# *Auditing - A Practical Approach (Canadian) 4th Edition 4th edition Moroney Solutions Manual*

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# Solutions Manual

**to accompany**

# Auditing: A Practical Approach

**Fourth Canadian Edition**

**by**

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## CHAPTER 2

## Ethics, Legal Liability, and Client Acceptance

WILEY

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# Chapter 2
# Ethics, Legal Liability, and Client Acceptance

## SOLUTIONS TO REVIEW QUESTIONS

### REVIEW QUESTION 2.1

Compliance with the fundamental principles of the code of professional conduct can contribute to the ability of the auditor to discharge their duty to act in the public interest. Upholding the fundamental ethical principles that apply to all members of the profession means to exhibit professional behaviour, act with integrity and due care, maintain professional competence, respect confidentiality, and act with objectivity. When a public accountant upholds these principles, it increases the reliability and the faithful representation of the information under audit. This level of professionalism is expected from the public and increases their confidence in the profession and the quality of the work being performed.

The requirement to act in the public interest means that auditors should consider how their actions impact the client and their employer. They must also consider the impact of their actions on others such as the client's employees, investors, credit providers, and those without direct financial interests in the client such as the broader business and financial community and members of the public. All these people could be reliant on the quality of the auditor's work, even though they are not party to the contract between the client and the audit firm.

The reliability of the financial statements and the audit report is potentially damaged if the auditor does not exhibit professional behaviour (protecting their reputation and the profession's reputation), act with integrity (honesty) and due care, maintain professional competence (executing the work with the required level of knowledge and skill), respect confidentiality (refrain from discussing the client's affairs with others inappropriately), and act with objectivity (being independent).
Unprofessional behaviour brings discredit to the profession.
A dishonest auditor could knowingly help publish a materially false, misleading, or reckless financial statement. Auditors who do not uphold due care principles could fail to act diligently in accordance with the applicable technical standards. Auditors who do not uphold professional competence principles could provide incompetent professional service. Disclosures of the client's confidential information without proper or specific authority from the client or without a legal duty to disclose could disadvantage the client in the conduct of its affairs. Auditors who compromise their objectivity could be biased or unduly influenced to publish an inappropriate audit opinion.

### REVIEW QUESTION 2.2

The four biases that may impair professional scepticism are:

**Availability bias**


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This bias involves considering information that is easy to remember as being more likely, more relevant, and more important. This can occur when an auditor does not consider possible alternatives as they are focusing on the most recent information that they have received. For example, suppose the client's repairs and maintenance expense is more than double that of the previous year. Management's explanation was that a windstorm caused significant damage. The auditor then focuses on searching for evidence to corroborate this information rather than looking for alternatives, such as the development of a new piece of equipment that should have been capitalized.

**Confirmation bias**
This bias occurs when the auditor favours evidence that confirms their beliefs or expectations, possibly downplaying or ignoring other relevant evidence. For example, accounts payable is down and the auditor believes this to be reasonable as sales are down and no further evidence is gathered. The auditor ignores the fact that management increased credit limits for its customers in order to boost sales and recorded the additional sales as deferred revenue, creating a classification issue.

**Overconfidence bias**
This bias occurs when the auditor overestimates their ability. For example, an auditor completes an inventory count twice as fast as the auditor the previous year and believes that it is because they were more efficient. After the file is reviewed it is determined that the sample selection was too small, and more evidence needs to be gathered.

**Anchoring bias**
This bias occurs when an auditor starts from an initial numerical value and then insufficiently adjusts that initial value in forming a final judgement. For example, management estimates the allowance for doubtful accounts to be $100,000. The auditor believes it to be too low and suggests the estimate should be $120,000. In fact, one of their major clients has declared bankruptcy and the estimate should be $200,000.

**REVIEW QUESTION 2.3**
Both aspects of independence are important. If an auditor has independence in fact, the auditor will act independently. Acting independently means that the auditors are free of the clients' influence and will perform their duties as required by the auditing standards and codes of ethics, even if the clients do not agree. Acting independently is essential for a high-quality audit.

However, despite how independently the auditor may act, the audit report will not be credible if the outside parties do not believe that the auditor acted independently. That is, outside parties may not believe the audit report has any credibility because they believe that the clients have influenced the auditor. Therefore, the auditor must be seen to be independent by outside parties. That is, the auditor must be independent in appearance for the audit report to be believed.


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If the auditor is seen to be independent but is really not independent, then the audit report will have credibility, but if later events reveal that the auditor did not act independently, the outside parties could suffer a loss from relying on an inappropriate audit opinion. Therefore, both independence in fact and independence in appearance are required for effective auditing.

**REVIEW QUESTION 2.4**

An auditor has a self-interest problem if the outcome of the audit (and/or the success of the company) affects the auditor's (i.e., the audit firm or the auditor as an individual) financial interests. The closeness in this case is manifested through the auditor's share ownership in the client, the client producing a very large part of the audit firm's audit or other services revenue, or the existence of loans or other financial interests between the auditor and the client. It is a problem for the audit's value because the auditor knows that a qualified audit report could adversely affect the client's share price, or a tough audit decision (e.g., requiring the client to write down the value of its assets) could encourage the client to seek another auditor. These concerns could prompt the auditor to act inappropriately during the audit.

The self-review problem arises when the auditor, as part of the audit, has to test transactions or systems that were recorded or provided by another part of the audit firm or by a previous employee of the audit firm, or the testing is performed by a previous employee of the client. The closeness is manifested by the fact that self-review means that there is too little separation between the client and the auditor with respect to that part of the audit, that is, the auditor is testing or reviewing itself. It is a problem for the audit because self-review impairs the primary source of value of a financial statements audit, that is, the independence of the auditor from the client. The lack of independence could mean that the auditor acts inappropriately during the audit, for example because they believe their work to be free of error or because they do not want something to be discovered.

Familiarity refers to a general closeness between the auditor (including the whole audit team) and the client. The closeness in this case is manifested in a relationship that is more one of friendship than that between independent auditor and client. The auditor could lose their objectivity during the audit and act inappropriately.

**REVIEW QUESTION 2.5**

The accounting profession and related parties such as clients and regulators have developed safeguards in order to minimize the risk of possible threats to independence as well as to act accordingly when threats surface, which includes CSQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements.

The safeguards accounting firms can put in place include establishing policies and procedures to ensure the quality of their service, and continuous education of staff about possible threats and the policies in place. Policies should include partner rotation (to mitigate the familiarity threat), peer review (to review all possible threats), and policies for


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staff if they become aware of any threats to independence. These procedures should also include an annual review of independence for each client that considers all independence threats as well as communication to the client annually to confirm the firm's independence. There are more examples of specific safeguards for each independence threat included in Table 2.2.

**REVIEW QUESTION 2.6**

The audit report is addressed to the shareholders of the audited company. However, there is very little contact between an auditor and the shareholders. One exception is that the auditor is required to attend the company's annual general meeting where there could be some dialogue between the shareholders and the auditor. In addition, the auditor could meet large shareholders, for example those on the board of the directors or who work for the company. Shareholders are responsible for the appointment and removal of the auditor, but in practice the selection of the auditor is done by the board who then recommends the appointment to the shareholders for their approval. It would be more realistic to regard the board of directors as the auditor's client because they are in charge of the company's governance. The CEO or CFO will be in charge of the client's financial reporting process and the auditor may have the most contact with them and the finance department, but they are not the client to whom the auditor reports.

**REVIEW QUESTION 2.7**

A client may bring an action against an auditor under contract law or tort law. The contract is between the client and the auditor. Damages under a breach of contract can only be claimed by a party to the contract.

Tort law allows any party to bring an action for negligence, provided the following three conditions are established:

- A duty of care was owed by the auditor
- There was a breach of the duty of care
- A loss was suffered as a consequence of that breach.

Therefore, tort law allows another party to bring an action (not just a party to the contract) if it can be shown that there was a duty of care to that party. This means that the client and other parties could potentially bring an action for negligence. The first condition appears to be the most difficult to prove.

For example, in the Pacific Acceptance case report, it was noted that the auditor could owe a duty of care to the client and its shareholders. The report discusses the problems facing plaintiffs when seeking to establish that the client or shareholders had suffered a loss as a result of the auditor's negligence. To ascertain a causal relationship between the negligent act and the loss suffered, reasonable foreseeability must be proven. This means that the auditor must have been aware that any negligence on their part could cause a loss to the client or their shareholders.


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In Hercules Management Ltd. (1997), the courts ruled that for a third party to be able to establish that an auditor owes them a duty of care, they would need to show the following:

- The report was prepared on the basis that it would be communicated to a third party.
- The report was likely to be relied upon by that third party.
- The third party ran the risk of suffering a loss if the report was negligently prepared.

The judgement in the Hercules case provided some relief for auditors as it made it far more difficult for a third party to establish that a duty of care was owed by the auditor. Today, it is advisable that a third party take steps to establish proximity before using an audit report to make a decision. They can request that an auditor provide them with a privity letter, which can be used to prove that a duty of care was owed to them.

The plaintiff must also show that the auditor breached its duty of care, for example, by conducting a poor-quality audit. Mere non-compliance with auditing standards may not be sufficient to show a breach of the duty of care. Finally, the plaintiff must establish that they suffered loss as a result of the breach of the duty of care. For example, the plaintiff must show that they relied on the audit report to make their investment that subsequently lost value.

**REVIEW QUESTION 2.8**

While litigation cannot be avoided in absolute terms, there are steps an auditor can take to reduce the risk of litigation. This includes hiring competent staff, ensuring continuation of education by training staff and updating their knowledge, ensuring compliance with ethical and auditing regulations, and ensuring compliance with policies and procedures established by the auditing firm.

**REVIEW QUESTION 2.9**

Client acceptance and continuance procedures are performed for the purpose of evaluating whether the auditor can service the client and still meet the relevant ethical and legal requirements. This is to protect the client and the auditor as well as those who will rely on the audit report. The client needs to be assured that the auditor has the appropriate skills and capacity to provide the audit at the appropriate level of quality and within the required time frame. The auditor needs to be sure that it can service the client in this way and protect itself from any conflicts of interest that could arise during the engagement. The public and other parties need to be assured that the audit was conducted appropriately and the auditor was able to exercise the required level of independence.

An auditor will not accept every client, even if it has capacity, because they would not be able to provide the required level of expertise to service the client's needs. Refusal to accept a client (or continue with an existing client) does not mean that the client is not auditable or lacks integrity. Another auditor could be better able to service the client because of capacity or expertise issues. However, the auditor's right to refuse a client means that the more difficult-to-audit clients find it hard to get an auditor and so have the incentive to either improve their systems and/or integrity, or go out of business. As such, the quality of financial reporting across the economy is likely to be higher.


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**REVIEW QUESTION 2.10**

An engagement letter is the contract between the client and the auditor. It contains clauses that make the responsibilities of each party clear, and can provide a method of handling disputes. CAS 210 *Agreeing the Terms of Audit Engagements* provides guidance on the preparation of engagement letters. An engagement letter is prepared by an auditor and acknowledged by a client before the commencement of an audit.

The purpose of an engagement letter is to set out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client. The letter will confirm the obligations of the client and the auditor in accordance with the various standards. While the engagement letter can expand upon the requirements that appear in legislation and standards, it cannot limit or contradict those requirements.

An engagement letter should include an explanation of the scope of the audit, the timing of the completion of various aspects of the audit, an overview of the client's responsibilities and the auditor's responsibilities, identification of the applicable financial reporting framework, and reference to the expected form and content of the audit report. A sample engagement letter is illustrated in figure 2.6.


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# SOLUTIONS TO PROFESSIONAL APPLICATION QUESTIONS

## PROFESSIONAL APPLICATION 2.1 – Ethical principles

The fundamental ethical principles that apply to all members of the professional bodies are to exhibit professional behaviour, act with integrity and due care, maintain professional competence, respect confidentiality, and act with objectivity.

Charles overstates his importance at the audit firm – he states that he is a partner when he is a senior auditor. This is a breach of integrity.

Charles tells William that the patriarch (male leader of the family) is having an affair with his personal assistant – this is gossip. Even if it is true, it is not professional behaviour to reveal private matters about a client to another party. Charles also states that he has his doubts about this person – this apparently means that Charles believes that the person is dishonest or unethical or incompetent (it is not clear what he means, but he is saying something negative). Once again, this is not professional behaviour.

Charles tells William that the family has increased its shareholding in another company, with potential benefits to that company. This information appears to have been gained as part of the audit, so revealing it to William is a breach of confidentiality. It is not relevant that William works for a bank that lends to the client. Charles does not have the client's permission to discuss this matter.

## PROFESSIONAL APPLICATION 2.2 – Application of the ethical framework

### Identify the Issue

It has come to the attention of Hardeep that a number of significant charges related to payables are very large purchases of personal goods. He is also aware that Sam Grey is renovating his home and is buying most of his materials through the business. Most of the expenses are being recorded as repairs and maintenance, and supplies expense. The total amounts charged are just above materiality. The issue is that it appears that Sam and his son Josh are not following the business entity principle where every business is to be accounted for separately from its owners.

### Determine who is affected

The effect of the possible accounting violation could decrease the company's profits and in turn the taxes payable, which would be personally advantageous for both Sam and Josh as together they own 55% of the shares of the company. The other shareholders are affected because if Sam and Josh are paying for personal expenses through the business, they are essentially stealing from the other shareholders. Since Sam and Josh appear to be doing this intentionally, this could lead to increased audit risk. The transactions identified were credit transactions, but it is possible that there are further personal expenses recorded through cash transactions as well. The question then becomes, how many other expenses were of a personal nature?


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**Alternatives to resolution**
The ethical dilemma is how to approach the client. The audit partner is going to have a discussion with Sam next week. It is important that the audit partner maintain professional scepticism when speaking with the client, but it would be inappropriate to jump to the conclusion that Sam and Josh did this intentionally. Some business owners use only one credit card for simplicity for both personal and business expenses. The bookkeeper may not always be aware of what is personal and may record it based on their judgement to what they think is the most appropriate account. At the end of the year, the business owner provides a list of all personal transactions to the accountant so that they can be adjusted appropriately.

Some alternatives include:
1. Discussion with Sam and Josh together
2. Discussion with Sam and Josh independently
3. Discussion with Sam and Josh both independently and then together
4. No discussions with either party and expressing an adverse opinion on the audit report

**Action**
If the audit partner decides to speak to Sam and Josh together, the explanations provided by one party might influence the responses from the other. The second alternative is the most ideal option, as speaking with Sam and Josh independently may lead to more honest responses from them. If the independent responses indicate there may be a need to speak to both Sam and Josh together, the third alternative would be appropriate. The fourth alternative is the least appropriate as this could have a negative impact on the business and the minority shareholders. The discussion with the client should include questions to see if they were aware of the transactions, how many there are, if they understand that it is a violation of the financial framework, and if they are willing to review all expense accounts, identify personal transactions, and record them appropriately to a due from shareholder account. It will also be important to ascertain an understanding of what the company's shareholder loan policy is and if any interest should be paid. How to proceed from there will be based on the client's responses.

**PROFESSIONAL APPLICATION 2.3 – Ethical issues**
Revenue recognition requires that revenue only be recognized when the performance obligation of delivering the goods is satisfied. In this case, goods were not delivered until the following year, on January 3 and therefore the revenue should be recorded in the next year. The CFO has asked you to record an entry that you know will violate these accounting principles.

As a recent hire to a company, you might be concerned about job security if you do not do what the CFO has requested. If you only take into consideration your personal situation, with small children to feed and a mortgage to pay, it is tempting to routinely record the journal entry as requested by the CFO. After all, the delivery did take place and it does not seem like there is any harm in recording the revenue just three days early.


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The fundamental ethical principles that apply to all members of the profession are to exhibit professional behaviour, act with integrity and due care, maintain professional competence, respect confidentiality, and act with objectivity.

If you record the requested transaction, you would not be acting with integrity. You could approach the audit committee and disclose to them the suggested transaction. You could also go to the board of directors and explain the situation. However, before doing this you should approach the CFO directly and explain that this adjustment does not satisfy GAAP and explain to him your concerns about how this could have an impact on the decisions of the users of the financial statements. If the CFO insists on the adjustment, you should then consider approaching the board of directors or the audit committee. While providing for your family is important, acting in an ethical manner is also important.

**PROFESSIONAL APPLICATION 2.4 – Ethical dilemma**

a. The code of professional conduct requires practitioners to exhibit professional behaviour, act with integrity and due care, maintain professional competence, respect confidentiality, and act with objectivity. Alex has a duty to his long-time client Hudson Hughes. However, the information he knows about Laura is not public and he only obtained it as part of his relationship with a previous client, Mark's Meats. In terms of the professional code of conduct, the issues of confidentiality must be considered.

b. **Identify the Issue**

   The issue is whether Alex must maintain confidentiality and not disclose this information to Hudson. If he does not disclose, will this have a future negative impact on Hudson?

   **Determine who is affected**
   Laura could be affected because if Alex reveals this information, Hudson may choose to fire her, leaving the single mother once again unemployed.

   Alex could be affected because if he discloses this information, he could be in breach of the code of professional conduct.

   Hudson could be affected because if Alex chooses not to reveal this information, there is a possibility that Laura may steal from her new employer. If Alex does reveal the information to Hudson and Laura is fired, Hudson will be affected because he will now have to find a new bookkeeper.

   **Alternatives to resolution**
   Options Alex can consider are:


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1. He can decide to break confidentiality and inform Hudson, which would be a violation of the code of professional conduct because he obtained this information as a result of his employment by Mark's Meats and it is not publicly available information.
2. He could maintain confidentiality and not disclose this information. It is not clear if Alex is performing an assurance engagement for Hudson Hughes, however if he is, this option will increase the risk relating to his engagement. Because Alex is aware that Laura has been unethical in the past, he would have to increase the audit procedures performed on the engagement.
3. Maintain confidentiality and not disclose this information, but discuss with Hudson the importance of internal controls and provide him with recommendations on how to safeguard his assets. If Hudson applies the recommendations, this would decrease the risk of fraud or theft as Laura's opportunities to commit such an action would be significantly reduced.

**Action**
The third option presented in the alternatives would be the recommended course of action. This option does not break the code of professional conduct and takes into consideration the interests of his long-time client, Hudson Hughes.

## PROFESSIONAL APPLICATION 2.5 – Professional scepticism

**Availability bias**
This bias involves considering information that is easy to remember as being more likely, more relevant, and more important. This can occur when an auditor does not consider possible alternatives as they are focusing on the most recent information that they have received. In this case the client has indicated that their customer composition has remained the same; therefore, they estimate a reasonable allowance would be 30 percent of accounts receivable over 90 days. The auditor then focuses on searching for evidence to corroborate this information by comparing this year's balance to the previous year's balance, rather than looking for alternatives, such as if sales have increased or decreased during the year.

**Overconfidence bias**
This bias occurs when the auditor overestimates their ability. In this case, the auditor believes she is an expert at auditing accounts receivable because she has audited this section on her past two engagements. Auditing the same section only twice is not a sufficient amount of experience to be an expert. This overconfidence can may cause the auditor to collect an insufficient amount of audit evidence.

**Anchoring bias**
This bias occurs when an auditor starts from an initial numerical value and then insufficiently adjusts that initial value in forming a final judgement. In this case, management estimates a reasonable allowance would be 30 percent of accounts receivable over 90 days. The auditor believes it to be too low and suggests the estimate should be 50 percent of accounts receivable over 90 days; however, because much of the balance was outstanding at the prior year-end, the estimate should be closer to 100 percent.


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**PROFESSIONAL APPLICATION 2.6 – Principles and rules of the code of professional conduct**

a) This case indicates a violation of the confidentiality principle. An auditor should not disclose client information to others outside the organization.
Joan has bought shares in her client, and there may also be a self-interest threat (impairment of independence). Furthermore, she used insider information to buy these shares, which is illegal.

b) There is a violation as the advertising is making an unsubstantiated claim in indicating the firm is the premier accounting firm in western Canada, implying that it is better than competing firms. This is a violation of the specific rule of professional conduct relating to advertising. There is also a fee issue as contingency fees based on the outcome of the engagement are not appropriate. This is a violation of the specific rule of professional conduct relating to fees and pricing, as contingency fees are not permitted for engagements where independence is required. Fees are to be based on an estimate of the work to be performed.

c) This scenario presents a self-review threat, as Sue is planning to prepare the tax provision and then audit it, thereby providing assurance over her own work. Also, there is a prohibition on providing bookkeeping services to reporting issuers.

d) In this case the client is a private company and therefore it may be possible for Sue to propose the journal entries and remain independent. Sue must be careful to ensure that the preparation of the journal entries does not cause a self-review threat where she is auditing her own work.

If the journal entries are simple bookkeeping entries, the self-review threat would not be significant. However, Sue should review the entries with management and ensure management understands them. Management should sign off on their approval of the entries and this documentation should be kept in the audit file.

If the entries involve complex accounting issues requiring significant judgement, the self-review threat would be significant. Sue would then have to ensure safeguards were in place to reduce the self-review threat to an acceptable level. She could do this by consulting with another professional accountant to confirm that the accounting treatment proposed is appropriate, thereby reducing the self-review threat to an acceptable level.

e) For compilation engagements, the preparation of routine journal entries or the provision of routine bookkeeping services does not create a self-review threat. As best practice, Sue should review the journal entries with management and obtain their written approval. However, the absence of management approval does not create an independence issue, except in Quebec. In Quebec, this situation would need to be disclosed, unless the entries were basic mechanical and posting-type entries.


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f) There is no self-interest threat provided the loan is within the bank's normal lending terms.

g) This presents a familiarity threat where a close relative (Phillip's father-in-law) holds a senior position as COO for Canada Bank.

h) This may represent a threat if the fees are significant. If the fees are significant, they may be considered in substance a loan to the client and therefore create a self-interest threat for James.

i) The following are issues with this scenario.
- First is the referral fee, as referral fees are not permitted.
- Second, she must ensure she exercises due care and conducts the audit in accordance with current standards. As she has not performed any audit engagements in the past four years, it is unlikely she is up to date with Canadian Auditing Standards (CASs).
- Alison also failed to demonstrate due care when she accepted the client without performing any of the required client acceptance procedures.

j) Independence is not required for compilation engagements, but Matt should disclose the fact that he is not independent in his written report accompanying the financial statements. The disclosure should indicate the nature of the relationship.

**PROFESSIONAL APPLICATION 2.7 – Professional conduct**

a) Jason is demonstrating a failure to maintain his professional competence.
b) Samantha is behaving improperly and must respond to the prospective auditor.
c) Sophie has demonstrated a failure to maintain the confidentiality of client information because she has not received permission from the client to provide more information.
d) There is a violation as the advertising is making a false claim in indicating the firm has the largest number of audit partners in the region.
e) Alan cannot have such a financial interest in the business because the auditor needs to be independent. Informing the bank, the primary user of the financial statements, does not solve the issue.

**PROFESSIONAL APPLICATION 2.8 – Independence safeguards**

1. Having the client approve proposed journal entries provides evidence that the client has reviewed and accepts responsibility for the adjustments (and the resulting changes to the financial statement balances). Therefore, in having the client take responsibility for those adjustments, it is a safeguard for a self-review threat.

2. By having all staff review a client list, the firm ensures it is aware of engagement clients to which certain staff must not be assigned. As firm members should limit and


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disclose the shares they hold in an audit client, this is a safeguard for the self-interest threat.

3. By participating in the same engagement over a number of years, the auditor may develop a close relationship with the client and client staff. This may lead to a familiarity threat. Therefore, rotating staff is a safeguard to that threat.
4. By having a policy indicating it is not acceptable for staff to date client personnel, it reduces the likelihood of a familiarity threat.
5. Auditors should regularly review fees per client to total fees to identify if the fees from one client are so significant that it leads to a self-interest threat.
6. There should be a cooling-off period before audit staff becomes employed at a client's business. This is to reduce the self-review threat.

**PROFESSIONAL APPLICATION 2.9– Receiving shares through inheritance**

Prior to the uncle's death, the shares were not held by Kerry or his wife – the connection through her uncle is too remote for a self-interest threat to have existed.

After the uncle's death, Kerry's wife is now the owner of the shares, which appears to give her a material ownership in the client, creating a potential self-interest threat for Kerry.

Now that Kerry is aware of the inheritance, he should inform the partner for this engagement in writing. The shares should be disposed of, or Kerry removed from the audit. If Kerry stays on the audit, additional safeguards should be considered such as discussing the matter with the client's audit committee or having Kerry's work reviewed by another member of the firm that has not been a member of the engagement team. Kerry will not be fired from the audit firm provided he follows the above procedures.

**PROFESSIONAL APPLICATION 2.10 – Provision of non-audit services to audit clients**

a) It is possible that increasing the revenue of the audit firm would increase Elise's reputation within the firm. However, if the growth in revenue creates any conflicts of interest or other ethical problems it could damage her reputation. If providing non-assurance services creates a threat to the auditor's independence, for example a self-review threat, safeguards would need to be applied to eliminate or reduce the threat.

b) Due to the self-review threat, Elise should avoid trying to provide Hertenstein with services that are then assured, such as internal audit services, financial information technology services, bookkeeping services, legal services, litigation support services, and corporate finance services and valuations. As Hertenstein is a public company, there are additional prohibitions. Prohibited services include actuarial services, human resources services, and tax calculations for the accounting entries.

c) Yes. Auditors can provide more non-audit services to a private company than to a listed public company. As mentioned in part b, there are additional prohibited services for firms auditing listed entities.


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Auditors of private companies may perform accounting, bookkeeping, and payroll services provided that these services are routine in nature. If a self-review threat presents itself as a result of performing these services, it must be reduced to an acceptable level. Possible safeguards to reduce such a threat are:

- Ensuring the audit client approves all account classifications
- Having the client sign off on all adjusting entries
- Ensuring the client understands and takes responsibility for the financial statements

**PROFESSIONAL APPLICATION 2.11 – Unpaid audit fees**

If fees are outstanding, the auditor could be perceived to have a conflict of interest because the auditor is more likely to be paid if the client survives and is happy with the auditor. In these cases, the auditor could be perceived as being more interested in the client's survival than an accurate audit report. Therefore, this gives rise to a self-interest threat.

The auditor should take steps to have the fees paid before the next audit. Other possible safeguards include advising the audit committee (if it exists) of the outstanding fees, or have another auditor review the engagement file. If the fees are significant and outstanding long enough that they may be considered similar to a loan, the firm should consider removing itself from the audit.

**PROFESSIONAL APPLICATION 2.12 – Independence threats and safeguards**

a) Personal relationships between a partner of the audit firm and the two directors poses a familiarity threat. This applies even if the partner is not part of the engagement team.

b) KFP should prepare and adopt a Quality Assurance Manual (QAM), which specifies the firm's policies with respect to independence. The QAM should include how the firm will identify independence threats for all assurance engagements. It should also list acceptable safeguards to reduce any identified threats to an acceptable level. The requirements of the Quality Assurance Manual should be explained to all firm members and compliance expected.

In this case, the relationship between the partner and the majority shareholders would be identified. The firm should not use the partner that is friends with Justin on the Featherbed engagement and should not accept the audit if that partner is required on the audit.

**PROFESSIONAL APPLICATION 2.13 – Independence threats and safeguards**

The following are threats to independence for KFP:

**ISSUE # 1**

a) The client's internal audit department is headed by an ex-partner of KFP.


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The rules of professional conduct generally place restrictions on audits where a former audit partner has a senior role within the client. The restrictions include a cooling-off period, which is usually a two- to five-year period between leaving the audit firm and the current audit. On this basis, there does not appear to be a contravention of the rules of professional conduct. In addition, the restriction sometimes applies to ex-auditors who become an officer of the company. In the case of Securimax, Rydell Creek does not appear to be an officer of the company (e.g., a director or senior manager) – he is the head of the internal audit department. This would certainly include the CFO or CEO, but it is unlikely to include the head of the internal audit department.

b) Safeguards:
- Ensure that Rydell Creek is not regarded as able to exert direct and significant influence over the subject matter of the external audit.
- Ensure that there was not a significant and personal relationship between Rydell Creek and the other members of the audit team based on their previous association as colleagues (to deal with the general familiarity threat).

An excerpt from the rules of professional conduct states that examples of circumstances that may create familiarity threats include, but are not limited to:
- A former partner of the firm being a director or officer of the client or an employee in a position to exert direct and significant influence over the subject matter of the engagement.

**ISSUE # 2**

a) Clarke Field has been the engagement partner for five years and will remain as review partner when Sally Woodrow is appointed as partner for the audit.

CPAB and many rules of professional conduct with respect to independence require rotation of senior audit personnel as follows stating that using the same:
- Lead engagement partner, or
- Audit review partner (if any), or
- Engagement quality control reviewer on an audit over a prolonged period may create a familiarity threat.

This threat is particularly relevant in the context of a financial statement audit of a listed public entity, and safeguards should be applied in such situations to reduce such a threat to an acceptable level. Accordingly in respect of the financial statement audit of listed public entities: (a) The lead engagement partner, the audit review partner (if any), and the engagement quality control reviewer should be rotated after serving in any of these capacities, or a combination thereof, for a pre-defined period, no longer than five financial years within a seven-year period; and, (b) Such an individual rotating after a pre-defined period should not participate in the audit engagement until a further period of time, no less than two years, since the end of the financial year following the end of the pre-defined period.

b) Safeguards:


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Clarke Field should not participate in the audit for two years.

**ISSUE # 3**

a) Sally Woodrow has been appointed to the position of partner and as partner in charge of the Securimax audit, but she may not be experienced enough to lead the audit. She is being promoted to partner to enable her to take over the audit. If she is not sufficiently experienced and qualified, there is a risk that the independence of the audit will be compromised.

b) Safeguards:
An independent (i.e., not previously involved with Securimax) senior audit partner should be appointed as review partner to assist Sally Woodrow.

**PROFESSIONAL APPLICATION 2.14 – Ethics of accepting engagements**

The fundamental principles of professional ethics include professional behaviour (upholding the reputation of the profession), integrity (being straightforward and honest) and due care (acting diligently and complying with technical and professional standards), professional competence (maintaining knowledge and skill at an appropriate level), confidentiality (not sharing information that is learned at work), and objectivity (not allowing personal feelings or prejudices to influence professional judgment).

The CEO of TLCL has asked the auditor to provide an opinion that the laser machines are fit for use without charging a fee as a gesture of goodwill, in the context of the future negotiations about the auditor appointment. There is an implicit invitation to provide a favourable opinion to ensure that the company audit is awarded to Fellowes and Associates.

If Tania provides the opinion without obtaining appropriate and sufficient evidence, she would be compromising both her integrity because the favourable opinion would not be honest, and her objectivity because her professional judgement would be influenced by the desire to gain the audit. There does not seem to be any threat to confidentiality, although her professional competence and behaviour on this particular engagement would be compromised because she would not be exercising her skill at an appropriate level (and she may not be qualified to provide the opinion on the lasers) and her actions could damage the profession's reputation.

Accepting an engagement without appropriate remuneration is also likely to create a conflict of interest. Fees should reflect the work involved and be set at a level that ensures adequate staff are assigned to the engagement and sufficient work is done to complete the engagement.

**PROFESSIONAL APPLICATION 2.15 – Independence issues in accepting engagements**

**Situation #1**


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One of the accountants intended to be part of the 2023 audit team owns shares in HCHG. The accountant's interest is not material to them.

a. Rules of professional conduct and independence guidelines state that a financial interest in a client may create a self-interest threat. A self-interest threat occurs when a firm or a member of the assurance team has a financial interest in an assurance client.

   Owning shares in an engagement client creates a direct financial interest. Independence rules generally require the auditor to consider the nature of the financial interest in order to determine the significance of the threat and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level. It is necessary to examine the nature of the financial interest. Matters to consider are whether the shareholding is direct or indirect, how material is the holding, and the role of the member of the assurance team holding the financial interest.

   Most independence rules also state that if a member of the assurance team, or their immediate family member, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be significant.

   Consider the following questions. What duties does the member of the assurance team perform? How senior is their role? How much judgement will they be required to exercise? If the person is very junior and/or the amount of the financial interest is very small, the threat is lower and fewer safeguards are required. However, if the person is more senior and/or the amount of the financial interest is greater, the safeguards would need to be more significant.

b. The only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:
   - Dispose of the direct financial interest prior to the individual becoming a member of the assurance team;
   - or
   - Remove the member of the assurance team from the assurance engagement.

**Situation #2**

a. Independence rules generally address the issues surrounding the provision of valuation services to an assurance client. The problem arises because in a financial statement audit the auditor is required to gather evidence about the client's valuation of the assets. If the auditor provided the valuation to the client, then the auditor has to audit their own work.

   A self-review threat may be created when an audit firm performs a valuation for an audit client that is to be incorporated into the client's financial statements. This is generally a problem if the valuation service involves the valuation of matters


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material to the financial statements and the valuation involves a significant degree of subjectivity.

The key questions are whether the item is material and whether there is a significant degree of subjectivity in the valuation service. The intangibles are stated to be material. Valuation of intangible assets is likely to be subjective, or at least more subjective than valuation of real property (land and buildings).

However, the question appears to state that the valuation services were provided prior to the audit engagement being accepted. If so, at this time, there was no conflict between Fellowes and Associates' duties as valuator and auditor. However, now, as auditor, Fellowes and Associates is required to provide an opinion on the valuation that it previously provided.

b. In this case, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard, and the valuation services should not be provided, or alternatively, the auditor should withdraw from the audit engagement.

Other safeguards that could apply to valuation situations include:

- Involving an additional professional accountant who was not a member of the assurance team to review the work;
- Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm, and
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

At a minimum, Fellowes and Associates should apply the safeguards with respect to the valuation of intangible assets. The valuation should be reviewed by an additional professional accountant, who is outside the audit team, they should obtain the client's acknowledgement of responsibility for the valuation, and they should not use the personnel involved in the valuation in the financial statement audit. However, it is likely that these safeguards would not be enough, given the high level of subjectivity in the valuation of intangible assets. Therefore, the client will either have to obtain another independent valuation or Fellowes and Associates should withdraw from the audit.

In the future, the audit firm should not perform valuations for audit clients that are likely to be the subject of a financial statement audit, unless they are immaterial and/or have a very low degree of subjectivity.

**PROFESSIONAL APPLICATION 2.16 – Independence considerations**

a) Solution


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| Ethical Threats | Managing these Threats |
|---|---|
| Orange Financials Co (Orange) has asked the engagement partner of Currant & Co to attend meetings with potential investors. This represents an advocacy threat as the audit firm may be perceived as promoting investment in Orange and this threatens objectivity. | The engagement partner should politely decline this request from Orange, as it represents too great a threat to independence. |
| Due to the stock exchange listing, Orange has requested that Currant & Co produce the financial statements. This represents a self-review threat. As Orange is currently not a listed company, Currant & Co is permitted to produce the financial statements and also audit them. However, Orange is seeking a listing and therefore these financial statements will be critical to the potential investors and this increases audit risk. | Ideally, Currant & Co should not undertake the preparation of the financial statements. Due to the imminent listing, this would probably represent too high a risk. If Currant & Co chooses to produce the financial statements, then separate teams should undertake each assignment and the audit team should not be part of the statement preparation process. |
| The assistant finance director of Orange has joined Currant & Co as a partner and has been proposed as the audit partner. This represents a self-review threat, as he was in a position to influence the financial statements while working at Orange. If he is the review partner, there could be a risk of him reviewing his own work. | This partner must not be involved in the audit of Orange for a defined period. An alternative review partner should be appointed. |
| Orange has several potential assignments available and Currant & Co wish to be appointed to these. There is a potential self-interest threat as these assurance fees along with the external audit fee could represent a significant proportion of Currant & Co's fee income. | The firm should assess whether these assignments along with the audit fee would represent a significant portion of Current and Co. fees to the extent it would impair independence. If the recurring fees are likely to result in an issue, then additional consideration should be given as to whether these assignments should be sought by the firm. |


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| Orange has implied to Currant & Co that they must complete the audit quickly and with minimal questions or issues if they wish to obtain the additional assignments. This creates an intimidation threat on the team as they may feel pressure to cut corners and not raise issues, and this could compromise the objectivity of the audit team. | The engagement partner should politely inform the finance director that the team will undertake the audit in accordance with all relevant CASs and their own quality control procedures. This means that the audit will take as long as is necessary to obtain sufficient, appropriate evidence to form an opinion. If any residual concerns remain or the intimidation threat continues, Currant & Co may need to consider resigning from the engagement. |
| The finance director has offered the team a free weekend away at a luxury hotel. This represents a self-interest threat as the acceptance of goods and services, unless insignificant in value, is not permitted. | As it is unlikely that a weekend at a luxury hotel for the whole team has an insignificant value, this offer should be politely declined. |
| The finance director has offered a senior team member a loan at a discounted interest rate. Orange does provide loans and hence the provision of a loan is within the normal course of business. However, if the loan is on preferential rates, as this is, it would represent a self-interest threat. | This loan must not be accepted by the senior member due to the preferential terms. However, if the terms of the loan are amended so that the interest rate charged is in line with Orange's normal levels, then the provision of the loan is acceptable. |

b) Appointing an audit committee will benefit Orange in the following ways:

- It will help to improve the quality of the financial reporting of Orange; although the company already has a finance director, the audit committee will assist by reviewing the financial statements.
- The finance director will benefit in that he will be able to raise concerns and discuss accounting issues with the audit committee.
- The audit committee will be responsible for appointing the external auditors and this will strengthen the auditor's independence and contribute to a channel of communication and forum for issues.
- If Orange has an internal audit (IA) department, then establishing an audit committee will also improve the independence of IA.
- The audit committee also pre-approves all non-audit services.


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**PROFESSIONAL APPLICATION 2.17 – Using the work of internal auditors**

The internal audit department focuses on the efficiency and effectiveness of production (i.e., operational or performance auditing) and compliance with government regulations (compliance auditing). The head of the internal audit department is a Chartered Professional Accountant and a member of the Institute of Internal Auditors and the other members of the department have performance auditing and compliance relevant experience and qualifications. The internal audit department is highly regarded within the business, reports to the board of directors as well as the CEO, and the reports appear to be acted upon. All these factors suggest that the internal audit department is well run and effective. However, they also suggest that it does not concentrate on issues directly relevant to financial reporting and auditing.

The external auditors are likely to review the internal audit department's work, particularly where it is relevant to operational indicators that are reflected in the accounts. They are likely to review the internal auditor's reports and their evaluations of internal control systems, particularly in production and inventory issues and general management issues. However, most of the internal audit department's findings on waste management regulations and efficiency matters will not be directly relevant to the external auditor's audit of accounting transactions and balances, unless a material financial implication is discovered, such as a potential liability.

**PROFESSIONAL APPLICATION 2.18 – Legal implications of client acceptance**

a) Steps to take to avoid the threat of litigation (in addition to the client continuation decision issues in part (b) below) include:
   - Hiring competent staff
   - Training staff and updating their knowledge regularly
   - Ensuring compliance with ethical regulations
   - Ensuring compliance with auditing regulations
   - Implementing policies and procedures that ensure:
     - Appropriate procedures are followed when accepting a new client (or client continuance)
     - Appropriate staff are allocated to clients
     - Ethical and independence issues are identified and dealt with on a timely basis
     - All work is fully documented
     - Adequate and appropriate evidence is gathered before forming an opinion
   - Meeting with Carolina's audit committee to discuss any significant issues identified as part of the audit
   - Following up on any significant weaknesses in the client's internal control procedures in a previous year's audit.

b) The client continuation decision is critical. Rebecca should evaluate and document the firm's ability to service this major client, Carolina Company Ltd., and any other major clients for the coming year. Canadian Standard on Quality Control (CSQC 1) "*Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other*


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*Assurance Engagements*" and CAS 220 "*Quality Control for an Audit of Financial Statements"* provide guidance on the procedures to be followed when making the client acceptance or continuance decision.

The key factors to be evaluated are client integrity and any threats to the auditor's compliance with the fundamental principles of professional ethics (professional behaviour, integrity and due care, professional competence, confidentiality, and objectivity). Although Carolina has been a client of the firm for several years, its integrity must still be re-evaluated. Rapid growth can create pressures within the client that could compromise its integrity. This is particularly so in the case of Carolina because there is already evidence of difficulties in its financial systems.

A major problem confronting the audit firm is its ability to comply with the fundamental principles of professional ethics.

Rebecca should also be concerned about the firm's ability to use professional competence and due care in audits for rapidly growing clients at a time when the audit firm is growing rapidly and the client is undergoing major changes to its reporting requirements. Does the audit firm have the expertise to audit listed clients? What sort of auditing difficulties are likely to be created by the stretched financial systems at Carolina?

The client continuation decision must be properly documented, and the engagement letter drafted to reflect the responsibilities of both parties

**PROFESSIONAL APPLICATION 2.19 – Auditor legal liability**

a) Since there is no contract with Xing Investments Inc., it is questionable if the auditor owes this third-party user a duty of care, especially since Ahmad & Partners were not aware that Xing was a user of the financial statements. However, Ahmad & Partners did have a contract with Canada Bank, and therefore they did owe the bank a duty of care.

b) Defences that Ahmad & Partners could use are:

- They did not owe Xing a duty of care as they were not a foreseen user.
- They conducted their audit in accordance with Canadian Auditing Standards (CASs), and therefore there was no negligence on their part.
- They could question whether Xing actually relied on the statements before investing in Chan Corporation.

**PROFESSIONAL APPLICATION 2.20 – Auditor legal liability**

The elements of negligence would apply to this case as follows:

1. There must be a duty of care owed to the party suing the auditor. In this case, HHH Corporation hired the auditors, and therefore the auditors owe a duty of care to the shareholders.


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2. There must be a breach of the duty of care (failure to follow CASs that would lead to a negligent audit). In this case, the shareholders would have to show that the auditors were negligent in their audit.

3. There must be proof that the party suffered a loss or damage. In this case, the new shareholders of HHH Corporation would have based their purchase of the shares on financial statements that misstated the company's operating results. It is not clear how that misstatement impacted the share purchase price.

**PROFESSIONAL APPLICATION 2.21 – Ethical issues and consequences**

a) Roy cannot audit the financial statements for his former company, as this gives rise to a self-review threat. A self-review threat occurs when any product or judgement from a previous assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement; or when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct and significant influence over the subject matter of an assurance engagement. In this case, the prior-year balances and the resulting financial statements were under Roy's complete influence.
   - Roy cannot audit the financial statements for his neighbour's company as this gives rise to a familiarity threat. A familiarity threat results when a member, firm, or member of the assurance team becomes too sympathetic to the client's interests, by virtue of a close relationship with an assurance client, its directors, officers, or employees. Arranging for other staff to perform the engagement does not mitigate this risk, particularly as Roy is a partner and therefore can override and influence the work of other members in the firm.
   - Roy cannot promise or suggest an unmodified opinion before he obtains and reviews sufficient appropriate evidence to support the opinion.
   - Roy cannot accept an audit fee of zero or of a percentage of the client's net income.

b) The audit firm is not negligent in issuing the audit report if the audit evidence shows that the opinion issued is supported. Roy had sufficient appropriate audit evidence that the bank loan was in default, therefore if this supported a going- concern comment in the report, the audit firm would not be negligent.

**PROFESSIONAL APPLICATION 2.22 – Client acceptance**

a) CAS 210 *Agreeing the Terms of Audit Engagements* provides guidance to Salt & Pepper on the steps they should take in accepting the new audit client, Cinnamon. It sets out a number of processes that the auditor should perform prior to accepting a new engagement, in addition to considering whether preconditions for the audit are in place.

   First, Salt & Pepper should assess the integrity of the client. Salt & Pepper should consider what they already know about the directors of Cinnamon; they


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need to consider the reputation and integrity of the directors. If necessary, the firm may want to obtain references if they do not formally know the directors. Salt & Pepper should communicate with the outgoing auditor of Cinnamon to assess if there are any ethical or professional reasons why they should not accept the appointment. They should obtain permission from Cinnamon's management to contact the existing auditor; if this is not given, then the engagement should be refused. If given permission to respond, the auditors should reply to Salt & Pepper, who should carefully review the response for any issues that could affect acceptance.

Salt & Pepper should consider whether they are competent to perform the work and whether they would have appropriate resources available, as well as any specialist skills or knowledge required for the audit.

They should also assess independence to ensure no significant threats exist. If threats exist, then the firm should ensure suitable safeguards are in place, or else they should refuse to accept the client.

b) Matters to be included in an audit engagement letter include:

- The objective and scope of the audit
- The responsibilities of the auditor
- The responsibilities of management
- Identification of the financial reporting framework for the preparation of the financial statements
- Expected form and content of any reports to be issued

c)

| **Issue** | **Recommendation** |
|---|---|
| Salt & Pepper has guaranteed that their audit will not last longer than two weeks and their fee is based on this promised time frame.<br>Complex audits would be extremely difficult to complete within two weeks as the team would be unlikely to be able to gather sufficient and appropriate audit evidence in this time, leading to the possibility of an incorrect opinion. | Salt & Pepper should cease this advertising campaign immediately.<br>For any potential clients who have approached Salt & Pepper as a result of this advertising, the firm should inform them that the audit duration will be based on the level of audit work required and this could be considerably longer than two weeks. |


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| Salt & Pepper has offered all new audit clients free bookkeeping for the first year of the engagement.<br><br>Additionally, if this service is offered for free, then in order to make a profit on the total engagement, Salt & Pepper could be inclined to substantially reduce the procedures undertaken on the audit engagement. | Salt & Pepper is prohibited from performing the bookkeeping because of the self-review threat. It must not do such work. |
| The firm is not updating engagement letters for existing clients on the basis that they do not change much on a yearly basis. | Engagement letters should be updated every year to ensure the client understands the terms of the engagement. |
| An existing client of Salt & Pepper has proposed an audit fee based on a percentage of the client's final pre-tax profit. This is a contingent fee arrangement and is prohibited. | Salt & Pepper should politely decline the proposed contingent fee arrangement as it would be a breach of the professional code of conduct.<br><br>They should inform the client that the fees will be based on the level of work required to obtain sufficient and appropriate audit evidence. |
| Salt & Pepper intends to use junior staff for the audit of their new client Cinnamon as the timing of the audit is when the firm is very busy. To ensure professional competence and due care, Salt & Pepper should have not only adequate staff but staff with the knowledge and competence to conduct the audit. | Salt & Pepper should review the staffing of Cinnamon and make changes to increase the amount of experienced team members. If this is not possible, they should discuss with the directors of Cinnamon to see whether the timing of the audit could be moved to a point where the firm has adequate staff resources. |


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| Salt & Pepper has not contacted Cinnamon's previous auditors Contacting the previous auditors is important as the firm needs to understand why Cinnamon has changed their auditors. Cinnamon may have been acting unethically and their previous auditors therefore refused to continue. In addition, it is a professional courtesy to contact the previous auditor | Salt & Pepper should contact the previous auditors to identify if there are any ethical issues that would prevent them from acting as auditors of Cinnamon. |

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**Case Study 2.1 — Cloud 9**

a)

- The relationship between David Collier and P.S. Nethercott is described as distant. Rules of professional conduct and independence rules discuss familiarity threats that can occur because of a close relationship, such as a member of the assurance team having an immediate family member or close family member who is a director or officer of the assurance client, or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement. In this case, P.S. Nethercott is not on the assurance team (and is not likely to be), and although the relationship is with a person in a position to be involved in the subject matter of the audit, the relationship is distant. There would be no threat to independence.

- The potential consulting fees are twice the size of the audit fee, creating a significant business relationship between the audit firm and the client, and potentially an undue dependence on the fees from this client (relative to total fees from all clients). According to rules of professional conduct and independence rules, a self-interest threat to the auditor's independence could arise from this relationship. In general, firms would limit the size of non-assurance service fees relative to the size of assurance fees for any one client, through either limiting the amount of non-assurance services provided or refusing to perform both for the same client. In addition, it is possible that a self-review threat could arise if the IT installation was relevant to the financial data that would be the subject matter of the audit in future periods. The non-assurance service (IT installation) in itself should also give rise to consideration of the threats to independence. In general, the self-review threat is likely to be too significant to allow both services to be provided by the same firm, except if the audit client clearly takes all management decisions with respect to the installation of the IT project, and non-assurance and assurance staff at the audit firm are kept separate.

- Purchases of products in the normal course of business and on an arm's-length basis, such as shoes from stores, is acceptable and is not an independence threat.

- The members of the IT department at the audit firm who own shares in the retailers could be involved in the audit. As such, their financial interests need to be considered. In this case, the shareholdings are in retailers that sell the audit client's products, and the shareholdings are material and have been disclosed to the audit firm. The shareholdings are not in the audit client, and the relationship does not allow the members of the IT department to influence management decisions at either the retailers or the audit client. There is no independence threat to the audit of Cloud 9.

- The last point does not relate to independence issues. In this case, the newspaper article suggests that the management of Cloud 9 Inc., the parent


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firm of the audit client, is engaged in illegal and/or unethical behaviour. The auditor is required to consider client integrity in the client acceptance decision (CSQC1 and CAS 220 *Quality Control for an Audit of Financial Statements*). In addition, the auditor is required to consider any threats to the fundamental principles. Such a threat could occur if the prospective client is dishonest or involved in illegal activities. The management of Cloud 9 Inc. have denied the allegations and invited international human rights groups to visit their factories. Cloud 9 Inc. is not the prospective client of W&S Partners, so it could be argued that the auditors are not concerned with this issue. However, a lack of integrity at the parent company could indicate a lack of integrity at the subsidiary level, and/or create other issues for the auditors related to dealings between the companies. The auditors could raise the issue with Cloud 9 Ltd. management, and if still concerned, also visit the factories.

b) Other issues to be considered in making the client acceptance decision include:
- Other issues relating to client integrity, such as reasons for the audit switch, client attitudes to risk, internal controls, accounting standards, full access to information, and payment of audit fee.
- Obtaining permission from the client to communicate with the previous auditor, third parties such as bankers and lawyers, and client personnel
- Reviewing press articles and other company disclosures
- Any potential threats to other fundamental principles, such as professional competence and due care through lack of auditor expertise in the client industry or insufficient audit staff

c) Prepare the client engagement letter as per example in figure 2.6.


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**Research Question 2.1**

a) Arguments for and against allowing former audit firm partners and/or employees to join audit committees are:

Advantages:

- Expertise of former auditors being available to the client should lead to an improvement in their financial statements, which benefits the client, its stakeholders, and the general public (through a general increase in reporting quality)
- Ex-auditors understand the problems facing the auditors and can help their new colleagues at the client respond appropriately to the auditor's requests

Disadvantages:

- Loss of auditor independence arising from close personal relationships between these former auditors and their former colleagues in the audit firm
- Audit committee might lose its independence when selecting audit firms (preference for their old firm) and in dealing with disputes

(b) Former audit partners might be recruited by the client in order to help the audit process by:

- Improving their systems and financial statements based on the ex-auditor's intimate knowledge of good control systems and financial reporting

However, they could also be recruited and then hinder the audit process by:

- Encouraging the audit firm to be "soft" on their friends
- Using the expertise of the former auditors to "get around" the system, that is, they know what the auditors will be looking for in terms of "red flags" and thus be better able to hide the problems,
- Sharing their knowledge of audit sampling methods in order to hide errors in items that are not likely to be sampled.


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