Ethics

Demonstration question

ACCA AAA exam standard question

S/D21 exam paper (Gruber)

Ben Wilson

AAA Expert Tutor

Exhibit 1 – Email from audit engagement partner

To: Audit manager

From: Al Powell, Audit engagement partner

Subject: Audit planning for Gruber Co

Date: 1 July 20X5

Hello

I have provided you with some information which you should use to help you with planning the audit of Gruber Co for the financial year ending 30 September 20X5. As you know, Gruber Co is a new audit client and the firm's client due diligence (know your client) and acceptance procedures were all successfully completed. Based on the analysis I have done on this industry, it is appropriate for overall materiality to be based on the profitability of the company.

(d) Using the information in Exhibit 5, discuss the ethical issues raised and recommend actions to be taken by our firm. **(8 marks)**

Exhibit 2 – Business and governance

The company was established 15 years ago by Martin Gruber, an engineer who had patented a new type of machine used in the oil industry. Martin, who is the company's chief executive officer, owns 60% of the shares in the company, with the remainder split equally between his brother and sister, Craig and Iris Gruber.

The company's board of directors includes Craig Gruber as chief finance officer (CFO), Iris Gruber as marketing director, and a non-family member, Kali Hayes, who is director of operations. Gruber Co has 300 employees, most of whom are mechanical engineers.

Martin is planning to sell his shares and retire from the business. Craig and Iris, who are younger than Martin, will retain their shares and their board positions. Initial discussion with a potential acquirer for Martin's shares began last month.

The company owns a head office and leases a production facility where machines are designed and assembled under contract with individual customers. Typically, an order takes 14 months to complete, from the initial design through to installation at the customer's premises. This is due to the large size of the machinery being produced to customer order and the very specific requirements of customers.

Exhibit 5 – Meeting notes

A meeting took place yesterday in which the audit engagement partner discussed the potential sale of Martin Gruber's shares with the company directors.

The company directors revealed that Willis Co is the company with whom negotiations have started in relation to the sale of Martin Gruber's shares. Willis Co is an existing audit client of McClane & Co.

The directors have requested that McClane & Co assist them with the sale by performing a vendor's due diligence service, in which they would conduct an independent review of Gruber Co's financial position and future prospects and produce a report on their findings to be provided to Willis Co.

Ben’s answer plan

Note – this is a ‘strong’ answer, planned / written under exam timed conditions. It isn’t perfect, but shows you what is achievable!

Discussion of ethical issues (8)

1. Conflict of interest - best interest of both parties - Martin Gruber (maximise sale price) - Willis Co - pay as little as possible - due diligence report could be perceived to favour one party over the other.

2. Confidentiality - commercially sensitive information - about Willis Co (obtained during the audit) - Could leak to Gruber inadvertently - Gruber may press the audit firm for any relevant information (could use to negotiate a better price) - potential synergies

3. Advocacy - report will be provided to Willis Co - perceived to be promoting the interest of Gruber Co - reasonable third party - lack of objectivity

4. Self review (NOT PLANNED / WRITTEN UP DUE TO TIME CONSTRAINTS)

Actions for the audit firm

1. Full disclosure to both parties - potential ethical issues - obtain informed consent of both parties - likely to be rejected by one or both sides - if not received, do not take on the work - consider resigning as auditor of Willis Co (Gruber may be more commercially attractive)

2. Separate teams - information barriers, no communication or access to files - reduce the risk of confidential information leaking.

3. Independent partner review - due diligence report - reasonable assumptions made, evidence supports the conclusions - audit file of Gruber Co - reduce risk of bias

Ben's full written answer

Note – this is a 'strong' answer, planned / written under exam timed conditions. It isn't perfect, but shows you what is achievable!

NOTE: Highlighted areas indicate where professional skills marks have been earned

Discussion of ethical issues

Conflict of interest
It will be hard to act in the best interest of both parties. Gruber Co (and Martin Gruber particularly) have an interest in maximising the sale price, so will push for the report to show Gruber's performance in the best possible light.

Willis Co have the opposite interest, wanting to pay as little as possible for Martin's shares, so favouring the report showing Gruber's position to be weak.

The due diligence report could be perceived by Gruber or Willis to favour one party over the other.

Confidentiality
McClane has access to confidential, commercially sensitive information about both companies, obtained as part of the audit work on each client.

Information about Willis Co, obtained during that audit, could leak to Gruber inadvertently. For example, information about potential synergies that could arise from buying the shares. Gruber may press McClane for any relevant information that they could use to negotiate a better price, putting McClane under pressure to provide it.

Willis Co are likely to be uncomfortable with the possibility of this happening.

Advocacy
The report will be provided to Willis Co, a third party, and will form the basis of the sales price negotiations. McClane's independent review of Gruber's future prospects could be perceived to be promoting the interest of Gruber Co to obtain a higher sales price.

A reasonable third party could perceive McClane to lack of objectivity, both with the due diligence work and the audit of Gruber.

Actions for McClane

Full disclosure should be made to both parties, detailing the potential ethical issues and any safeguards that McClane could put in place to reduce those threats, so that both parties are fully aware of the situation

McClane should seek the informed consent of both parties (in writing). This is likely to be rejected by one or both sides (particularly Willis, given that the potential leakage of confidential information).

Ben's full written answer

Note – this is a 'strong' answer, planned / written under exam timed conditions. It isn't perfect, but shows you what is achievable!

If informed consent is not received, do not take on the work. Consider resigning as auditor of Willis Co, as the Gruber Co work may be more commercially attractive.

If informed consent is received, use separate teams with information barriers in place. This will reduce the risk of communication between the individuals performing the work (and there should be no access to files).

Ensure that nobody working on the Gruber due diligence work has had any involvement with the Willis Co audit, to reduce the risk of confidential information leaking.

An independent partner review of both the due diligence report and the Gruber audit should be performed. Ensure that reasonable assumptions were made and that the evidence on file supports the conclusions. This should reduce the risk of bias.

Examiner's mark plan - technical

Note – this is 'perfect' answer. It isn't realistic to write this much in the time available! I've included this answer as a reference tool only.

(d)	**Ethical issues** Up to 1 mark for each relevant, explained point: – Conflict of interest between Gruber Co and Willis Co – Conflict of interest impact on auditor's objectivity – Requirement that a professional accountant shall not allow a conflict of interest to compromise professional judgement – Risk relates to the valuation of the Gruber shares – Risk of breach of confidentiality – Full disclosure to be made to both parties and consent obtained – Safeguards may be used to reduce the threat to objectivity (max 2 marks) – Advocacy threat in relation to Gruber Co – Safeguards to reduce advocacy threat (max 2 marks) – Management responsibilities in relation to Gruber Co – Self-review threat re audit of investment in Willis Co – Safeguards to reduce self-review threat (max 2 marks) – Valuation should not be provided if material impact on financial statements and involves significant degree of subjective judgement	
	Maximum	**8**

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Examiner’s mark plan – professional skills

Professional scepticism and professional judgement

-Effective challenge of information supplied and techniques carried out to support key facts and/or decisions (E.G. MARTIN GRUBER INCETIVISED TO MAXIMISE THE SALES PRICE)

-Appropriate application of professional judgement to draw conclusions and make informed decisions about the courses of action which are appropriate in the context of the audit engagement (ALL ACTIONS FOR THE AUDITOR MUST BE RELEVANT TO THE PLANNING PHASE)

-Identification of possible management bias or error (E.G. THE DOMINANCE OF MARTING GRUBER ON THE BOARD AND OTHER BOARD MEMBERS RELATED TO HIM MAY NOT CHALLENGE HIS DECISIONS)

Commercial acumen
- Appropriate recognition of the wider implications on the audit firm when considering the potential conflict of interest (E.G. SENSITIVE INFORMATION ABOUT WILLIS CO CAN BE LEAKED TO GRUBER AND GRUBER)