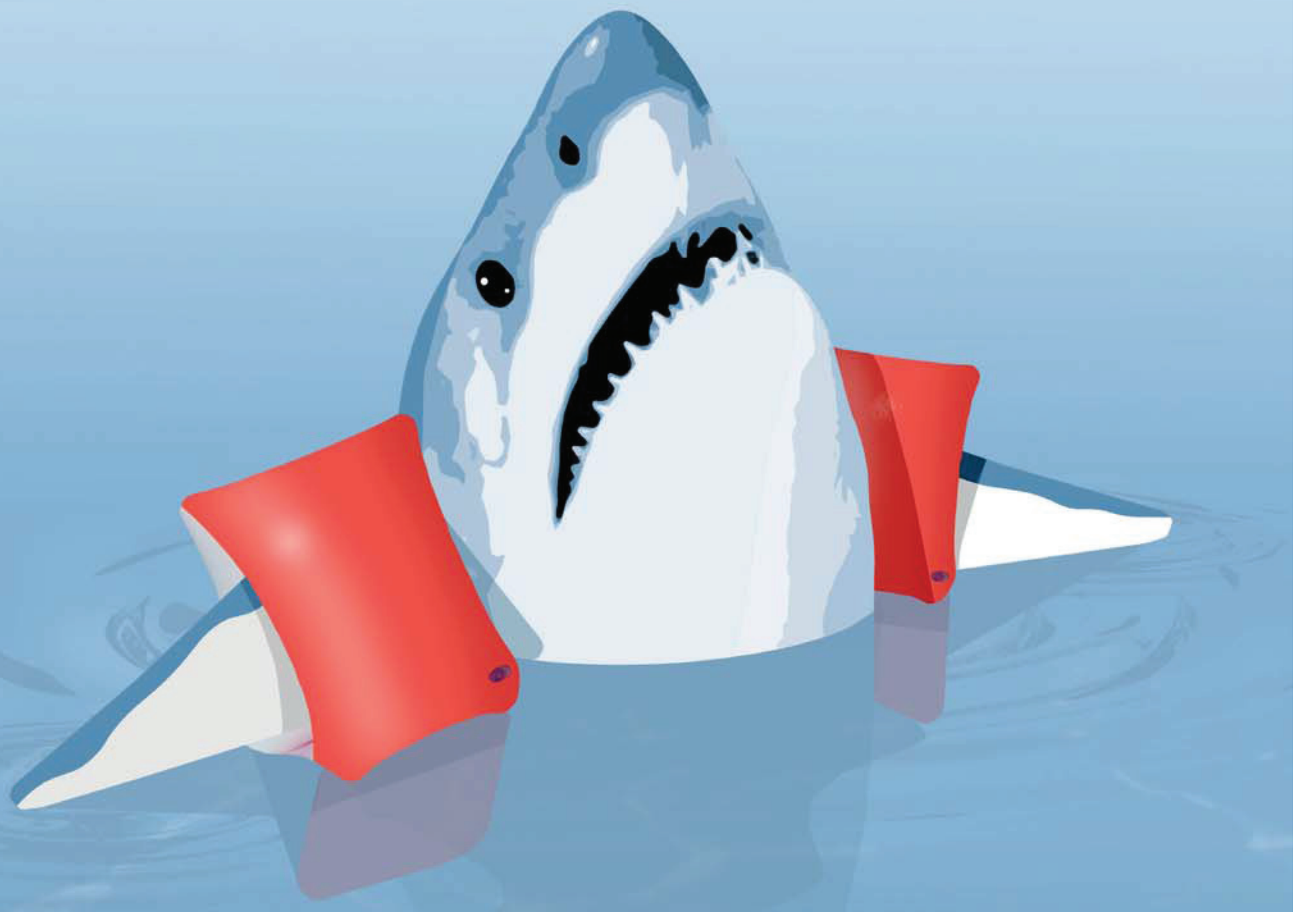
BEYOND REPROACH

Although Ethical Standards for Auditors have been around for some years, there are still areas where auditors commonly struggle to consider and safeguard threats to their independence, as QAD reviewers **Nick Reynolds** and **Henrietta Thompson** outline



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Like all ICAEW members, auditors are expected to demonstrate the highest standards of professional conduct. It is not enough to believe you are behaving ethically, or even to behave ethically - you must also demonstrate this at every stage of the audit process. Usually, most auditors are comfortable with the concepts outlined in Ethical Standard (ES) 1 *Integrity, objectivity and independence*, and the need for threats to be considered and for safeguards to be applied. However, during QAD monitoring visits reviewers find some areas where financial, business, employment and other relationships raise problems repeatedly.

Relationships between audit clients, partners, staff and their immediate and close family members can create significant ethical challenges. Although QAD doesn't often find auditors whose partners or staff are themselves directors or shareholders in audit clients, this is not unheard of. More commonly, QAD encounters circumstances where relationships are not prohibited, but the threats need to be considered and safeguarded: for example, if partners or staff may have brothers or sisters who are audit clients. This is permitted, provided you can demonstrate that you have considered the threats and implemented safeguards, where necessary, to ensure that you are independent.

THE INFLUENCE OF TRUSTEES

Trustee shareholdings are a particular problem area, and came up a number of times during the 2013 and 2012 monitoring visits. Typically, an individual in a firm is asked to be the trustee of a family trust which holds shares in an audit client. In many cases, these holdings will be material to the trust, and this creates a conflict for the firm, similar to when an individual in a firm holds shares in the audit client directly. The trustee should not be the responsible individual (RI) on that audit or in a position to influence it. This includes those in the firm's chain of command who are in a position to exert influence over the audit partner, so you need to think quite broadly.

In a small firm, a senior partner is very likely to be in the chain of command over a junior partner who acts as RI – unless you can clearly show otherwise. As trusteeships tend to go to the firm's senior partners, with many years of client relationships, it can be difficult to meet the requirements of the Ethical Standards (ES) if the firm wants to continue as auditor and as trustee. See the full set at **bit.ly/1oX7qNc**

As not all cases are so clear cut, there can be significant judgement involved. It is important to consider how a reasonable person would see your relationship with an audit client. In the given circumstances, would they understand why you consider yourself to be an independent auditor?

Guidance on trustee shareholdings is available in *Audit news 52* (**bit.ly/1yVSIMi**) and in the ethics section of the ICAEW website (**bit.ly/Xy3q0c**).

The first priority is to have a thorough process to gather relevant information from all of your partners and staff, so that you can identify threats. Annual declarations of independence from all staff are essential. If you have quite a few audits, make staff aware of all of them, so that they know who they need to be independent of. Once you have identified a threat, consult as necessary, and remember to document your safeguards, and the reasons for your conclusions.

LONG ASSOCIATION AND FEES

Independence challenges can also arise for auditors and audit firms because long associations between the audited entity and partners and staff can lead to self-interest, self-review and familiarity threats to their objectivity. Fee dependency can also create threats.

ES 3 *Long Association with the Audit Engagement* is clear on the rules for listed entities, with five-year rotation of RIs, except in the rare cases where the client feels there are exceptional circumstances that justify an extension to seven years (whether these years have been accrued continuously or in aggregate). In practice, this impacts on relatively few audit firms.

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The rules are also clear on the need for all audit firms to assess the threats that long association pose to the auditor's objectivity and independence and the need to apply safeguards to reduce any threats to an acceptable level – and the 10-year rule affects a great many audit firms.

ES 3 paragraph 9 states that: "Once an audit engagement partner has held this role for a continuous period of ten years, careful consideration is given as to whether a reasonable and informed third party would consider the audit firm's objectivity and independence to be impaired." It goes on to suggest various appropriate safeguards, such as those listed in paragraph 8 of ES 3, which are: rotation of the RI, involvement of an additional partner, and applying independent quality control reviews to the engagement in question. There are fewer options for firms with just one RI, where rotation is impossible.

The examples of the safeguards given in paragraph 8 of ES 3 should always be considered. In practice, QAD finds that rather than apply safeguards such as these, many firms take the other option outlined in ES 3, paragraph 9 (b): documenting why the RI continues to participate in the audit engagement without any safeguards and communicating this reasoning to those charged with governance of the audit client. The second element is particularly important and should not be ignored, even if the firm is concerned that this could be an invitation for the client to re-tender for the audit. You will need to judge the possible consequences – and the paragraph 8 safeguards will be a better route in some circumstances.

FINANCIAL INDEPENDENCE

The financial nature of the firm's relationship with clients must also be considered: fee dependency is a threat. Remember that if you expect ongoing fees for audit and non-audit services from a client or a statutory group of audit clients to regularly exceed 15% of your practice income, you cannot remain as auditor. It is acceptable to have the occasional year when special work arises and you exceed the 15% threshold. But if you continue with this work, year-on-year, then it must be considered as part of the ongoing fee. (If you have a listed audit client, this percentage reduces to 10%.)

For an unlisted client, you may also need additional safeguards where the total fees are regularly between 10% and 15% of total practice income. In these cases, unless the client qualifies as a small company, you need an external independent quality control review before the audit report is finalised.

This is what many term an external hot file review, so it is quite a big deal if it applies – and it will add to the cost. (Similar rules apply for listed audit clients, with the threshold of between 5% and 10% of fees.)

If the client qualifies as a small company, no hot review is needed, as you can take the exemption available in the ES *Provisions Available for Smaller Entities* (PASE) at **bit.ly/1qmMz7k**

Clearly, smaller audit practices are more likely to have difficulties with fee dependency. However, there are a few factors which can help, especially if you are a sole practitioner. Other earned income can count towards the total income figure, for example, and if you have connected practices it is possible that these may meet the definition of a network firm and can also count towards the total income.

On the ICAEW website you will find an ethics FAQ relating to this (at **bit.ly/1te4uBV**), and the definition of a network is also given in detail (at **bit.ly/1vdhY0j**).

NON-AUDIT SERVICES

Most auditors provide some non-audit services to their audit clients, and within the parameters of the Ethical Standards there is nothing wrong with this; but the associated threats must be considered. The types of non-audit services that you can provide are significantly curtailed if you audit a listed client, as you cannot provide any accounting assistance, except in an emergency. Some smaller listed companies can struggle with financial reporting, and in these cases you will need to encourage them to include another accountancy firm to assist.

For many audit clients, preparation of the accounts and tax disclosures are all part of the annual audit. Yet however good an accountant you are, mistakes can happen, and you need to identify and safeguard threats; though here, as with fee dependency, you can use PASE where applicable.

If you are preparing the accounts, you need to consider whether there is a risk that you are making decisions about the accounting for particular items without knowing the full facts. Make sure you discuss these points fully with management so, for example, you can establish that a particular liability meets the definition of a provision rather than a contingent liability, or it is correct to account for turnover as principal rather than agent.

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One of the riskiest times in an audit is when last-minute adjustments are made, and QAD does see cases where they do not get enough scrutiny. If the adjustments are material, who is going to check that you have not inadvertently got your debits and credits the wrong way around or made some other error in the heat of the moment? If threats such as this are not identified and addressed, a situation may arise where somebody has made an error, but both you and the client have happily signed materially misstated accounts.

The strongest safeguards are where the audit team or the senior members of the team reviewing work are independent from the non-audit services provided by the firm; no one looks as critically at their own work as they do at someone else's. So if you have processed a change, get someone else – including the client – to check it. Better still, ask the client to process the change and then you can check it.

This article reprises the first half of an hour-long QAD webinar that took place earlier in 2014 – a full recording is available at bit.ly/1nup2Re

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