Salt & Pepper & Co (Salt & Pepper) is a firm of Chartered Certified Accountants which has seen its revenue decline steadily over the past few years. The firm is looking to increase its revenue and client base and so has developed a new advertising strategy where it has guaranteed that its audits will minimise disruption to companies as they will not last longer than two weeks.

In addition, Salt & Pepper has offered all new audit clients a free accounts preparation service for the first year of the engagement, as it is believed that time spent on the audit will be reduced if the firm has produced the financial statements.

The firm is seeking to reduce audit costs and has therefore decided not to update the engagement letters of existing clients, on the basis that these letters do not tend to change much on a yearly basis.

One of Salt & Pepper's existing clients has proposed that this year's audit fee should be based on a percentage of their final pre-tax profit. The partners are excited about this option as they believe it will increase the overall audit fee.
Salt & Pepper has recently obtained a new audit client, Cinnamon Brothers Co (Cinnamon), whose year end is 31 December. Cinnamon requires their audit to be completed by the end of February; however, this is a very busy time for Salt & Pepper and so it is intended to use more junior staff as they are available.
Additionally, in order to save time and cost, Salt & Pepper have not contacted Cinnamon's previous auditors.

Required:

i) Identify and explain FIVE ethical risks which arise from the above actions of Salt & Pepper & Co; and

ii) For each ethical risk explain the steps which Salt & Pepper & Co should adopt to reduce the risks arising.

Note: The total marks will be split equally between each part. (10 marks)

Examiners Report

Part (c) for 10 marks required an identification and explanation of five ethical risks which arise from the audit firm's actions and how these risks may be reduced. This question was answered well by most candidates.

Candidates were able to identify from the scenario the ethical risks arising from the firm's actions. Some candidates did not explain the risks correctly or in sufficient detail, sometimes just identifying the risk and not explaining correctly how this was an ethical issue. For example, many identified the risk of the audit fee being based on a percentage of the client's pre-tax profit; however this was incorrectly explained as being an issue of fee dependence rather than it being a contingent fee. As the risk was incorrectly explained this resulted in an irrelevant action for reducing the ethical risk. Therefore only the identification ½ marks would have been awarded.

In addition some candidates incorrectly thought that there was an ethical risk because Cinnamon wanted their audit complete by February. The ethical risk was that in order to meet the client's deadline the firm would be using more junior staff and hence increased the risk of giving an incorrect opinion.

The second part of this question required steps for reducing the ethical risks. Candidates' performance was generally satisfactory although some answers tended to be quite brief. For example for the risk of the engagement letters not being updated, the response given by some candidates was "Update the engagement letters," this is not a sufficiently detailed explanation.

Some candidates thought that a risk had to be identified for each of the ethical threats of self-review, self-interest etc. This resulted in them trying to identify a situation from the scenario to fit each of the types of threats. This is not the correct approach to take as it is unlikely that the scenario will be based around one of each of the five ethical threats.