

You are the audit engagement partner at A & Y, a small firm of public accountants. You were recently appointed as auditor to a local company named B Ltd. The previous auditors, Z & Co, had resigned due to having so few audit clients that it was no longer commercially viable for the firm to retain its registered public accounting firm status. This had provided the opportunity for your firm to take on the client and you and your fellow partners were delighted to be gaining an audit client in what was proving to be a difficult business environment. Times were certainly tough and you were well aware that redundancies were not out of the question if more work was not picked up quickly. You had met Mr X, B Ltd's Managing Director (MD), at various local events and had a good personal relationship with him. Mr X was someone with a very good reputation in the local business community and was involved in a lot of charitable fundraising activities. You believed that this was a good client to win and, with Mr X's considerable business connections, this might not be the only audit client that you would pick up in the coming months. Mr X had assured you that a good working pack would be prepared by his newly installed finance director (FD) to support the figures in the draft financial statements. Additionally, the client would arrange for the final publication of the accounts.

Six months down the line, you are sitting at your desk reviewing the audit working papers of B Ltd. As you had imagined, the fieldwork had been done within budget and the files appeared to show that, as Mr X had earlier advised, the company had maintained a good set of records and produced appropriate documentation to support the draft figures. Some minor errors had been noted and added to the summary of unadjusted errors, but nothing of any significance, and you had all but finished your review. You looked at your watch, another 20 minutes would see you complete your task – the client was now keen to sign off in seven days time, three weeks earlier than had originally been envisaged. This had just allowed you time to review the files in advance of a meeting with Mr X and his FD later that week to discuss any major issues prior to signing.

You continued with the task at hand and opened the creditors section of the file and reviewed the lead schedule. Everything this year appeared in line with that of the previous year. There were no major variations and, to be honest, you had not expected any. There was, however, a note from the audit senior stating that a large accrual had been included for taxes – and indeed an accrual of \$163,937 was included in the accounts. This appeared to consist of a charge of \$15,000 for the year in question and the backlog of the amount which had been accrued in previous years. It was clear that the company had not made a payment of taxes for a period of 8 years. It had, however, ensured that the expense had been properly reflected in the accounts. You made a note of this and added it to your list of points to be discussed at the client meeting. You remembered that no mention was made of this fact in the consent letter which you had received from the predecessor auditor. You had not been given access to their working papers for the previous year.

Whilst the accounts appear to be correctly stated, on the premise that taxes are due to be paid, you are concerned that it would appear as though the company had never tried to resolve this issue with the tax authorities. You also have concerns about how this item will be treated in the corporate tax computation.

What do you do now?

Analysis of Scenario: What are the readily-identifiable ethical issues for your decision?

I. For you personally

- Given your firm's financial situation (redundancies had been mooted) and the additional work you hope may be generated from your relationship with this client, is there additional pressure on you to placate the client? Is there someone within your firm with whom you can discuss the issue?

II. For the public accounting firm

- The company has correctly accounted for the situation but is this sufficient? If the company received a bill to pay all of the outstanding taxes immediately would it have sufficient cash resources to do so? Does this have an impact on your assessment of going concern?
- Although the company has correctly accounted for this matter, how has the tax figure been treated in previous corporate tax returns?
- If the tax authorities discovered their discrepancy at a later date, would this impact on your firm's reputation?

III. Who are the key parties who can influence, or will be affected by, your decision?

- 'You'; your fellow partners; the MD; the other directors of B Ltd; the shareholders (if different from the directors); the general public; and tax authorities.

IV. What fundamental ethical principles for accountants are most applicable and is there an apparent conflict between them?

- Integrity: The need to have a full and frank open discussion on this issue with the MD and the FD of B Ltd. What happens if they are resolute in continuing as is?
- Objectivity: As this is a new client, this might naturally be assumed, however the economic conditions and the possible additional work that might come your way are a potential threat to your objectivity.
- Confidentiality: Assumed, but is there a wider social responsibility?
- Professional behaviour: Does it serve the public interest for this situation to continue and how does this contrast with the need for confidentiality?

V. Is there any further information (including legal obligations) or discussion that might be relevant?

- You obviously have to discuss the issue with the MD and FD of B Ltd at the forthcoming meeting to get a handle on all the relevant facts.

VI. Is there a conflict between the 'Guardian' and 'Commercial' strands of an accountant's responsibilities?

- It would appear that there may be a conflict. The commercial interests of the firm are properly best served by not pressurising the company to report this matter to the tax authorities but how does that equate with the auditor's 'Guardian' role?

VII. Based on the information available, is there scope for an imaginative solution?

- You could explain the potential consequences to the MD if this error is ever discovered by the tax authorities and encourage him to get the company to voluntarily approach the tax authorities with a view to seeing whether they would accept a delayed settlement of any sums due, preferably spread over a number of years and with little or no associated interest or penalties and with no related publicity. Additionally, you may wish to highlight to the MD that if there are plans to sell the company then any due diligence undertaken on behalf of the prospective purchaser is likely to discover this non-payment of taxes which could impact on the sale.

VIII. Are there any other comments?

- If the client refuses to do anything, does this impact on your ability to continue acting as auditor for this client?