alleged fraudulent activity is a forensic investigation. If Church & Co were to conduct the forensic investigation, this would be a non-audit service performed for an audit client. Specifically, this investigation would be deemed a litigation support service.

According to IFAC's *Code of Ethics for Professional Accountants*, before a firm accepts an engagement to provide a non-audit service to an audit client, a determination should be made as to whether providing such a service would create a threat to independence. Self-review, self-interest and advocacy threats to independence may arise.

The self-review threat exists because the forensic investigation will determine the monetary amount of the fraud, and the amount which Christian Ltd will attempt to recover from the fraudsters. Given the potential scale of the fraud, it could be that the amounts involved are material to the financial statements and therefore the audit team would be reviewing figures determined by members of the audit firm.

In addition, the forensic investigation team will, as part of their work, review systems and controls over expenses claimed by Christian Ltd's employees. This means that the forensic investigation team are also exposed to a self-review threat, as they will be reviewing systems and controls which have been considered during the audit of Christian Ltd's financial statements.

The advocacy threat arises because going to court and speaking as an expert witness in relation to the fraud would be seen as the audit firm promoting the interests of its client and supporting a position taken by management in an adversarial context.

A self-interest threat could also arise, as the forensic investigation may be a lucrative source of income for Church & Co. This could create the perception that Church & Co is reliant on Christian Ltd for income and impairs the objectivity of the firm.

The firm should evaluate the significance of these threats. In particular, the firm should consider the potential materiality of the amounts involved in the fraud, and the degree of subjectivity that may be involved in determining the amounts involved.

If the matter is material, and would involve significant judgements, then no safeguards would reduce the threat to an acceptable level, and the forensic investigation should not be conducted by the audit firm.

It is likely, however, that the investigation would not involve a significant degree of judgement and the investigation could be performed as long as safeguards were used, such as:

- Having a senior member of the audit firm, who was not involved in the forensic investigation, review the results of the investigation and the impact on the financial statements;
- Performing a second partner review on the audit of Christian Ltd; and
- Ensuring that the forensic investigation is not performed by anyone involved in the audit engagement. Possibly the investigation could be performed by a different office of the firm.

Ethical Standard 5 (Revised) *Non-audit services provided to audit clients* requires that when considering a proposed engagement to provide a non-audit service to an audited entity, details of the proposed engagement should be communicated to the audit engagement partner. Therefore, it is crucial that the audit engagement partner is responsible for the

acceptance decision. It is the audit partner, who is required to identify and assess the significance of threats to objectivity, identify and assess the effectiveness of available safeguards, and consider whether the objectives of the proposed engagement are consistent with the objectives of the audit of the financial statements.

The audit engagement partner is also responsible for ensuring that the reasoning for a decision to undertake an engagement to provide a non-audit service to an audit client, and any safeguards adopted, is appropriately documented.

It is also required that those charged with governance are informed of all facts and matters which impact the auditor's objectivity in relation to the provision of non-audit services, including the safeguards which are put in place. Therefore, the situation should be discussed with Christian Ltd's board of directors, and audit committee if one exists.

Furthermore, the IFAC Code's fundamental ethical principles apply to all professional assignments, including a forensic investigation. One of the fundamental principles is that of professional competence and due care. Forensic investigations are specialist assignments and may require very specific skills, which will not be possessed by individuals unless they have undergone specific training. Church & Co must consider whether there are any members of the firm who possess the necessary skills before accepting the assignment. It is likely that relatively senior staff will need to be assigned to the investigation, which will bring necessary authority and experience to the investigation team. It should be considered whether Church & Co is able to divert senior staff from other assignments at short notice. Resourcing the team could be a problem.

In addition, confidentiality is a crucial issue in such investigations as members of the investigation team will have access to sensitive information which will be used as evidence in court. Any breach of confidentiality could jeopardise the integrity of the legal proceedings against the fraudsters. Anyone involved with the investigation must be made aware of these issues and confidentiality agreements should be signed.

(b)

The issue of auditors providing non-audit services to audit clients has been topical for many years, and there are many arguments for and against their outright prohibition.

Those arguing in favour of outright prohibition suggest that this would be a simple way to eliminate the threats to objectivity, which the provision of non-audit services to audit clients creates. Typically, management, self-interest and self-review threats arise, which result in the perception that the auditor cannot be objective when performing the audit service. Certain non-audit services are prohibited on the basis that the threats that arise are too significant to be overcome by any safeguards, for example the provision of bookkeeping services to listed audit clients.

In particular, non-audit services can be very lucrative, leading potentially to a self-interest threat. The greater the volume and financial significance of the non-audit services provided, the greater the risk that the auditor will have relationship and economic reasons not to challenge management's views and positions with the necessary degree of professional skepticism.

It has also been argued that outright prohibition would benefit the market, allowing smaller audit firms to provide the services which larger firms would no longer be able to offer to their audit clients.

However, there are also many arguments against outright prohibition. By having the same firm provide the audit and the non-audit service, the client benefits in two ways. The audit firm will already possess a good knowledge and understanding of the client and its operating environment, resulting in deeper insight and a better quality service being provided. This will then lead to cost benefits, as the non-audit service will be provided in a more efficient way.

Audit firms would also argue that participation in services such as due diligence reviews and forensic investigations, allows the audit firm to understand their clients' business and risks better and to obtain insights into management's objectives and capabilities which are useful in an audit context.

Finally, non-audit services can be safely provided as long as steps are taken to assess potential threats to objectivity, and to adequately address those risks, for example, by the use of separate teams to provide audit and non-audit services.

The UK *Corporate Governance Code* requires the audit committee to review and monitor the external auditor's independence and objectivity. This includes the audit committee evaluating approving the provision of non-audit services by the audit firm.

In addition, the annual report of listed entities should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded. The fees paid in relation to the provision of non-audit services must also be disclosed. These measures should ensure that assignments to provide non-audit services are scrutinised and disclosed, providing a safeguard to minimise threats to objectivity.

To conclude, a principles-based approach to the provision of non-audit services, in which such services can be provided as long as risks are assessed and managed, appears to benefit both audit firms and their clients.