Auditing - A Practical Approach (Canadian) 4th Edition 4th edition Moroney Test Bank

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CHAPTER 2

ETHICS, LEGAL LIABILITY, AND CLIENT ACCEPTANCE

CHAPTER LEARNING OBJECTIVES

1. Describe the fundamental principles of professional ethics.
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 both 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 judgement). There are also specific rules that incorporate the guiding ethical principles and that are enforceable. Some of these rules concern fees and pricing, advertising, contact with predecessor auditors, firm names, and professional contact. Despite principles and rules to guide professional conduct, professional accountants can expect to face ethical dilemmas over their careers. A framework for solving ethical dilemmas includes identifying the ethical issues, determining who is affected by the outcome of the dilemma and how each individual or group is affected, identifying the likely alternatives available to the person who must resolve the dilemma, and deciding on the appropriate action.

2. Describe professional judgement and professional skepticism.
Professional judgement relates to the level of expertise, knowledge, and training that an auditor uses throughout an audit. A framework for professional judgement decision-making includes identifying the problem, gathering the facts, performing the analysis, making a decision, and documenting the decision-making process. Professional skepticism is a component of professional judgement. Professional skepticism means having a questioning mind, being alert to conditions that indicate a misstatement whether due to fraud or error, and critically assessing evidence. While there are qualities associated with professional skepticism, external factors and unconscious biases can impede it. Common biases that can impede auditor professional skepticism are the availability bias, confirmation bias, overconfidence bias, and the anchoring bias.

3. Define and assess auditor independence.
Independence is the ability to make a decision that is free from bias, personal beliefs, and client pressures. An external auditor must not only be independent of their client, they must also appear to be independent of their client. Threats to auditor independence include self-interest, self-review, advocacy, familiarity, and intimidation threats. A self-interest threat can occur when an auditor has a financial interest in a client. A self-review threat can occur when an auditor must form an opinion on their own work or work done by others in their firm. An advocacy threat can occur when an auditor acts on behalf of their client. A familiarity threat can occur when there is a close relationship between the auditor and their client. An intimidation threat can occur when an auditor feels threatened by their client. Safeguards to auditor independence include the code of ethics, legislation, the establishment of audit committees by clients, client acceptance and continuance procedures, partner rotation policies, and education within accounting firms.

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4. Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.

Auditors report to their clients' shareholders. These are the owners who rely on the audited financial statements when evaluating the performance of their company. The board of directors represents the shareholders and oversees the activities of the company and its management. It is the directors' responsibility to ensure that the financial statements being audited are fairly presented. The audit committee is responsible for liaising between the external auditor, the internal auditor, and those charged with governance to aid the board of directors in ensuring that the financial statements are fairly presented and that the external auditor has access to all records and other evidence required to form their opinion. The external auditor may use the work performed by the internal auditors after considering the function's objectivity, technical competence, and due professional care, and the effectiveness of communication between internal and external auditors.

5. Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.

Contributory negligence is where a client is found to be negligent and to have contributed to the loss suffered by the plaintiff. To successfully sue an auditor, a plaintiff must prove that a duty of care was owed by the auditor, there was a breach of that duty, and a loss was suffered as a result of that breach. Several cases are discussed in the chapter in relation to an auditor's liability to third parties. To establish that an auditor owes them a duty of care, a third party must now establish that the auditor was aware that the third party was going to use the financial statements and that the users relied on the financial statements for the purpose for which they were prepared.

6. Identify the factors to consider in the client acceptance or continuance decision.

Factors to consider include the integrity of a client, such as the client's reputation and attitude to risk, accounting policies, and internal controls. An auditor will gain an understanding of the client through communication with the client's previous auditor (in the case of a client acceptance decision), staff, management, and other relevant parties. The final stage in the client acceptance or continuance decision process involves preparing an engagement letter, which sets out the terms of the audit engagement to avoid any misunderstandings between the auditor and their client.

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TRUE-FALSE STATEMENTS

1. Compliance with the fundamental ethical principles is mandatory for all members of the accounting profession.

Answer: True

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Analytic

2. Objectivity refers to the obligation that all members of the professional bodies be Straightforward and honest.

Answer: False

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Analytic

3. The auditor uses professional skepticism during the decision-making process as an element of professional judgement.

Answer: True

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe professional judgement and professional skepticism.
Section Reference: 2.2 Professional judgement and professional skepticism
CPA Competency: Audit and Assurance
AACSB: Analytic

4. Trusting in management's ability to make appropriate estimates is a strategy to avoid bias.

Answer: False

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe professional judgement and professional skepticism.

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Section Reference: 2.2 Professional judgement and professional skepticism
CPA Competency: Audit and Assurance
AACSB: Analytic

5. Independence in appearance is the ability to act with integrity, objectivity and professional scepticism.

Answer: False

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

6. An example of an advocacy threat is encouraging others to buy shares or bonds being sold by the client.

Answer: True

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

7. An effective audit committee will enhance the independence of the external audit function.

Answer: True

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

8. When auditors divest themselves of shares owned in a client company, they are eliminating their self-review threat to independence.

Answer: False

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.

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Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

9. The key difficulty for third parties in successfully claiming against the auditor is establishing that the client's management contributed to the third party's loss.

Answer: False

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor’s legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

10. Ensuring compliance with auditing regulations will **not** assist auditors in avoiding litigation.

Answer: False

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor’s legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

11. Third parties are anyone other than the client and its shareholders that use the financial statements to make a decision.

Answer: True

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor’s legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

12. Being negligent means **not** exercising due care.

Answer: True

Bloomcode: Comprehension

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Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

13. Auditors can help avoid litigation by implementing policies and procedures that ensure all work is fully documented.

Answer: True

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

14. When assessing client integrity, the auditor will consider the appropriateness of the client's interpretation of accounting rules.

Answer: True

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

15. An engagement letter sets out the terms of the engagement.

Answer: True

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

16. An engagement letter does **not** include an overview of the client's responsibility for the

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preparation of the financial statements.

Answer: False

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

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MULTIPLE CHOICE QUESTIONS

17. Jim Spence wrote up an advertisement for his firm. In his draft to the local newspaper, he indicated that the firm was able to provide services that he knew it could not deliver. Which part of the profession's standards or codes of conduct was Jim breaking?

a) objectivity
b) professional behaviour
c) confidentiality
d) communication

Answer: b

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Ethics

18. Members must attain a level of competence and keep up to date with changes in regulations. To which fundamental principle of the Code of Ethics for Professional Accountants does this refer?

a) objectivity
b) professional competence and due care
c) professional behaviour
d) integrity

Answer: b

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Analytic

19. All members of professional bodies must be straightforward and honest. To which fundamental principle of the Code of Ethics for Professional Accountants does this refer?

a) confidentiality
b) objectivity
c) integrity
d) professional behaviour

Answer: c

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Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Analytic

20. The obligation is that all members of the professional bodies are **not** allowed to let their personal feelings influence their judgment. To which fundamental principle of the Code of Ethics for Professional Accountants does this refer?

a) confidentiality
b) objectivity
c) integrity
d) professional behaviour

Answer: b

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Analytic

21. Which of the following is not one of the fundamental principles of the Code of Ethics for Professional Accountants?

a) confidentiality
b) objectivity
c) integrity
d) intelligence

Answer: d

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Analytic

22. Which of the following is a fundamental principle of professional ethics?

a) confidentiality
b) objectivity
c) integrity

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d) all of the answers are correct

Answer: d

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Ethics

23. Professional behaviour refers to the obligation that all members of the professional bodies

a) ensure that they do not harm the reputation of the accounting profession.
b) not allow their personal feelings or prejudices to influence their professional judgment.
c) refrain from disclosing information to people outside of their workplace that is learned as a result of their employment.
d) be straightforward and honest.

Answer: a

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Ethics

24. Objectivity refers to the obligation that all members of the professional bodies

a) be straightforward and honest.
b) refrain from disclosing information to people outside of their workplace that is learned as a result of their employment.
c) not allow their personal feelings or prejudices to influence their professional judgment.
d) ensure that they do not harm the reputation of the accounting profession.

Answer: c

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional.
Section Reference: 2.1 The fundamental principles of professional ethic
CPA Competency: Audit and Assurance
AACSB: Ethics

25. Which of the following is not a common form of bias that may affect an auditor?

a) objectivity bias

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b) confirmation bias
c) availability bias
d) overconfidence bias

Answer: a

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe professional judgement and professional skepticism.
Section Reference: 2.2 Professional judgement and professional skepticism
CPA Competency: Audit and Assurance
AACSB: Analytic

26. Qualities associated with professional skepticism include all of the following except

a) withholding judgement until appropriate evidence is gathered
b) trust in management's ability to make appropriate estimates
c) tendency to inquire
d) self-confidence to challenge assumptions

Answer: b

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe professional judgement and professional skepticism.
Section Reference: 2.2 Professional judgement and professional skepticism
CPA Competency: Audit and Assurance
AACSB: Analytic

27. Which of the following are considered qualities associated with professional skepticism?

a) withholding judgement until appropriate evidence is gathered
b) self-confidence to challenge assumptions
c) tendency to inquire
d) All of the answers are correct

Answer: d

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe professional judgement and professional skepticism.
Section Reference: 2.2 Professional judgement and professional skepticism
CPA Competency: Audit and Assurance
AACSB: Analytic

28. Faith Goodfellow has been an audit manager at Happy & Gumble LLP, CPA's the past ten years. Two years ago, she performed human resources and internal audit functions for 9 months while her client underwent a major restructuring. Her firm has a policy of changing audit

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partners and managers every five to seven years. She is reluctant to take on the audit because she believes there is an independence threat. Which threat is in play?

a) integrity threat
b) familiarity threat
c) self-review threat
d) advocacy threat

Answer: c

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Ethics

29. Jane Lee just joined the firm of Jansen & Dennison LLP (JD). She found out that she owns shares in a client company of JD. She is going to divest herself of these shares. Which threat to her independence will she be eliminating?

a) self-interest threat
b) self-review threat
c) familiarity threat
d) advocacy threat

Answer: a

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Ethics

30. Moanna Johnson, CPA lives in the same neighbourhood as one of her major clients. She and her children are involved in the Lower Thames Yacht Club, as are many of her client's management employees. How would her independence threat best be described?

a) self-interest threat
b) self-review threat
c) advocacy threat
d) none of these

Answer: d

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Define and assess auditor independence.

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Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

31. Krista Kirschfield audits a company that has market capitalization of $20,000,000. There is also a requirement that the partners in her firm be rotated every seven years and the audit committee must pre-approve all services provided to the client by Krista's firm. What kind of client is this?

a) small business
b) diversified
c) reporting issuer
d) partnership

Answer: c

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

32. When Jeffrey Bona, CPA tried to collect last year's audit fees, he was told that he would receive the fees for the previous year and the current year upon finishing this year's work and issuing a "clean" audit opinion. This was non-negotiable and he was told that if he did not want to go along with it, the client would get another auditor. When he decided to leave his client, what threat to his independence did he mitigate?

a) self-interest threat
b) self-review threat
c) advocacy threat
d) intimidation threat

Answer: d

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

33. The firm of McMaster and Martin, CPAs is concerned that its client's current corporate culture may have an impact on the firm's independence. What kinds of safeguards can the client introduce or create to reduce the threat to independence?

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a) introduce appropriate corporate governance mechanisms such as the establishment of an audit committee
b) ensure that the responsibility for the appointment and removal of an auditor rests with independent directors on the audit committee or the board
c) both a and b
d) none of the above

Answer: c

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

34. Auditor independence is

a) defined as acting with integrity, objectivity and professional scepticism.
b) essential when complying with the ethical principles to act with integrity and objectivity.
c) both a and b
d) not fundamental to every audit.

Answer: c

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

35. Independence in appearance is

a) the ability to act with integrity, objectivity and professional scepticism.
b) the belief that independence of mind has been achieved.
c) the ability to make a decision that is free from bias, personal beliefs and client pressures.
d) also referred to as actual independence.

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

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36. Threats to the independence of auditors include

a) familiarity threats.
b) self-interest threats.
c) advocacy threats.
d) all of the answers are correct

Answer: d

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

37. A self-interest threat refers to the threat that can occur when an accounting firm or its staff

a) is threatened by the client's staff or directors.
b) has a financial interest in an audit client.
c) needs to form an opinion on their own work or work performed by others in the firm.
d) acts on behalf of its assurance client.

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

38. Which of the following is an example of a familiarity threat to independence?

a) a bank account held with the client
b) performing services for the client that are then assured
c) owning shares of the client
d) a former partner of the assurance firm holding a senior position with the client

Answer: d

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
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39. What type of threat to independence arises when an accounting firm acts on behalf of its assurance client?

a) advocacy threat
b) self-interest threat
c) intimidation threat
d) self-review threat

Answer: a

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

40. Intimidation threats to independence include

a) the threat that that the client will use a different assurance firm next year.
b) a close business relationship with the client.
c) representing the client in a legal dispute.
d) preparing information for the client that is then assured.

Answer: a

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

41. Safeguards to independence are created by

a) the general public.
b) the profession, legislation or regulation.
c) lawyers.
d) dependent directors.

Answer: b

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
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42. An example of a safeguard to independence created by accounting firms is

a) the establishment of a code of ethics.
b) legislation that requires that an auditor be independent.
c) the existence of client acceptance and continuation procedures.
d) the establishment of an audit committee.

Answer: c

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

43. Having policies and procedures to ensure the quality of an assurance engagement is an example of a safeguard to independence created by

a) the client's audit committee.
b) the *Canada Business Corporations Act*.
c) the client's board of directors.
d) the accounting firm.

Answer: d

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

44. When the external auditors perform work they are responsible for auditing the financial statements. Which users are the auditors least likely to deal with in fulfilling their duties?

a) executive directors of the board
b) audit committee of the board
c) shareholders
d) internal auditors

Answer: c

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor’s relationships with others

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CPA Competency: Audit and Assurance
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45. What key groups have a professional link with the external auditor?

a) client's board of directors, audit committee, and prospective shareholders
b) client's shareholders, the board of directors, audit committee and the internal audit team
c) client's shareholders and prospective shareholders and board of directors
d) client's shareholders only

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

46. The audit committee should

a) consist of only non-executive directors of the Board of Directors.
b) consist of major shareholders of the client company.
c) report to the shareholders at the annual general meeting.
d) consist of both executive and non-executive directors of the Board of Directors.

Answer: a

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

47. The audit committee

a) communicates with the auditor regarding any disagreements with management regarding accounting policies and the financial statements.
b) has the responsibility to ensure that the financial statements are presented fairly.
c) makes decisions regarding the appointment and/or removal of auditors.
d) reports directly to the shareholders.

Answer: b

Bloomcode: Comprehension

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Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

48. The relationship between the external and internal auditor can be described as

a) the internal audit function is separate and independent of the external audit.
b) the external auditor can review the effectiveness of the internal audit function to modify the nature and timing of audit testing.
c) the external auditor relies solely on the internal auditor's reports.
d) non-existent. Under no circumstances can the external auditor rely on any work of the internal audit function.

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

49. The main recipients of the financial statements and the attached audit report are acknowledged as

a) the board of directors.
b) the shareholders or members.
c) the audit committee.
d) the provincial stock exchanges.

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

50. Examples of board committees include the

a) risk committee.
b) nomination committee.

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c) compensation committee.
d) all of the answers are correct

Answer: d

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

51. It is the responsibility of the board of directors to

a) ensure that the financial statements are fairly presented.
b) provide an opinion on the fair presentation of the financial statements.
c) direct the auditors to audit specific financial statement accounts.
d) determine if shareholders should sell their investment in the company.

Answer: a

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

52. Executive directors are

a) part of the company's management team.
b) full-time employees of the company.
c) not members of the company's board of directors.
d) both a and b

Answer: d

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor's relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

53. Yollande Beauchemin withdrew from a client engagement. The client sued her for not

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fulfilling the understanding in the engagement letter and can establish that Yollande owed him a duty of due care. How can this be done using legal means?

a) the client can sue the auditor for breach of contract
b) the client can claim that the auditor failed to take reasonable care in the performance of the audit
c) both a and b
d) none of the above

Answer: a

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

54. The Kingston Cotton Mill case states that the duty of the auditor is to

a) assume that the clients' statements are not materially misstated.
b) approach the audit with professional scepticism.
c) approach the audit with suspicion.
d) always issue a clean opinion on the client's financial statements.

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

55. The Pacific Acceptance case set the standards of reasonable care and skill required for the conduct of an audit. Which one of the following was **not** one of the recommendations?

a) closely supervise and review the work of junior staff
b) properly document procedures used
c) duty to use reasonable care and skill
d) promptly report material fraud

Answer: d

Bloomcode: Comprehension
Difficulty: Easy

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Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

56. Contributory negligence means

a) the actions of the client as well as the actions of the auditor lead to losses suffered.
b) actions by the client and shareholders led to losses suffered.
c) actions of the client lead to the losses suffered.
d) actions of the auditor lead to losses suffered.

Answer: a

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

57. Which of the following statements regarding the auditor's responsibility to third parties is **correct**?

a) The auditor has no legal responsibility to third parties.
b) Third parties can sue the auditor under contract for any losses suffered.
c) Third parties can sue the auditor if they were owed a duty of care, suffered a loss, and the auditor was negligent in the conduct of the audit.
d) Third parties can sue, whether or not they suffered a loss, as long as they establish that the auditor owed them a duty of care and the auditor was negligent.

Answer: c

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

58. An auditor can decrease the possibility of litigation by

a) preparing engagement letters.
b) complying with ethical principles and pronouncements.
c) ensuring all audit staff have the required skills and competence to conduct the audit.

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d) all of the answers are correct

Answer: d

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

59. Management failed to put in a system of adequate internal controls. The public accounting firm uncovered the weakness, but did not report it to the Board members of the company. What kind of liability, if any, would the auditors be exposed to?

a) breach of contract
b) contributory negligence
c) both a and b
d) no liability

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

60. The principles established by Justice Moffitt in the *Pacific Acceptance* case do **not** include

a) auditors are watchdogs but not bloodhounds.
b) auditors must properly document procedures used.
c) auditors have a duty to use reasonable skills and care.
d) auditors must audit the whole year.

Answer: a

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
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61. Under tort law, to prove that an auditor has been negligent the plaintiff must establish

a) there was a breach of the duty of care.
b) a loss was suffered as a result of the breach of duty of care.
c) a duty of care was owed by the auditor.
d) all of the answers are correct

Answer: d

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

62. Auditors can decrease the possibility of litigation by

a) ensuring compliance with ethical regulations.
b) meeting with the client's nomination committee to discuss any significant audit issues.
c) training their staff and regularly updating their knowledge.
d) both a and c

Answer: d

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

63. James Taggert has reviewed the engagement letter his firm has prepared for a client. Which of these elements would he be surprised to find?

a) unrestricted access to persons within the entity in order to obtain audit evidence
b) references to Canadian generally accepted auditing standards
c) management's responsibilities
d) previous year's internal control issues

Answer: d

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions

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CPA Competency: Audit and Assurance
AACSB: Analytic

64. Which of the following statements is **not** true regarding engagement letters?

a) Engagement letters are prepared by the client and acknowledged by the auditor before commencement of each audit.
b) Engagement letters are a form of contract between the auditor and the client.
c) Engagement letters are prepared before commencing every audit engagement.
d) Engagement letters set out the terms of the audit engagement.

Answer: a

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

65. If a prospective new audit client does **not** allow the auditor to contact its existing auditor,

a) the auditor should contact the existing auditor anyway because it is the duty.
b) the auditor should refuse to take on the prospective new client.
c) the existing auditor should contact the new auditor to tell them all about the client.
d) the auditor should respect the prospective client’s right to privacy.

Answer: b

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

66. An auditor's assessment of their client's integrity would **not** include

a) whether the auditor has sufficiently competent staff to complete the audit.
b) the client's attitude to audit fees and its willingness to pay a fair amount.
c) the client's attitude to risk exposure and management.
d) the reputation of the client and its management.

Answer: a

Bloomcode: Comprehension

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Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

67. The final stage in the client acceptance and continuance decision process involves

a) the auditor obtaining a management representation letter from the client.
b) the auditor preparing an independence declaration statement.
c) the client's audit committee meeting with the auditor.
d) the preparation of an engagement letter.

Answer: d

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

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SHORT ANSWER QUESTIONS

68. Explain the five fundamental principles of professional ethics.

Answer: The fundamental ethical principles that apply to all members of the professional bodies are to act with integrity, objectivity, professional competence and due care, confidentiality and professional behaviour. Integrity refers to the obligation that all members of the professional bodies be straightforward and honest. Objectivity refers to the obligation that all members of the professional bodies not allow their personal feelings or prejudices to influence their professional judgment. Professional competence and due care refers to the obligation that all members of the professional bodies maintain their knowledge and skill at a level required by the professional bodies. Confidentiality refers to the obligation that all members of the professional bodies refrain from disclosing information to people outside of their workplace that is learned as a result of their employment. Professional behaviour refers to the obligation that all members of the professional bodies comply with rules and regulations and ensure that they do not harm the reputation of the profession.

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethics
CPA Competency: Audit and Assurance
AACSB: Analytic

69. For the following scenarios, state the violation(s) to the Rules of Professional Conduct:

a) Chance Randall, CPA, began a telephone campaign to grow his client base. He began calling companies listed in the telephone directly within a twenty mile radius advising them of his accounting services. After making several phone calls, Chase finally landed a new audit client, Big Bob's Auto Sales and Leasing Ltd. In order to secure this new business, Chase entered into an agreement with Big Bob whereby Chase would receive a flat fee every time he referred one of his clients to Big Bob's. He would also earn a 1% percent commission on any vehicle sale or lease that resulted from the referral. As their business relationship grew overtime, Chase asked Big Bob for a loan claiming he wanted to expand his accounting practice. He in fact took the funds for his own personal use without advising his client.

b) Anand Lee, CPA, was the CFO of ABC Incorporated. In his role as CFO, he became aware of a material error in the company's inventory for the annual financial statements in the amount of approximately $1.5 million. Anand brought the matters to the attention of senior management, who casually indicated that year end was already completed and thus they did not want to harm investor confidence by reissuing the financial statements, but Anand did not seek assistance or guidance from either the professional body or the securities commission.

c) Sahajpreet Singh, CPA, obtained his designation in 2000. Since that time, he has built up a significant tax practice. In late 2015, a new client approached Sahajpreet and asked him to perform an audit engagement. Believing this could lead to a substantial amount of tax work

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in the future, Sahajpreet agreed, even though he had not taken any accounting or assurance courses for many years. In performing the audit engagement, Sahajpreet obtained an engagement letter, put the financial statements together based on the clients trial balance, and attached a review engagement report. The financial statements contained a material error.

Answer:
a)

- By cold calling and implementing a telephone campaign to get new business, Chase violated the rule of no solicitation.
- Chase accepted a referral fee in the form of the flat fee for referring his clients to the car dealership. Referral fees are not permitted.
- Chase accepted a commission in terms of a 1% on auto sales and leases, which is not permitted.
- There is an impairment of independence in that Chase accepted a loan from a client and continued to be the client's auditor.
- Chase failed to maintain the good reputation of the profession when he accepted the loan to use for his personal use.

b)

- Anand Lee failed to conduct himself in a manner which would maintain the good reputation of the profession and its ability to serve the public interest in that he allowed users to rely on financial statements that were materially misstated.
- Anand Lee was associated with false and misleading information in that he knew the financial statements were materially misstated but did not do anything to correct them.

c)

- Sahajpreet failed to maintain his professional competence by keeping himself informed of, and complying with, developments in professional standards in all functions in which he practiced.
- Sahajpreet associated himself with financial statements that were false and misleading, and he would have known this had the work been performed in accordance with the standards for review engagements. The procedures required for a review engagement were not performed.
- There was no documentation of analytics, discussion and enquiry to establish plausibility.

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Describe the fundamental principles of professional ethics.
Section Reference: 2.1 The fundamental principles of professional ethics
CPA Competency: Audit and Assurance
AACSB: Analytic

70. Distinguish between independence of mind and independence in appearance.

Answer: Independence is essential when complying with the ethical principles to act with integrity and objectivity. Independence of mind is the ability to act with integrity, objectivity and professional scepticism. It is the ability to make a decision that is free from bias, personal beliefs and client pressures. Independence of mind is also referred to as actual independence.

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Independence in appearance is the belief that independence of mind has been achieved. It is not enough for an auditor to be independent of mind; they must also be seen to be independent.

Bloomcode: Knowledge
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

71. Describe the three categories of safeguards to an auditor's independence.

Answer: Safeguards are mechanisms that have been developed by the accounting profession, legislators, regulators, clients and accounting firms. The accounting profession, legislation and regulation have created a range of safeguards including education of accountants about the threats to independence, the establishment of a code of ethics, and legislation that requires that an auditor be independent. Clients can put in place appropriate mechanisms that will reduce the threat to independence. These include having appropriate corporate governance mechanisms, such as the establishment of an audit committee and establishing policies and procedures dedicated to ensuring that the financial statements are true and fair. Accounting firms also have in place a range of safeguards to ensure independence such as policies and procedures to ensure the quality of their service and providing continuing education for their staff regarding these policies and procedures.

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

72. For each of the following, indicate if there is a threat to independence. If so, state the threat and a possible safeguard.

a) Ty Tomas, CPA is unaware that his audit client, James Jackets Co. makes up 20% of Ty Tomas firms revenues.

b) Luca Lobo goes to his assurance client, Joe’s Auto Mart to buy a used car for his daughter. Due to their business relationship, Joe offers James a vehicle below cost.

c) Olivia Dazzle has been auditing Fancy Dance Studio for many years. Fancy Dance Studio has been experiencing financial difficulties and has not been able to pay its audit fees for the last three years. Fancy now owes Olivia Dazzle $50,000 in assurance fees.

d) Robert Razo has three review engagements. One of the review engagements is done for Hugo’s Meatshop Ltd., which is 80% owned by Robert’s father-in-law, Igor Slovlog. The remaining 20% of the Meatshop is owned by Igor’s four children.

Answer:

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a) There is a self-interest threat in that there is the possibility of client reliance for Ty Tomas. A safeguard against this is to regularly review the assurance fees earned from each client in comparisons to total fees from all clients.

b) Car dealers are not in the business of selling cars below cost. The discount below cost is similar to a gift and therefore gives rise to a familiarity threat, in that Luca Lobo, the auditor has accepted a "gift" from his client. A safeguard for this is to have a firm policy whereby non trivial gifts from clients are not accepted.

c) This leads to a self-interest threat as significant fees outstanding are considered to be similar to a loan to the client. It could also lead to an intimidation threat by the client, in that the client could threaten to leave the firm and the auditor would be faced with a large receivable write off. A possible safeguard is to ensure all fees in arrears are collected before performing additional services to prevent any further fee dependence.

d) This is a familiarity threat in that family members of the auditor own shares of the company under audit. It is also a self-interest threat in that his wife owns shares in the entity. There is no appropriate safeguard in this situation. Robert should resign from the engagement immediately.

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

73. The five key threats to auditor independence are self-interest, self-review, advocacy, familiarity, and intimidation threats. Provide an example of each threat and suggest a safeguard against each identified threat.

Answer: This is only a suggested answer and student responses may vary.

Threat	Example	Safeguard
Self-interest threat	An audit firm relies on the fees from a client.	Regular review of assurance and other fees earned from each client compared with total fees from all assurance clients.
Self-review threat	An assurance team audits records that were prepared by a colleague in their firm on behalf of the client.	When providing non-audit services, ensuring that the client is responsible for overseeing and guiding that work and making any final decisions regarding the outcomes of that work.
Advocacy Threat	An auditor represents an audit client in a legal case.	Policies and procedures prohibiting the representation of clients in any disputes or legal matters.

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Familiarity threat	An auditor has a family member involved in the preparation of the accounting information subject to audit.	Procedures when assigning staff to assurance clients ensuring no close personal relationships exist between assurance team members and client personnel.
Intimidation threat	A client threatens to dismiss the audit firm.	Avoidance of fee dependence.

Bloomcode: Application
Difficulty: Medium
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

74. Indicate whether you agree or disagree with the following statements and explain your reasoning.

a) To ensure independence of prospective and continuing clients, an audit firm must review the threats to independence, and make certain that safeguards are put in place to limit or remove those threats.

b) The final stage in the client acceptance and continuance decision process involves assessing independence threats.

c) By signing the engagement letter, management is not necessarily considered to be responsible for the financial statements.

d) To successfully sue an auditor, a plaintiff must only prove that a duty of care was owed by the auditor.

Answer:
a) Agree. An audit firm should always assess independence before the client acceptance or continuance decision is made.

b) Disagree. The final stage in the client acceptance and continuance decision process involves the preparation of an engagement letter. An engagement letter is prepared by an auditor and acknowledged by a client before the commencement of an audit.

c) Disagree. Management is considered to be responsible for the financial statements and acknowledges this responsibility when they sign the engagement letter.

d) Disagree. To successfully sue an auditor, a plaintiff must prove not only that a duty of care was owed by the auditor, but also that there was a breach of that duty, and a loss was suffered as a result of that breach.
To establish that an auditor owes them a duty of care, a third party must now establish that the auditor was aware that the third party was going to use the financial statements and that the users relied on the financial statements for the purpose they were prepared.

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Bloomcode: Application
Difficulty: Medium
Learning Objective: Define and assess auditor independence.
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.3 Independence
Section Reference: 2.5 Legal liability
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

75. Simean & Co, a firm of CPA's, issued an unqualified audit report for its client, Xiing Manufacturing Corporation, a footwear manufacturer in Asia. Xiing Manufacturing, listed its head office in Toronto, Ontario, and its shares were traded on a Canadian Stock Exchange. Besides the shareholders, Simean & Co. knew the company was in the process of refinancing a significant bank loan coming due, and the bank was anxious to see the year end results. After an unqualified audit report was issued, the regulator of the stock exchange halted the trading of the shares after allegations of management fraud came to light. As a result, the share price plummeted and the company went out of business.

Required:
(a) To whom did Simean & Co. owe a duty of care?
(b) What must the bank demonstrate to establish negligence?
(c) What are the defences available to Simean & Co?

Answer:
a) The auditor owes a duty of care to the client, Xiing Manufacturing, as established when the engagement letter is signed.

The auditor also owes a duty of care to third parties. However, this duty is usually limited to fraud or gross negligence unless the auditor has actual knowledge that the third party will rely on the statements. In this case, the bank is a known user and therefore the auditor owes the bank a duty of care. The auditor would not owe a duty of care to all known users unless fraud or gross negligence is established. There is nothing to suggest that this is the case.

(b) There are four requirements for negligence to be established:

1. Simean & Co. owed the bank a duty of care.
2. There was a breach of that duty (such as failure to follow generally accepted auditing standards).
3. There must be proof that damage resulted.
4. There must be a reasonably proximate connection between the breach of duty and the resulting damage.

(c) The auditor can deny that the plaintiff has established the necessary conditions to recover damages by asserting the following:

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- There was no legal duty of care to the plaintiff.
- There was no breach of that duty (such as failure to follow generally accepted auditing standards).
- No damage resulted.
- There was no reasonably proximate connection between the breach of duty and the resulting damage.

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
AACSB: Analytic

76. Categorize each of the following items as either a factor that relates to contract law or tort law.

1. auditor failed to take reasonable care in the performance of the audit
2. auditor fails to live up to their responsibility implicit in agreeing to act as the auditor and explicit in the engagement letter
3. the work was below the standard that may be reasonably expected from a designated public accountant
4. the injured party must prove that the auditor's carelessness or unintentional behaviour caused harm and therefore breached the duty of care
5. a client can sue the auditor for breach of contract

Answer:

Contract Law	Tort Law
2. auditor fails to live up to their responsibility implicit in agreeing to act as the auditor and explicit in the engagement letter 5. a client can sue the auditor for breach of contract	1. auditor failed to take reasonable care in the performance of the audit 3. the work was below the standard that may be reasonably expected from a designated public accountant 4. the injured party must prove that the auditor's carelessness or unintentional behaviour caused harm and therefore breached the duty of care

Bloomcode: Application
Difficulty: Medium
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Section Reference: 2.5 Legal liability
CPA Competency: Audit and Assurance
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77. Explain the purpose and major contents of an engagement letter between the auditor and their client.

Answer: The engagement letter is a form of contract between an auditor and their client. Its purpose is to set out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client. The letter confirms the obligations of the client and the auditor. It also includes 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 responsibility for the preparation of the financial statements, the requirement that the auditor have access to all information required, independence considerations and fees.

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
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ESSAY QUESTIONS

78. Independence is considered one of the key characteristics of auditors. Explain why auditor independence is so important to the effectiveness of an audit and explain the various threats to an auditor's independence.

Answer: Answers may vary.

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Define and assess auditor independence.
Section Reference: 2.3 Independence
CPA Competency: Audit and Assurance
AACSB: Analytic

79. Audit committees have been widely recommended as being an important mechanism for enhancing the external auditor's independence. What are the important characteristics of audit committees and discuss why these characteristics are considered so important to a committee's effective and efficient operation.

Answer: Answers may vary.

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor’s relationships with others
CPA Competency: Audit and Assurance
AACSB: Analytic

80. The key difficulty for third parties in legal action against auditors has been establishing that a duty of care was owed to them by their auditor. Explain the development of the relevant legal principles relating to an auditor's duty of care to third parties with reference to specific case law.

Answer: Answers may vary.

Bloomcode: Comprehension
Difficulty: Easy
Learning Objective: Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement.
Section Reference: 2.4 The auditor’s relationships with others
CPA Competency: Audit and Assurance
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CASE QUESTION

81. Amelia Vadilia is a junior auditor working on the audit of Activia Linens Company. Amelia performed an inventory count where she noticed an unusually large amount of green fabric for use in manufacturing Activia products. When she inquired with the warehouse manager about why the quantity of green fabric was disproportionate with other colors the manager replied by saying "that green fabric products never sells and has been sitting there as long as I can remember". When Amelia looked over the inventory ledger, she noticed these materials were accounted for and totaled $220,000. Because the materials were recognized in the accounting records and the reasonable explanation provided by the warehouse manager, Amelia did not see a need for further inquiries. She documented her work in the audit file and proceeded to seek the advice of the manager on the audit, Michael Visco. Michael commented, "Activia is long-standing client, always pays their fees on time, and has never had any inventory issues in the past. They will obviously use the green fabric in production at some point, so I would suggest removing any notes of the mater in the audit file and continue working on other audit areas." Amelia did not feel great about this discussion with her manager and did not know how to proceed knowing there is likely an inventory obsolescence issue.

Required:

a) Did Amelia use professional skepticism in her decision-making process? Explain all instances where Amelia did and did not apply professional skepticism during her audit of Activia Linens Company.
b) Discuss the ethical dilemma presented to Amelia by identifying each step of the ethical dilemma framework.

Answer: Students responses may vary.

a) Amelia used professional skepticism both initially when she saw the green fabric, first noticing that it appeared disproportionate from the rest of the fabric colors, and then when following up by asking the warehouse manager for an explanation. She gathered evidence to support a possible inventory obsolescence issue by tracing the green fabric to the inventory ledger and establishing the $220,000 recorded value. Amelia did a great job exercising her professional skepticism from the onset of her inventory count.
b) The application of the framework for ethical dilemmas for Amelia can be summarized as follows:
    1. Identify the ethical dilemma: Amelia is being told by her audit manager to remove the evidence of Amelia uncovering the inventory obsolescence issue from the audit file, and forget it ever happened. Amelia feels uneasy about the situation knowing there is likely a misstatement in inventory.
    2. Determine who is affected: Activia management and the external users of its financial statements such as banks and investors will be the key parties affected by the possible inventory misstatement. Should the misstatement prove to be material to the users, there can be a significant impact on Amelia, Michael, and their accounting firm.
    3. Identify the likely alternatives available:
        - Amelia can take Michael's recommendation and remove the documentation from the file and ignore the issue, or
        - Amelia can highlight the possible impact of the issue to Michael and ask him to reconsider, or

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- Amelia can discuss the issue with the firm's managing partner in charge, or
- Amelia can ask to be removed from the audit entirely.

4. Decide on the appropriate action: Amelia should first request that Michael further investigate the inventory issue by highlighting its impact/importance, and if he does not agree, Amelia should push the matter to the managing partner of the firm.

Bloomcode: Analysis
Difficulty: Medium
Learning Objective: Describe the fundamental principles of professional ethics.
Learning Objective: Describe professional judgement and professional skepticism.
Section Reference: 2.1 The fundamental principles of professional ethics
Section Reference: 2.2 Professional judgement and professional skepticism
CPA Competency: Audit and Assurance
AACSB: Analytic

82. The CPL Audit Committee has a policy of changing audit firms every five years to ensure that they receive fresh approaches from different audit firms. Accordingly, the CPL Board has asked Ginger & Paprika LLP to replace its previous audit firm.

CPL is a manufacturer and distributor of wire ropes, industrial cables, and rigging cables and has a reputation for its ability to fill special orders and to ship across Canada from its Thunder Bay facility on time and at competitive prices. They have a reputation among their customers for going the extra mile and have kept a loyal customer base for over a century.

Curtis Sanza, a new partner at Ginger & Paprika LLP, a growing CPA firm in northern Ontario, is excited about CPL becoming a potential new client. The previous week he met with the Canadian President of CPL, Jinyi Gu.

Curtis Sanza quickly decided that Jinyi Gu was a man of integrity and his frank and open opinions would make it a pleasure to deal with him. He also appeared to have a competent management team in place.

Curtis also wanted to make an impression on his new firm by bringing in several new clients in the next year or two, as a good portion of his future compensation will be derived from new business.

He is also aware that any negligence on his part during the client acceptance phase would reflect on his professional judgment and open the firm to possible litigation.

The senior partner, Walter Peters, has invited Curtis Sanza to join him in his office to discuss CPL.

Required:

a) You are Walter Peters, the Senior Partner at Ginger & Paprika LLP. What would be on your "checklist" of client acceptance questions? Prepare an exhaustive inventory of all the questions you would ask Jack before deciding to accept or reject CPL.
b) The firm recently lost a lawsuit and has parted ways with the partner-in-charge of the aggrieved client. What can Walter Peters do to avoid litigation?

Answer:

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a) The first step involves the assessment of client integrity. When assessing client integrity, the auditor will consider the following questions:

1. What is the reputation of the client, its management, directors, and key stakeholders?
2. What are the reasons provided for switching audit firms (client acceptance decision)?
3. What is the client's attitude to risk exposure and management?
4. What is the client's attitude to the implementation and maintenance of adequate internal controls to mitigate (minimize) identified risks?
5. To what extent is the client's interpretation of accounting rules appropriate?
6. To what extent is the client willing to allow the auditor full access to information required to form their opinion?
7. What is the client's attitude to audit fees and its willingness to pay a fair amount for the work completed?

Here is a possible checklist of questions with regard to the firm's possible existing prohibitions that would preclude the firm or any staff member from performing the engagement:

8. We would ask about the prohibitions listed below:

   A. Financial interests in entity.
   B. Loans and guarantees to/from client.
   C. Close business relationships with client.
   D. Family and personal relationships with client.
   E. Future or recent employment with entity serving as officer, director, or company secretary of client.
   F. Provision of non-assurance services such as corporate finance or legal services that involve dispute resolution.
   G. Performance of management functions for the client.
   H. Making journal entries or accounting classifications without first obtaining management's approval.
   I. Acceptance of gifts or hospitality from client (other than clearly insignificant).
   J. Fee quote that is considerably less than market price for the engagement.
   K. Provision of legal services.
   L. Preparation of source documentation.
   M. Provision of corporate finance services.

Are we satisfied there are no significant "threats" to independence? Address each of the following threats in relation to the firm and any member of the engagement team:

A. Self-interest (i.e., where loss of client fees would be material).
B. Self-review (i.e., the nature and extent of bookkeeping services required or where a judgment from a previous engagement needs to be evaluated in reaching conclusions).
C. Advocacy (i.e., acting as an advocate on behalf of client in litigation or in share promotion).
D. Familiarity (i.e., being too sympathetic to the client's interests).
E. Intimidation (i.e., being deterred from acting objectively and exercising professional scepticism).

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Walter Peters would also ask about whether there are any safeguards to reduce the above threat(s) to independence identified to an acceptable level.

b) One of the ways that an auditor can avoid litigation is to follow up on any significant weaknesses in the client's internal control procedures in a previous year's audit. There are a number of ways that an auditor can avoid litigation. These include:

A. hiring competent staff
B. training staff and updating their knowledge regularly
C. ensuring compliance with ethical regulations
D. ensuring compliance with auditing regulations
E. implementing policies and procedures that ensure:
   – appropriate procedures are followed when accepting a new client
   – 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
F. meeting with a client's audit committee to discuss any significant issues identified as part of the audit
G. Following up on any significant weaknesses in the client's internal control procedures in a previous year's audit.

Bloomcode: Application
Difficulty: Medium
Learning Objective: Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties.
Learning Objective: Identify the factors to consider in the client acceptance or continuance decision.
Section Reference: 2.5 Legal liability
Section Reference: 2.6 Client acceptance and continuance decisions
CPA Competency: Audit and Assurance
AACSB: Analytic

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