

Testbank

to accompany

Auditing: a practical approach 2e

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Chapter 2 – Ethics, legal liability and client acceptance

True/False

1. 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

*a. True
b. False

Correct answer: a

2. For an auditor to be truly independent they must possess independence of mind and independence of appearance.

*a. True
b. False

Correct answer: a

3. The role of the Internal Auditors will enhance the work of the external auditors by further developing the findings of the external auditors between engagements

a. True
*b. False

Correct answer: b

4. An engagement letter is prepared by the auditors and signed by the client at the conclusion of the audit process.

a. True
*b. False

Correct answer: b

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

*a. True
b. False

Correct answer: a

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

a. True
*b. False

Correct answer: b

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

*a. True
b. False

Correct answer: a

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

*a. True
b. False

Correct answer: a

9. A famous statement by Lord Justice Lopes in the Pacific Acceptance case was that an auditor "...is a watchdog, but not a bloodhound."

a. True
*b. False

Correct answer: b

10. A privity letter acknowledges that the third party intends to rely on the audited financial report.

*a. True
b. False

Correct answer: a

11. 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.

a. True
*b. False

Correct answer: b

12. Ensuring compliance with auditing regulations will not assist auditors to avoid litigation.

a. True
*b. False

Correct answer: b

13. Third parties are anyone other than the client and its shareholders that uses the financial report to make a decision.

*a. True
b. False

Correct answer: a

14. Being negligent means not exercising due care.

*a. True
b. False

Correct answer: a

15. The judgement in the *Esanda* case has made it far easier for third parties to establish that a duty of care is owed by the auditor.

a. True
*b. False

Correct answer: b

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

*a. True
b. False

Correct answer: a

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

*a. True
b. False

Correct answer: a

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

*a. True
b. False

Correct answer: a

19. An engagement letter does not include an overview of the client's responsibility for the preparation of the financial report.

a. True
*b. False

Correct answer: b

Multiple Choice

20. Professional competence refers to the to the members of a professional body;
- a. Maintain a level of commitment to their industry associations
 - b. Maintain a level of understanding of their clients business operations
 - *c. Maintain their level of knowledge and skill required by the professional body
 - d. Maintain the knowledge to adequately operate in their clients industry

Correct answer: c

Learning Objective 2.1 ~ outline the fundamental principles of professional ethics

21. Which of the following is a fundamental principle of professional ethics?
- a. confidentiality
 - b. objectivity
 - c. integrity
 - *d. all of the above

Correct answer: d

Learning Objective 2.1 ~ outline the fundamental principles of professional ethics

22. 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 judgement
 - 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

Correct answer: a

Learning Objective 2.1 ~ outline the fundamental principles of professional ethics

23. 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 judgement
 - d. ensure that they do not harm the reputation of the accounting profession

Correct answer: c

Learning Objective 2.1 ~ outline the fundamental principles of professional ethics

24. 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

Correct answer: c

Learning Objective 2.2 ~ define and assess auditor independence

25. 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

Correct answer: b

Learning Objective 2.2 ~ define and assess auditor independence

26. Threats to the independence of auditors include:
- a. familiarity threats
 - b. self-interest threats
 - c. advocacy threats
 - *d. all of the above

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

27. 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

Correct answer: b

Learning Objective 2.2 ~ define and assess auditor independence

28. 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. both a and b
 - *d. a former partner of the assurance firm holds a senior position with the client

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

29. What type of threat to independence arises when an accounting firm acts on behalf of its assurance client results?
- *a. advocacy threat
 - b. self-interest threat
 - c. intimidation threat
 - d. self-review threat

Correct answer: a

Learning Objective 2.2 ~ define and assess auditor independence

30. Intimidation threats to independence include:
- *a. the threat 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

Correct answer: a

Learning Objective 2.2 ~ define and assess auditor independence

31. Safeguards to independence are created by:
- a. accounting firms
 - b. the profession, legislation or regulation
 - c. clients
 - *d. all of the above

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

32. 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

Correct answer: c

Learning Objective 2.2 ~ define and assess auditor independence

33. Having policies and procedures to ensure the quality of an accounting firm's service is an example of a safeguard to independence created by:
- a. the client's audit committee
 - b. the *Corporations Act*
 - c. the client's board of directors
 - *d. None of the above

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

34. The main recipients of the financial report and the attached audit report are acknowledged as:
- a. the board of directors
 - *b. the shareholders or members
 - c. the audit committee
 - d. the Australian Securities and Investments Commission

Correct answer: b

Learning Objective 2.3 ~ specify the relationship between an auditor and key groups they have a professional link with during the audit engagement

35. Examples of board committees include the:

- a. risk committee
- b. nomination committee
- c. remuneration committee
- *d. all of the above

Correct answer: d

Learning Objective 2.3 ~ specify the relationship between an auditor and key groups they have a professional link with during the audit engagement

36. It is the responsibility of the board of directors to:

- *a. ensure that the financial report is prepared so as to provide a true and fair view
- b. provide an opinion on the truth and fairness of the financial statements
- c. direct the auditors to audit specific financial statement accounts
- d. none of the above

Correct answer: a

Learning Objective 2.3 ~ specify the relationship between an auditor and key groups they have a professional link with during the audit engagement

37. 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. a and b

Correct answer: d

Learning Objective 2.3 ~ specify the relationship between an auditor and key groups they have a professional link with during the audit engagement

38. According to the ASX Corporate Governance Council, an audit committee should:

- a. not have a formal charter
- *b. consist of a majority of independent directors
- c. be chaired by the chairman of the board of directors
- d. have at least four members

Correct answer: b

Learning Objective 2.3 ~ specify the relationship between an auditor and key groups they have a professional link with during the audit engagement

39. 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

Correct answer: a

Learning Objective 2.4 ~ illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties

40. 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 above

Correct answer: d

Learning Objective 2.4 ~ illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties

41. Which of the following was an observation or recommendation by Justice Owen in the HIH Royal Commission Report?

- a. boards of directors should establish an audit committee
- b. auditor independence is not a critical element in establishing the credibility of an auditor's report
- *c. an independent and objective audit, conducted with an appropriate degree of professional scepticism, is required
- d. audit reports should be addressed to shareholders

Correct answer: c

Learning Objective 2.4 ~ illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties

42. Which of these cases established the legal principle that auditors owe a duty of care to shareholders as a group and not to individual shareholders?
- a. Esanda
 - *b. Caparo
 - c. Scott Group
 - d. Pacific Acceptance

Correct answer: b

Learning Objective 2.4 ~ illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties

43. Auditors can avoid 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. a and c

Correct answer: d

Learning Objective 2.4 ~ illustrate the auditor's legal liability to their client, contributory negligence and the extent to which an auditor is liable to third parties

44. 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

Correct answer: a

Learning Objective 2.5 ~ categorise the factors to consider in the client acceptance or continuance decision

45. 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

Correct answer: d

Learning Objective 2.5 ~ categorise the factors to consider in the client acceptance or continuance decision

Short Answer Questions

46. 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 (APES 110, s. 100.4). 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 judgement. 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.

Learning Objective 2.1 ~ outline the fundamental principles of professional ethics

47. 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. 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.

Learning Objective 2.2 ~ define and assess auditor independence

48. 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 (APES 110, s. 290). 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 report is 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.

Learning Objective 2.2 ~ define and assess auditor independence

49. Discuss the findings in the *Esanda* case as they relate to an auditor's liability to a third party.

Answer: The High Court of Australia found in favour of the auditor and 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.

Learning Objective 2.3 ~ specify the relationship between an auditor and key groups they have a professional link with during the audit engagement

50. 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 will confirm the obligations of the client and the auditor in accordance with the Corporations Act. 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 report, the requirement that the auditor have access to all information required, independence considerations and fees.

Learning Objective 2.5 ~ categorise the factors to consider in the client acceptance or continuance decision

Essay Questions

51. 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.

52. 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.

53. 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.