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# **Testbank**

to accompany

## **Auditing: a practical approach 4e**

by

**Moroney et al.**

# **WILEY**

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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

General Feedback:

Correct answer: *a*

*Learning Objective 2.1 ~ explain the fundamental principles of professional ethics*

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

- \*a. True
- b. False

General Feedback:

Correct answer: *a*

*Learning Objective 2.1 ~ explain the fundamental principles of professional ethics*

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

- \*a. True
- b. False

General Feedback:

Correct answer: *a*

*Learning Objective 2.2 ~ define and assess auditor independence*

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

- \*a. True
- b. False

General Feedback:

Correct answer: *a*

*Learning Objective 2.2 ~ define and assess auditor independence*

5. Independence in appearance is the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement.

- a. True
- \*b. False

General Feedback:

Correct answer: *b*

*Learning Objective 2.2 ~ define and assess auditor independence*

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

- \*a. True
- b. False

General Feedback:

Correct answer: *a*

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

7. 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

General Feedback:

Correct answer: *b*

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

8. 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

General Feedback:

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*

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.

- a. True

\*b. False

General Feedback:

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*

10. For auditors to be liable to third parties for negligence, a duty of care must exist.

\*a. True

b. False

General Feedback:

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*

11. Third parties are anyone other than the client and its shareholders that use the financial report.

\*a. True

b. False

General Feedback:

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*

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

a. True

\*b. False

General Feedback:

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*

13. 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

General Feedback:

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*

14. Being negligent means not exercising due care.

- \*a. True
- b. False

General Feedback:

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*

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

- \*a. True
- b. False

General Feedback:

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*

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

- a. True
- \*b. False

**General Feedback:**

Correct answer: *b*

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

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

- a. True
- \*b. False

General Feedback:

Correct answer: *b*

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

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

\*a. True

b. False

General Feedback:

Correct answer: *a*

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

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

\*a. True

b. False

General Feedback:

Correct answer: *a*

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

## **Multiple-choice questions**

20. Professional competence refers to the members of a professional body;

- a. Maintaining the knowledge to adequately operate in their client's industry.
- b. Maintaining a level of understanding of their client's business operations.
- c. Maintaining a level of commitment to their industry associations.
- \*d. Maintaining knowledge and skill at a level required by the professional body.

General Feedback:

Correct answer: d

Learning Objective 2.1 ~ explain the fundamental principles of professional ethics

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

- a. respect the privacy of information learned as a consequence of their work.
- b. not allow their personal feelings or prejudices to influence their professional judgement.
- \*c. avoid conduct which may discredit the accounting profession.
- d. be straightforward and honest.

*General Feedback:*

Correct answer: c

Learning Objective 2.1 ~ explain the fundamental principles of professional ethics

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

- a. integrity.
- b. objectivity.
- c. confidentiality.
- \*d. all of the above.

General Feedback:

Correct answer: d

Learning Objective 2.1 ~ explain the fundamental principles of professional ethics

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

- a. avoid conduct which may discredit the accounting profession.
- b. respect the privacy of information learned as a consequence of their work.
- c. be straightforward and honest.
- \*d. not allow their personal feelings or prejudices to influence their professional judgement.

*General Feedback:*

Correct answer: d

Learning Objective 2.1 ~ explain the fundamental principles of professional ethics

24. Threats to the independence of auditors include:

- a. self-interest threats.
- b. familiarity threats.
- c. advocacy threats.
- \*d. all of the above.

*General Feedback:*

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

25. Independence in appearance is:

- \*a. the avoidance of facts that would make a third party believe that integrity, objectivity or professional scepticism has been compromised
- b. the ability to act with integrity, objectivity and professional scepticism.
- c. also referred to as actual independence.
- d. the ability to make a decision that is free from bias, personal beliefs and client pressures.

*General Feedback:*

Correct answer: a

Learning Objective 2.2 ~ define and assess auditor independence

26. 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.

*General Feedback:*

Correct answer: c

Learning Objective 2.2 ~ define and assess auditor independence

27. 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 holdings a senior position with the client.

General Feedback:

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

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

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

*General Feedback:*

Correct answer: b

Learning Objective 2.2 ~ define and assess auditor independence

29. Intimidation threats to independence include:

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

*General Feedback:*

Correct answer: b

Learning Objective 2.2 ~ define and assess auditor independence

30. What type of threat to independence arises when an accounting firm promotes a client's position to the point that it compromises the firm's objectivity?

- a. self-interest threat.
- \*b. advocacy threat.
- c. self-review threat.
- d. intimidation threat.

General Feedback:

Correct answer: b

Learning Objective 2.2 ~ define and assess auditor independence

31. 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 *Corporations Act*.
- b. the client's audit committee.
- c. the client's board of directors.
- \*d. None of the above.

General Feedback:

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

32. Safeguards to independence are created by:

- a. clients.
- b. the profession, legislation or regulation.
- c. accounting firms.
- \*d. all of the above.

*General Feedback:*

Correct answer: d

Learning Objective 2.2 ~ define and assess auditor independence

33. An example of a safeguard to independence created by accounting firms is:

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

General Feedback:

Correct answer: a

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 audit committee.
- \*b. the shareholders or members.
- c. the board of directors.
- d. the Australian Securities and Investments Commission.

General Feedback:

Correct answer: b

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

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

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

General Feedback:

Correct answer: c

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

36. Examples of board committees include the:

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

*General Feedback:*

Correct answer: d

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

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

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

General Feedback:

Correct answer: b

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

38. 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.

General Feedback:

Correct answer: d

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

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

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

*General Feedback:*

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

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

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

*General Feedback:*

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

41. Under tort law, to prove that an auditor has been negligent the plaintiff must establish:

- a. a duty of care was owed by the auditor.
- b. a loss was suffered as a result of the breach of duty of care.
- c. there was a breach of the duty of care.
- \*d. all of the above.

*General Feedback:*

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

42. 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.

*General Feedback:*

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

43. 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. Caparo.
- b. Esanda.
- c. Pacific Acceptance.
- d. Scott Group.

*General Feedback:*

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

44. An auditor's assessment of their client's integrity would not include:

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

*General Feedback:*

Correct answer: b

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

*General Feedback:*

Correct answer: c

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.

a. 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. 110.1 A1). 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 principle that members respect the privacy of information learned as a consequence of their work. Professional behaviour refers to the obligation to comply with relevant laws and regulations and avoid conduct which may discredit the profession.

*Learning Objective 2.1 ~ explain the fundamental principles of professional ethics*

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

a. Safeguards are mechanisms that have been developed by the accounting profession, legislators, regulators, clients and accounting firms (APES 110, s. 120). 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*

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

a. Independence is essential when complying with the ethical principles to act with integrity and objectivity. Independence of mind is the state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, thereby allowing an individual to act with integrity, and exercise 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 avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude that a firm's, or an audit team member's, integrity, objectivity or professional scepticism has been compromised. 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*

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

a. 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 ~ describe 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.

a. 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.

*a. Guided by instructor*

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.

*a. Guided by instructor*

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.

*a. Guided by instructor*