Solutions Manual

to accompany

Auditing: a practical approach 2nd edition

by

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CHAPTER 2

Ethics, legal liability and client acceptance

WILEY

John Wiley & Sons Australia, Ltd 2013

Chapter 2 –Ethics, legal liability and client acceptance

REVIEW QUESTIONS

2.11 Explain how compliance with each of the five fundamental principles in APES 110 contributes to the ability of the auditor to discharge the duty to act in the public interest.

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 (APES 110, 100.4).

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

2.12 Which is more important, independence of mind or independence in appearance? Explain.

Both aspects of independence are important. If an auditor has independence of mind 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 auditors may act, the audit reports will not be credible if the outside parties do not believe that the auditors acted independently. That is, the outside parties do not believe the audit reports have 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.

If the auditor is seen to be independent but is really not independent, then the audit reports 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 of mind and independence in appearance are required for effective auditing.

2.13 The self-interest, self-review and familiarity threats all arise from an inappropriate closeness between the auditor and the client. Explain how that closeness is likely to manifest in each case and why it is a problem for the value of the audit.

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 report 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.

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.

2.14 Explain the relationship between the auditor and the shareholders of the audited company. How realistic is it to regard the shareholders as the clients of the auditor?

The audit report is addressed to the shareholders of the audited company. However, there is very little contact between an auditor and the members. One exception is that the auditor is required to attend the company's Annual General Meeting where there could be some dialogue between the members 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 recommend 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 most contact with them and the finance department, but they are not the client to whom the auditor reports.

2.15 Why is it so important that an audit committee not have any executive directors as members?

Executive directors are employees of the company who are also members of the board of directors. Non-executive directors are members of the board who are not employees of the company, but they could be ex-employees and/or major shareholders. Executive directors are generally regarded as being less independent with respect to the audit because they are part of the subject of the audit. That is, the executives, such as the CEO or CFO are in charge of the company's operations and financial reports and so their work is being audited.

The audit committee is a sub-committee of the board of directors and its responsibilities include selection of the company's auditors and overseeing the contract with the external auditors (and sometimes the internal audit department). The external auditors need to feel confident about bringing issues and difficulties they encounter during the audit to the attention of the audit committee. The auditors need to believe that the audit committee will not attempt to cover up the problems and will not try to persuade the external auditors to drop any major issue. If an executive director is on the audit committee they are regarded as being more likely to try to cover up any problems because such problems would reflect badly in the executive director's performance as an employee. Not allowing executive directors to be part of the audit committee avoids such potential conflicts of interest.

2.16 Some companies outsource their internal audit function to a public accounting firm. Explain how this would affect the external auditor's evaluation of the reliability of the internal audit function.

Outsourcing an internal audit function could provide the advantages of potentially better qualified auditors and a better resourced auditing function. It also allows small companies that would not be able to justify the establishment of a fully functioning internal audit department to have an internal audit function. An outsourced internal audit function is also likely to be more independent because they are not employees of the company and will not have the familiarity problems that could arise when one employee of a company is required to audit another employee's work.

Outsourcing has the disadvantage that the internal auditors would have less knowledge about the company and its systems. Such lack of knowledge may mean that employees could find it easier to hide problems from the internal auditors. Outsourced internal auditors are removed from employee social networks and thus may not be alert to problems known by employees. For example, employees may know of another employee's gambling problems which could tempt them to steal from the company.

2.17 What are the three conditions that must be proven for an auditor to be found negligent under tort law? Based on a review of the legal cases discussed in the chapter, which conditions appear to be most difficult to prove?

A client may bring an action against an auditor under contract 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
- 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 HIH Royal Commission 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.
In Esanda (1997) the High Court of Australia 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 Esanda 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 audited 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 which subsequently lost value.

2.18 Explain how an auditor would use auditing standards to avoid legal liability.

For a case brought by a client or another party to succeed against an auditor it must be shown that they breached the terms of the contract and/or were negligent. An auditor will use internal documentation to show that all duties were conducted to a reasonable standard. Failure to follow auditing standards would imply that the work was not conducted to a reasonable standard, but it is still possible that an auditor could be found to be negligent even if the strict letter of the auditing standards was followed. This is because the test is not whether or not the standards were followed, but whether it was reasonable to expect an auditor to act in a particular way. All circumstances must be examined on a case-by-case basis, and there could be conditions which would create a reasonable expectation that the auditor would have performed additional procedures or acted differently in some way. Therefore, compliance with auditing standards is generally regarded as a minimum, not a maximum, requirement to avoid legal liability.

2.19 Why are there procedures governing the client acceptance or continuance decision? Explain why auditors do not accept every client.

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.

2.20 What is the purpose of an engagement letter? Are all engagement letters the same?

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.

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 Corporations Act. 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 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 report, the requirement that the auditor have access to all information required, independence considerations and fees.

2.21 What is proportionate liability? Does it offer any protection for auditors?

Proportionate liability is suggested as a method of limiting the size of the auditor's liability. In some jurisdictions the judge is required to determine the extent of liability of each defendant in a case, depending on what is just and fair and on the facts of the case. The system is an attempt to stop any plaintiffs pursing auditors for 100% of the loss because the auditors have the 'deepest pockets'. In other words, even if the auditor was responsible for a minor part of the loss, in the past the plaintiffs have sued the auditors for the entire loss, knowing that auditors' insurance and financial resources provide a better chance for recovering than suing directors or other parties who do not have significant assets. This system is known as 'joint and several liability' – one of the defendants can be responsible for all the losses. Now, the judge would consider whether auditors were responsible for 100% of the loss, or some smaller amount, and award damages against the auditor that were related to the size of, or proportionate to, their responsibility.

2.22 Explain the difference between self-interest and self-review threats. Give an example of each.

Self-interest relates to the auditor's position, or concerns. For example, the auditor is interested in being paid fees for doing an audit. An auditor can also be concerned with the value of any financial investment in a client. If the client fails, the auditor's investment in the client would likely lose value. The threat arises because the auditor is financial interested in the client doing well (through their fees or investment), but as the auditor they could be required to require the client to write-down asset values, or qualify the audit report. The auditor is conflicted because they have a reason not to be independent and impartial. For further examples see 200.4 of APES 110.

Self-review relates to the auditor doing audit work that evaluates judgements made by the auditor themselves, or by another member of the audit team or firm (which is considered to be the same as the auditor themselves). For example, an individual might have worked for the client then left the client to work for the audit firm. If that individual has to audit the work done by them whilst working for the client, there is a self-review threat – the auditor is reviewing themself. A similar problem arises if the auditor has to review work done by another member of their audit firm (even if that person was in the consulting division, not in the audit section). The auditor is conflicted because the auditor does not want to expose a problem in the work done by themself or by another member of their audit firm, but as an auditor must be impartial and state if the work is not acceptable. For further examples see 200.5 of APES 110.

PROFESSIONAL APPLICATION QUESTIONS

2.23 Ethical principles

Required
Discuss the ethical principles that are potentially breached by Charles's behaviour at the party.

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 (APES 110, 100.4).
Charles overstates his importance at the audit firm – he states that he is a partner but he is a 'senior' (which is less senior than a partner). 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 the 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 which lends to the client, Charles does not have the client's permission to discuss this matter.

2.24 Client acceptance decision

Required
Explain whether your audit team should continue to tender for the audit work of Holiday Parks Ltd.

Accountants are required by APES 110 to be objective, to not allow bias, conflict of interest or undue influence of others to override professional or business judgments. It is possible that tendering for both audit and non-audit services at the same time could provide a threat to the objectivity of the auditor. The audit firm should have safeguards to prevent the tendering process for the non-audit services to impact on the audit team.
The audit firm also needs to consider the size of the potential contracts. It is possible that successfully tendering for both audit and non-audit services could affect the importance of the client to the audit firm. That is, the client could provide so much of the accounting firm's fees that the auditor's judgment could be affected by any perceived pressure to not upset the client in any way (fear of losing the contracts could make the auditor be 'softer').
Another aspect to consider is whether the tax consulting work would affect the substance of the audit in any way. A self-review threat can arise when auditors are judging work done by others in their firm. Auditors should not place themselves in a position where there is a risk that they will not appropriate judge the results of a

previous judgement of a member of the audit firm. Is it likely that the audit work will rely on the tax consulting work in any way? If a threat is identified, the auditor should consider appropriate safeguards (e.g. use an external expert to provide assurance of the taxation work in question).
If the audit team judges the above threats to its independence to be significant, the audit team should withdraw from the audit tendering process, or the firm should withdraw from the tax consulting tendering.

2.25 Setting audit fees
Required
Explain whether CCC Partners should agree to Muir Industries' request

Section 240 of APES 110 discusses fees and the appropriate arrangements for setting fees.
Fees should not be set so low that it may be difficult to perform the required services to the appropriate standards. There is a risk that discounting the fee as suggested in the question would result in the fee being too low to cover the cost of the work, and may place pressure on the audit team to cut corners, or not do the appropriate quality and quantity of work.
Section 290 also discusses fees. An auditor should not become dependent on the fees from a particular client. It is possible that the combination of audit and consulting fees in this case could make the auditor dependent on the client, and potentially compromising the auditor's independence because there're is perceived pressure to keep the client happy with the audit to keep the work and total fees from the client. The fact that the auditor is considering a request to discount the audit fees in order to win the other work suggests that the audit firm could be in danger of being dependent on the client.

2.26 Client continuance
Required
Should FFF Partners agree to Stephen Software's request? Explain

FFF Partners cannot agree to issue any report without doing the required work. If there is no time to do any further audit work, then the client can give the bank the financial statements and the audit report for the year ended 30 June 2013.
It is usual to provide a review, rather than an audit report, for six monthly periods, although audits can also be provided.

FFF Partners should assess the client and their ability to service the client in a client continuance decision. ASQC 1 (ISQC1) provides guidance on the procedures to be followed.
The auditor must consider client integrity. In addition to the information gleaned from past relationship with the client, FFF Partners would consider whether the client request to issue an audit report without doing the required work in order to secure a loan would affect their decision to continue with this client. The request indicates that the client is willing to expose itself, and the auditor, to risk. It also suggests that the client is under pressure to secure a loan in a short time frame. FFF Partners should consider what else the client might be doing, that it should not be, in order to secure the loan.

Even though the client is an existing client, the auditor should still consider any threats to compliance with the fundamental principles of professional ethics (APES 110). Is there any reason to believe that the client is being dishonest in its application for the loan? Does the audit firm have the appropriate staff to do the audit and review work? It is possible that a better staffed audit firm could do the work required to meet the bank's request in a timely way. If FFF Partners does not have the appropriate staff, it should decline the engagement.

Finally, FFF Partners should consider if it needs to issue an engagement letter for the new work so that both the client and the auditor understand the terms of the engagement. Normally, a new engagement letter is not required each year. However, if the terms of the engagement have changed significantly, especially with respect to the half-yearly accounts and audit, a new letter might be required.

2.27 Receiving shares through inheritance

Required

Advise Kerry's wife of the options available to Kerry to avoid any conflict of interest, and thus avoid being dismissed from the audit firm.

APES 110:

290.107 If a member of the Assurance Team, or their Immediate Family member receives, by way of, for example, an **inheritance**, gift or, as a result of a merger, a Direct Financial Interest or a material Indirect Financial Interest in the Assurance Client, a self-interest threat would be created. The following safeguards should be applied to eliminate the threat or reduce it to an acceptable level:

(a) Disposing of the Financial Interest at the earliest practical date; or

(b) Removing the member of the Assurance Team from the Assurance Engagement.

During the period prior to disposal of the Financial Interest or the removal of the individual from the Assurance Team, consideration should be given to whether additional safeguards are necessary to reduce the threat to an acceptable level. Such safeguards might include:

• Discussing the matter with those charged with governance, such as the audit committee; or

• Involving an additional professional accountant to review the work done, or otherwise advise as necessary.

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 prior to his death.

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

s 290.107 suggests that the shares should be disposed of, or Kerry removed from the audit. If Kerry stays on the audit the shares should be sold and the additional safeguard of discussing the matter with the client's audit committee should apply if the disposal of the shares would take some time.

Kerry will not get the sack from the audit firm provided he follows the above procedures.

2.28 Client acceptance decision
Required

(a) **Explain whether any safeguards could be put in place to reduce the threat to an acceptable level.**
(b) **Would it make any difference to your answers if the shares were held by a tax partner in the office, rather than being held directly by DDD?**

DDD is the audit firm. It has a financial interest in the company WaterFun that is material to DDD. This is a self-interest threat because DDD is supposed to do the audit without fearing that an unfavourable audit could lead to a reduction in the value of WaterFun's shares. If DDD has a material interest in WaterFun, it is likely that the audit team could feel under pressure to 'go easy' on the audit to protect the value of the investment.
APES 110.12 (a) discusses self-interest threats and states that it is the threat that a financial or other interest will inappropriately influence an accountant's judgment or behaviour. Further, section 200 gives an example of a self-interest threat for an auditor arising when the auditor has a direct financial interest in the audit client.

(a) Safeguards for threats to independence are discussed in detail in APES 110, section 290. Section 290.104 prohibits an audit firm from performing an audit where the audit firm has a material financial interest in the client. No safeguards would be able to reduce the threat to an acceptable level and the firm should not accept the engagement, or the financial interest should be disposed of before accepting the engagement:

290.104 If a member of the Audit Team, a member of that individual's Immediate Family, or a Firm has a Direct Financial Interest or a material Indirect Financial Interest in the Audit Client, the self-interest threat created would be so significant that no safeguards could reduce the threat to an Acceptable Level. Therefore, none of the following shall have a Direct Financial Interest or a material Indirect Financial Interest in the client: a member of the Audit Team; a member of that individual's Immediate Family; or the Firm.

(b) Section 290 makes a distinction between the audit firm, the members of the audit team, and other members of the audit firm. However, if the tax partner holding the financial interest is in the same office as the audit team, the threat is still so significant that no safeguard would be sufficient, and the firm should not accept the engagement, or the financial interest should be disposed of before accepting the engagement:

290.108 If other partners in the Office in which the Engagement Partner practices in connection with the Audit Engagement, or their Immediate Family members, hold a Direct Financial Interest or a material Indirect Financial Interest in that Audit Client, the self-interest threat created would be so significant that no safeguards could reduce the threat to an Acceptable Level. Therefore, neither such partners nor their Immediate Family members shall hold any such Financial Interests in such an Audit Client.

290.110 If other partners and managerial employees who provide non-audit services to the Audit Client, except those whose involvement is minimal, or their Immediate Family members, hold a Direct Financial Interest or a material Indirect Financial Interest in the Audit Client, the self-interest threat created would be so significant that no safeguards could reduce the threat to an Acceptable Level. Accordingly, neither such personnel nor their Immediate Family members shall hold any such Financial Interests in such an Audit Client.

2.29 Auditor liability for misleading accounts
Required
Discuss the auditor's liability for losses suffered by (a) Mega Shopping Centres investors, and (b) other parties.

The misclassification of liabilities as non-current instead of current potentially means that anyone analysing the financial position of Mega Shopping Centres would be misled. If the liabilities are current, it is likely that they are due to be paid within 12 months, although they could also be renegotiated and the repayment date extended. The reader of the accounts would not be sure if Mega had to repay the debt, and would have doubt about the ability of the company to continue in business.

The directors and managers of Mega are likely to say that they relied on information provided to them by the finance department. The reports from the finance department probably did not state that the debts were due to be repaid soon. However, the directors and managers are under an obligation to ask questions about important matters such as large debts. They are also obliged to monitor the financial position of their company. They cannot just rely on others.

The auditors are likely to say that they relied on information provided by the managers about the due date for the debt repayments. However, the auditors should gather evidence about the repayment date, not just rely on what the managers tell them.

(a) The investors in Mega could bring legal action against the auditors, arguing they suffered financial loss as a result of the misclassification of the debt. The auditors reported that the financial accounts were in accordance with the Corporations Act and accounting standards (which they were not, because the debt was misclassified), and that the accounts were true and fair (which they were not because they gave a misleading picture).

It is likely that the auditors are liable to the investors in Mega Shopping Centres because of their loss and the failure of the auditors to following auditing standards, such as those requiring auditors to gather sufficient and appropriate evidence about the liabilities and their disclosures. The auditor could be liable under both contract law (failure to perform the audit they were contracted to do) and tort of negligence. The investors would need to establish that the auditor owed them a duty of care and the duty of care was breached, and that the investors suffered a loss as a result of that negligence.

(b) Third parties cannot rely on contract law. Other parties would try to rely on tort law. In addition, to duty of care, breach of the duty and loss, they have to establish that there was reasonable foreseeability. This means that the other parties would have to establish that the auditor was aware, or should have been aware, that any negligence on their part could cause a loss to the third parties. This is more difficult than establishing foreseeability of the loss suffered by investors. Caparo (1990) established the concept of reasonable proximity, where the auditor must be aware of the third party as a group and the decision they intend to make when using the audited report. Third parties would have a better case if they obtain a Privity Letter which can be used to prove that a duty of care was owed to them. Otherwise, there would need to be some special circumstances before the auditor was liable to them in this case.

2.30 Provision of non-audit services to audit clients

Required

(a) Comment on Elise's belief that increasing non-audit service fee revenue from her audit client would increase her reputation in the audit firm.

(b) Which non-audit services would you advise Elise to avoid trying to sell to Hertenstein Ltd because of their potential ethical issues for the audit firm?

(c) Would it make any difference to your answers if Hertenstein Ltd was a proprietary company, not a listed public company?

(a) It is possible that increasing the profitability 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 Elise's reputation. See APES 110, s. 290.158 – if the provision of non-assurance services creates a threat to the auditor's independence, safeguards would need to be applied to eliminate or reduce the threat.

(b) See 290.159 of APES 110 for a guide to which services to avoid. This section states that the auditor should avoid acting as an executive of the client company. The auditor should not be involved in transactions, making decisions about the audit firm's recommendations, management reporting to directors, or acting as manager of the client within the previous two years.
s. 290.161 discusses less significant threats, which should only be offered after careful consideration because they could create self-review or self-interest threats. These include having custody of a client's assets, supervising client employees, and preparing source documents. The section also discusses examples of safeguards, such as making arrangements so that personnel providing such services do not participate in the audit, and gaining additional advice on the impact of such services.

(c) Yes. Auditors can provide more non-audit services to a proprietary company than to a listed company.

290.170 The Firm, or a Network Firm, may provide an Audit Client that is not a Listed Entity with accounting and bookkeeping services, including payroll services, of a routine or mechanical nature, provided any self-review threat created is reduced to an acceptable level.
Examples of such services include:
• Recording transactions for which the Audit Client has determined or approved the appropriate account classification;
• Posting coded transactions to the Audit Client's general ledger;
• Preparing Financial Statements based on information in the trial balance; and
• Posting the Audit Client approved entries to the trial balance.

The section continues by explaining that the significance of any threat created should be evaluated and, if the threat is other than Clearly Insignificant, safeguards should be considered and applied as necessary to reduce the threat to an acceptable level.

2.31 Unpaid audit fees

Required
Explain the ethical problem in this case. Why is it a problem? What can be done about it?

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.
The auditor should take steps to have the fees paid before the next audit or remove itself from the audit.
See APES 110:
290.208 A self-interest threat may be created if fees due from an Assurance Client remain unpaid for a long time, especially if a significant part is not paid before the issue of the assurance report for the following year. Generally the payment of such fees should be required before the report is issued. The following safeguards may be applicable:
• Discussing the level of outstanding fees with the audit committee, or others charged with governance.
• Involving an additional professional accountant who did not take part in the Assurance Engagement to provide advice or review the work performed.
The Firm should also consider whether the overdue fees might be regarded as being equivalent to a loan to the Client and whether, because of the significance of the overdue fees, it is appropriate for the Firm to be re-appointed.

2.32 Using the work of internal auditors

Required
Comment on the extent of reliance the external auditor should place on the work of the internal audit department at Theobald Ltd. Explain the likely impact of the internal audit department's work on the audit plan.

The internal audit department focuses on efficiency and effectiveness of production (i.e. performance auditing) and compliance with government regulations (compliance auditing). The head of the internal audit department is a CPA 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 which 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 regulations and efficiency matters will not be directly relevant to the external auditors' audit of accounting transactions and balances.

2.33 Legal implications of client acceptance

Required

(a) Provide guidance to Rebecca about the steps she can take to avoid the threat of litigation if Carolina Company Ltd fails.

(b) What should Rebecca consider when making the client continuance decision for Carolina Company Ltd for the next financial year?

(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
    - 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 a client'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
- dealing with privity letter requests in accordance with the guidance provided in AGS 1014 *Privity Letter Requests.*

(b) The client continuation decision is critical. Rebecca should evaluate and document the firm's ability to service the major client, Carolina Company Ltd, and any other

major clients for the coming year. APES 320 Quality Control for Firms and ASQC 1 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 (integrity, objectivity, professional competence and due care, confidentiality and professional behaviour). Although Carolina Company has been a client of the firm for several years, its integrity must still be reevaluated. Rapid growth can create pressures within the client that could compromise its integrity. This is particularly so in the case of Carolina Company 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 be particularly concerned with the firm's ability to be objective given its dependence on the large client's fees. Although, Carolina Company is only one of the major clients experiencing rapid growth, fee dependence arises when a client's fees form a significant proportion of the audit firm's overall revenue. APES 110 provides guidance about safeguards when this proportion reaches 15%.
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.

2.34 Independence threats and safeguards

Required

(a) Identify and explain the significant threats to independence for KFP Partners in accepting the audit of Featherbed.

(b) Explain any relevant and practical safeguards that KFP could implement to reduce the threats.

(a) Personal relationships between a partner of the audit firm and the two directors – familiarity threat. This applies even if the partner is not part of the engagement team because the partner is a senior member of the audit firm.
From APES 110
200.7 Examples of circumstances that may create familiarity threats include, but are not limited to:

- A member of the Engagement Team having a Close or Immediate Family relationship with a Director or Officer of the Client.
- A member of the Engagement Team having a Close or Immediate Family relationship with an employee of the Client who is in a position to exert direct and significant influence over the subject matter of the Engagement.

- 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.
- Accepting gifts or preferential treatment from a Client, unless the value is Clearly Insignificant.
- Long association of senior personnel with the Assurance Client.

(b) APES 110 suggests that the audit firm should document the policies that relate to this type of threat to independence, the evaluation of the threat and the safeguards to reduce the threats. They should also have policies and procedures to prevent that partner from inappropriately influencing the outcome of the assurance engagement. The firm should not use that partner on the Featherbed engagement, and should not accept the audit if that partner is required on the audit.

200.12 (extract)
• For Firms that perform Assurance Engagements, documented Independence policies regarding the identification of threats to Independence, the evaluation of the significance of these threats and the evaluation and application of safeguards to eliminate or reduce the threats, other than those that are clearly insignificant, to an acceptable level.
• Documented internal policies and procedures requiring compliance with the fundamental principles.
- Policies and procedures to prohibit individuals who are not members of an Engagement Team from inappropriately influencing the outcome of the Engagement.

2.35 Independence threats and safeguards

Required

(a) Are there any threats to independence for KFP in its audit of Securimax?
(b) Can you propose any recommendations to safeguard KFP against the potential independence threats you have identified? Explain.

Issues raised in the case:
(i) The client's internal audit department is headed by an ex-partner of KFP.
Both APES 110 and the Corporations Act place restrictions on audits where a former audit partner has a senior role within the client.
The Corporations Act restriction (CORPORATIONS ACT 2001 - SECT 324CK) is limited to a period of 5 years between leaving the audit firm and the current audit (2 years if the person retired rather than just left the firm s. 324CI). On this basis, there is no contravention of the Act. In addition, the restriction 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.
APES 110 does not specify a 5 year time limit, and the person could be an officer or director or an employee in a position to exert direct and significant influence over the subject matter of the engagement. 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 wasn't 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).
APES 110:
200.7 Examples of circumstances that may create familiarity threats include, but are not limited to: (extract)
• 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.

(ii) Clarke Field has been the partner for 5 years and will remain as review partner when Sally Woodrow is appointed as partner for the audit.
APES 110 and the Corporations Act require rotation of senior audit personnel as follows:
APES 110: 290.154
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 Entity and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly in respect of the Financial Statement audit of Listed 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 has elapsed.

See also CORPORATIONS ACT 2001 - SECT 324DC : Audit firm's rotation obligation

(b) Safeguards:
Clarke Field should not participate in the audit for two years.

(iii) Appointment of Sally Woodrow to position of partner and as partner in charge of the Securimax audit.
Is Sally Woodrow 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 to lead the audit 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.

2.36 Ethics of accepting engagements
Required:
Explain why Tania should have reservations about accepting the engagement in respect of the linear accelerators. Make appropriate reference to fundamental ethical principles in your answer.

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

The CEO of TCCL has requested the auditor provide an opinion that the linear accelerators are fit for use without charging a fee as a gesture of goodwill, in the context of the future negotiations about the audit tender. There is an implicit invitation to provide a favourable opinion to ensure that the audit tender is awarded to Fellowes and Associates again.
If Tania provides the opinion without obtaining appropriate and sufficient evidence she would be compromising her integrity because the favourable opinion would not be honest, and her objectivity because her professional judgement would be influenced by the desire to win the tender again. 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 accelerators) 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 that adequate staffing are assigned to the engagement and sufficient work done to complete the engagement.

2.37 Independence issues in accepting engagements

(a) Using your knowledge of APES 110, identify and explain the potential type of threat to Fellowes and Associates' independence in situations (1) and (2) above.

(b) What action should Fellowes and Associates take to eliminate the potential threats to independence in situations (1) and (2) above? What safeguards should be instituted to reduce the risk of similar independence threats occurring in the future?

One of the accountants intended to be part of the 2014 audit team owns shares in HCHG. The accountant's interest is not material to him.

Section AUST290.41.3 of APES 110 states that a financial interest in a client may create a self-interest threat. Owning shares in an engagement client creates a direct financial interest. S. 290.104 requires the auditor to consider the nature of the financial interest in order to determine the significance of the threat and the appropriate safeguards. 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.

Therefore, what duties does the member of the assurance team perform? How senior is his role? How much judgement will he 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.

Section 290.106 states that if a member of the assurance team has a direct financial interest, as in this case, the only safeguards available to eliminate the threat are to dispose of the direct financial interest prior to the individual becoming a member of the assurance team, or to remove the member of the assurance team from the engagement.

AUST290.41.3 "Self-Interest Threat" occurs when a Firm or a member of the Assurance Team could benefit from a Financial Interest in, or other self-interest conflict with, an Assurance Client.
Examples of circumstances that may create this threat include, but are not limited to:
• A Direct Financial Interest or material Indirect Financial Interest in an Assurance Client;
290.104 A Financial Interest in an Assurance Client may create a self-interest threat. In evaluating 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. This includes an evaluation of the role of the person holding the Financial Interest, the materiality of the Financial Interest and the type of Financial Interest (Direct or Indirect).

290.106 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 so significant the only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:
(a) Dispose of the Direct Financial Interest prior to the individual becoming a member of the Assurance Team;
(b) Dispose of the Indirect Financial Interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the Assurance Team; or
(c) Remove the member of the Assurance Team from the Assurance Engagement.

Fellowes and Associates was previously engaged by HCHG to value its intellectual property. The consolidated balance sheet as at 30 June 2014 includes intangible assets of $30 million, which were valued by Fellowes and Associates on 1 March 2014 following HCHG's acquisition of the subsidiary Shady Oaks Hospital. The intangibles are considered material to HCHG.

APES 110 ss. 290.174 – 290.179 address the issues surrounding the provision of valuation services to an assurance client. The problem arises because in a financial report 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. Specifically, (s.290.176) this is a problem if the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity. 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.

Therefore, the key questions are whether the item is material, 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). This implies that Fellowes and Associates should withdraw from the audit or the client should obtain another independent valuation for the intangibles.

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 valuer and auditor. However, now, as auditor, Fellowes and Associates is required to provide an opinion on the valuation which it previously provided.

Other safeguards that could apply to valuation situations (s. 290.177) include
- involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise as necessary;
- 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 in s. 290.177 with respect to the intangible assets valuation. 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 should not use the personnel involved in the valuation on the financial report audit. However, it is likely that these safeguards would not be enough, given the high level of subjectivity in the intangible assets valuation. 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 the financial report audit, unless they are immaterial and/or have a very low degree of subjectivity.

Case Study Cloud 9

Solution

1. Prepare a document that explains the impact, if any, of each piece of relevant information on your client acceptance decision for Cloud 9 Pty Ltd.

Issues (sections refer to APES 110):

- The relationship between David Collier and P.S. Nethercott is described as distant. Section 290.41.6 discusses familiarity threats which 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 s. 290.41.3 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 (s. 290.41.4) 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 risk to consideration of the threats to independence (s. 290.46). The matter is discussed in detail in ss. 290.187 – 290.191. 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 (s. 290.134).

- Members of the IT department at the audit firm 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.

- This point does not relate to independence issues. In this case, the newspaper article suggests that the management of Cloud 9 Inc, the parent 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 (ASQC1). In addition, s. 210 of APES 110 requires the auditor 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&D 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 local level, and/or create other issues for the auditors related to dealings between the companies. The auditors could raise the issue with Cloud 9 Pty Ltd management, and if still concerned, also visit the factories.

2. List and explain any additional actions you would take before making your client acceptance recommendation to the partner, Jo Wadley, in this case.

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 fees.
- Obtaining permission from the client to communicate with the previous auditor, third parties such as bankers and lawyers, and client personnel
- Review press
- 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

3. Assume the decision is made to accept Cloud 9 as a client. Prepare the client engagement letter.

Prepare client engagement letter as per example in text.

Research Question

(a) What are the arguments for and against allowing former audit firm partners and/or employees to join audit committees?

(b) Explain how these accounting experts could help or hinder the audit process and thereby have an impact on the quality of a company's internal controls and financial reports.

(a) Arguments:
Advantages

- expertise of former auditors being available to client, should lead to an improvement in their financial reports 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
- improve their systems and financial reports based on the ex-auditor's intimate knowledge of good control systems and financial reporting

However, they could also be recruited to

- encourage the audit firm to be 'soft' on their mates,
- use 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 better able to hide the problems,
- share their knowledge of audit sampling methods could be used to hide errors in items that are not likely to be sampled.

