

Chapter Two:

MULTIPLE CHOICE. Choose the one alternative that best completes the statement or answers the question.

1)

While performing services for their clients, auditors, as professionals, have a duty to provide a level of care which is:

A)

free from judgement errors.

B)

superior to that of other auditors.

C)

reasonable.

D)

greater than the average auditor.

Answer:

C

Diff: 1

Topic: Audit regulation

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.1. Describe the main elements of the complex and dynamic regulatory environment in which auditors practise.

2)

Auditors are affected by laws that have been developed by passage through governmental agencies. These are referred to as:

A)

common law.

B)

statutory law.

C)

federal law.

D)

judicial law.

Answer:

B

Diff: 1

Topic: Audit regulation

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.1. Describe the main elements of the complex and dynamic regulatory environment in which auditors practise.

3)

Professionals have long had a legal duty to provide a reasonable level of care while performing work for those they serve because:

A)

it is an implied part of the contract entered into by any professional and his or her client.

B)

professional standards require it.

C)

the criminal law of fraud requires it.

D)

all of the above

Answer:

A

Diff: 1

Topic: Audit regulation

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.1. Describe the main elements of the complex and dynamic regulatory environment in which auditors practise.

4)

Auditors should understand their obligations to clients and third parties under:

1. contract law

2. common law

3. trade practices

4. corporations and securities statutes

A)

1, 2, & 4

B)

1, 2, & 3

C)

1, 3, & 4

D)

1, 2, 3, & 4

Answer:

D

Topic: Audit regulation

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.1. Describe the main elements of the complex and dynamic regulatory environment in which auditors practise.

5)

Auditing is highly regulated, subject to many regulatory influences, including:

1. professional bodies
2. stock exchanges
3. government regulatory agencies
4. state and federal legislation

A)

1, 2, & 4

B)

1, 2, & 3

C)

1, 3, & 4

D)

1, 2, 3, & 4

Answer:

D

Diff: 2

Topic: Audit regulation

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.1. Describe the main elements of the complex and dynamic regulatory environment in which auditors practise.

6) Which area of auditing is NOT affected by statutory regulation?

- A) auditing standards B) auditor independence
C) monitoring of auditors D) All areas of auditing are affected.

Answer: D

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Analytical Thinking

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

7)

The Financial Reporting Council's functions include monitoring the adequacy of systems to ensure the adequacy of:

A)

professional bodies disciplinary procedures.

B)

auditor independence.

C)

professional bodies quality assurance reviews.

D)

all of the above

Answer:

D

Diff: 1

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

8) What are two areas of liability in auditing?

- A) professional liability and criminal liability B) criminal liability and liability under statutory law
C) professional liability and liability under common law D) criminal liability and corporate liability

Answer: B

Diff: 1

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

9)

To be appointed as the auditor of a corporation under the *Corporations Act 2001*, the relevant person must be a registered company auditor or an authorised audit company. Which of the following are criteria for registration by ASIC?

A)

An individual must satisfy requirements in relation to his or her educational qualifications.

B)

Requirements established in s. 1280 of the *Corporations Act*.

C)

An individual must satisfy requirements in relation to his or her character.

D)

All of the above

Answer:

D

Diff: 1

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

10) Regulators are the composition of:

A) the Auditing and Assurance Standards Board. B) an entity's audit committee.

C) an entity's board of directors. D) corporate governance.

Answer: A

Diff: 1

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

11) The Financial Reporting Council (FRC):

A) is the authority for producing auditing standards. B) monitors individual auditors.

C) monitors individual engagements.

D) can seek information about disciplinary actions.

Answer: A

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

12) Which country is responsible for the passage of the *Sarbanes-Oxley Act of 2002*?

A) Australia

B) England

C) Canada

D) United States

Answer: D

Diff: 1

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

13)

Which one of the following statements is correct about criminal actions brought against auditors in Australia?

A)

They have resulted in substantial damages being awarded when they have been successful.

B)

None has resulted in prison sentences.

C)

They have often failed due to lack of causation.

D)

They have been few in number.

Answer:

D

Diff: 1

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

14)

The monitoring of auditors is the primary legal function of:

A)

the Financial Reporting Council (FRC).

B)

each individual firm (for its own staff).

C)

the professional bodies.

D)

all of the above

Answer:

A

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

15)

The activities and duties of auditors may be subject to considerable statutory direction or influences, including:

1. *Crimes Act 1914*
2. *Trade Practices Act 1974*
3. *Corporations Act 2001*
4. *Auditor Independence Act 2004*

A)

1, 2, & 4

B)

1, 2, & 3

C)

1, 3, & 4

D)

1, 2, 3, & 4

Answer:

B

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

16)

A function of the Financial Reporting Council (FRC) is to:

A)

review particular audits.

B)

monitor individual audits and auditors.

C)

require information from a professional body about reviews of a particular audit or disciplinary actions against any particular person.

D)

all of the above

Answer:

C

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

17)

The statutory requirements for independence mean an auditor is prohibited from engaging in audit activity if:

A)

the auditor is aware of a conflict of interest situation in relation to the client but doesn't take all reasonable steps to resolve it.

B)

the auditor is not aware of a conflict of interest situation in relation to the client and doesn't take all reasonable steps to resolve it.

C)

there is a breach of the ethical requirements.

D)

there is a breach of the auditor registration requirements.

Answer:

A

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

18)

Sections 324CE–324CH list specific conditions of contraventions of the independence requirements. The specific conditions include circumstances where the auditor:

A)

is an officer of the client company.

B)

is an audit-critical employee of the client company.

C)

has an investment in the company.

D)

all of the above

Answer:

D

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

19)

In rare cases, auditors have been held liable for criminal acts. A criminal conviction against an auditor can result only when it is demonstrated that the auditor:

A)

caused a financial loss to an innocent third party.

B)

was negligent.

C)

employed a negligent assistant.

D)

was involved knowingly in the presentation of false financial statements.

Answer:

D

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

20)

Which entities require rotation of auditors?

A)

listed companies

B)

listed companies and other disclosing entities

C)

charities and other nonprofit organisations

D)

all entities who owe money to the Australian Taxation Office

Answer:

A

Diff: 3

Topic: Statutes and auditors' liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.2 Describe the main elements of statutory regulation and relevant to auditors and auditing.

21)

It is a criminal offence for an auditor to:

A)

conduct an audit without due care.

B)

fail to detect material fraud.

C)

withhold information from the client.

D)

contravene the independence requirements in the *Corporations Act*.

Answer:

D

Diff: 2

Topic: Criminal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.3. Specify what constitutes criminal liability for auditors.

22)

An auditor failing to report to ASIC a contravention of the *Corporations Act* by a client is an example of:

a securities violation.

B)

criminal liability.

C)

a breach of common law.

D)

contributory negligence.

Answer:

B

Diff: 2

Topic: Criminal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.3. Specify what constitutes criminal liability for auditors.

23)

Statutory offences of auditors can arise through:

A)

making or authorising false or misleading statements.

B)

failing to take reasonable steps to ensure that a statement is not false or misleading.

C)

both of the above

D)

none of the above

Answer:

C

Diff: 2

Topic: Criminal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.3. Specify what constitutes criminal liability for auditors.

24)

The *reasonable person* concept establishes in law that:

A)

an audit in accordance with auditing standards is subject to limitations and cannot be relied upon for complete assurance that all errors and irregularities will be found.

B)

the courts do not require that the auditor become the insurer or guarantor of the accuracy of the statements.

C)

the public accounting firm is not expected to be infallible.

D)

all of the above

Answer:

D

Diff: 2

Topic: Criminal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.3. Specify what constitutes criminal liability for auditors.

25)

Under the laws of agency, partners of a public accounting firm may be liable for the works of others on whom they rely. This would NOT include:

A)

other public accounting firms engaged to do part of the work.

B)

employees of the public accounting firm.

C)

employees of the client.

D)

specialists called upon to provide technical information to the public accounting firm.

Answer:

C

Diff: 1

Topic: Legal concepts affecting liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.4. Define the primary legal concepts affecting auditors' liability.

26) What does NOT result when the auditor issues an erroneous opinion as the result of an underlying failure to comply with the requirements of Australian auditing standards?

A) negligent auditing B) business failure C) criminal liability D) both A and B

Answer: B

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

27) Failure to perform and audit with due care subjects which party to potential criminal liability?

A) the board of directors B) the audit committee

C) the auditor D) the internal auditor

Answer: C

Diff: 1

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

28)

The *London and General Bank Ltd (No.2)* case found that auditors have a duty to report to:

A)

directors and shareholders.

B)

the directors and ASIC.

C)

anyone who may rely on the audited financial reports.

D)

shareholders.

Answer:

D

Diff: 1

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

29)

The *Pacific Acceptance* case was significant because it:

A)

allowed contributory negligence as a defence for audit failure.

B)

dealt with auditors' liability to shareholders.

C)

established that liability might exist to third parties.

D)

dealt with aspects related to auditors' duties.

Answer:

D

Diff:

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

30)

A 'negligence calculus' has four components. Which of the following is NOT a component?

A)

likely seriousness of harm

B)

taking precautions to avoid harm

C)

taking out insurance against causing harm

D)

probability of harm occurring

Answer:

C

Diff: 1

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

31)

Which of the following is an illustration of auditor's liability to a client?

A)

Federal government prosecutes auditor for knowingly issuing an incorrect audit report.

B)

Combined group of stockholders sue auditor for not discovering materially misstated financial statements.

C)

Bank sues auditor for not discovering that borrower's financial statements are misstated.

D)

Client sues auditor for not discovering a theft of assets by an employee.

Answer:

D

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

32)

It is clear from s. 199A of the *Corporations Act* that auditors:

A)

can design clauses in letters of engagement to exempt or indemnify an auditor from or against any legal liability that would otherwise attach to the auditor.

B)

have the defence of contributory negligence available to them.

C)

cannot contract out of their duty to client companies.

D)

all of the above

Answer:

C

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

33)

Many of the major legal cases against public accountants have dealt with:

A)

disputes over income tax preparation services.

B)

disputes arising in the performance of MAS contracts.

C)

audited financial statements.

D)

disputes over the accuracy of bookkeeping services.

Answer:

C

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

34)

Tort actions against public accounting firms are more common than breach of contract actions because:

A)

the burden of proof is on the auditor rather than on the person suing.

B)

the person suing need prove only negligence.

C)

there are more torts than contracts.

D)

the amounts recoverable are normally larger.

Answer:

D

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

35)

Which one of the following was NOT a finding in the *Pacific Acceptance* case?

A)

Audit programs should be updated each year.

B)

The auditors were entitled to rely on management representations.

C)

The auditors failed to use appropriate vouching procedures.

D)

Certain discoveries should have been communicated by the auditors to the board of directors.

Answer:

B

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

36)

That which constitutes reasonable care, skill, and caution in an audit depends on the:

A)

particular circumstances of each case.

B)

level of audit risk involved.

C)

integrity of management.

D)

auditing standards existing at the time.

Answer:

A

Diff: 3

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

37)

The auditor's duty to inform management about irregularities regardless of materiality was established in which one of the following cases?

A)

WA Chip and Pulp Co

B)

Pacific Acceptance

C)

AWA

D)

Kingston Cotton Mills

Answer:

A

Diff: 3

Topic: Liability to clients

38)

The *AWA* case and the *Pacific Acceptance* case discussed:

A)

client acceptance.

the duty to inform management.

C)

privity letters.

management representation letters.

Answer:

B

Diff: 2

Topic: Liability to clients

AACSB: Ethical understanding and reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

39)

Contributory negligence:

A)

failed as a defence in the *AWA* case.

B)

cannot be used in cases involving a breach of statutory duty.

C)

has been interpreted very widely by Australian courts.

D)

was successfully argued in the *Pacific Acceptance* case.

Answer:

B

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

40)

In third-party suits, which of the auditor's defences contends lack of privity of contract?

A)

non-negligent performance

B)

absence of causal connections

C)

contributory negligence

D)

lack of duty

Answer:

D

Diff: 1

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

41)

Which one of the following was NOT set out as a test for establishing a duty of care in *Al Saudi Banque*?

A)

reasonableness

B)

intention to induce

C)

foreseeability

D)

proximity

Answer:

B

Diff: 1

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditors' liability to third parties under common law.

42) Which document serves as an acknowledgement of a third party's reliance on the audited financial reports for decisions?

- A) management representation letter
- B) audit engagement letter
- C) letter from client's legal counsel
- D) privity letter

Answer: D

Diff: 1

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditors' liability to third parties under common law.

43)

Audit reports are an insufficient basis for financing decisions by a diligent financier because:

A)

the audit report is out of date by the time of publication.

B)

the auditor might be negligent.

C)

an inappropriate audit opinion might be issued as a result of not complying with auditing standards.

D)

an unqualified audit opinion might be issued when the financial statements are materially misstated.

Answer:

A

Diff: 1

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditors' liability to third parties under common law.

44)

Which one of the following statements is correct about *Candler v Crane, Christmas & Co*?

A)

A special relationship did not exist.

B)

There was no liability for financial loss.

C)

Losses were not foreseeable.

D)

all of the above

Answer:

B

Diff: 2

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

45)

In the *Scott Group* case, the auditors were found to owe a duty of care to:

A)

the contractual parties only.

B)

a totally unknown third party.

C)

the body of shareholders as a whole.

D)

existing creditors.

Answer:

B

Diff: 2

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

46)

In the *Caparo* case, it was stated that the purpose of the audit report is to:

A)

only provide information to the company and its shareholders.

B)

provide information to third parties.

C)

report on the accuracy of the financial statements.

D)

all of the above

Answer:

C

Diff: 2

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

47)

The judgement in the *Caparo* case decreed no auditor liability to a third party because:

A)

a duty of care could not be established.

B)

no loss was suffered.

C)

a breach of duty of care could not be demonstrated.

D)

causation could not be established.

Answer:

A

Diff: 2

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

48)

To succeed in an action against the auditor, the client must be able to show that:

A)

the auditor was grossly negligent.

B)

there is a close causal connection between the auditor's breach of the standard of due care and the damages suffered by the client.

C)

the auditor was fraudulent.

D)

there was a written contract.

Answer:

B

Diff: 2

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

49)

Which of the following is NOT a test a plaintiff must satisfy in order to recover damages against the auditor?

A)

A duty of care was owed.

B)

Plaintiff's performance was negligent.

C)

A duty of care was breached.

D)

Plaintiff suffered losses.

Answer:

B

Diff: 1

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditors' liability to third parties under common law.

50)

In the *AGC* case, the court held the view that communication between AGC and the auditor:

A)

established proximity.

B)

indicated that reliance was reasonable.

C)

was evidence of a necessary special relationship.

D)

did not bring about a relationship giving rise to a duty of care.

Answer:

D

Diff: 3

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

51)

In the *Columbia Coffee and Tea* case, the auditors were found to owe a duty of care to a third party because:

A)

the criteria established in *Al Saudi Banque* were satisfied.

B)

of a statement contained in the auditor's manual.

C)

the party and its intended reliance were known.

D)

all of the above

Answer:

B

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

52)

The AGC case added which one of the following criteria to the tests determining whether a duty of care is owed to a third party?

A)

prevailing community standards

B)

purpose of reliance must be known

C)

intention to induce

D)

user must be known

Answer:

C

Diff: 3

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

53)

The *Columbia Coffee and Tea* judgement:

A)

sought to apply a common sense approach.

B)

endorsed the judgement made in the AGC case.

C)

was applied by the High Court in its *Esanda* decision.

D)

all of the above

Answer:

A

Diff: 3

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

54)

In the *Esanda Finance Corporation Ltd v Peat Hungerfords* case, the court:

A)

confirmed the auditors' duties as stated in the *Pacific Acceptance* case.

B)

stated the auditors were aware of the intention of the third party's reliance on the audit report.

C)

stated auditors must undertake the audit with reasonable skill and care.

D)

all of the above

Answer:

B

Diff: 3

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

55)

The notion of proximity:

A)

is separate from consideration of reasonable reliance.

B)

has a precise legal definition.

C)

can relate to nonspecific third parties.

D)

is not separate from foreseeability.

Answer:

D

Diff: 3

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

56)

In which case was it held that an auditor did not owe a duty of care to potential shareholders?

A)

Caparo

B)

Cambridge Credit

C)

London and General Bank

D)

Nelson Guarantee Corp Ltd

Answer:

A

Diff: 3

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

57)

A privity letter should NOT be provided:

A)

under any circumstances.

B)

if the audit is being conducted under the *Corporations Act*.

C)

if the third party seeking it fails to acknowledge in writing the potential inadequacy of the audit report for its purpose.

D)

if reliance is foreseeable.

Answer:

C

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

58)

In connection with the examination of financial statements, an independent auditor could be responsible for failure to detect a material fraud if:

A)

the auditor performing important parts of the work failed to discover a close relationship between the treasurer and the cashier.

B)

statistical sampling techniques were not used on the audit engagement.

C)

the auditor planned the work in a hasty and inefficient manner.

D)

the fraud was perpetrated by one trusted client employee, who circumvented the existing internal controls.

Answer:

C

Diff: 2

Topic: Fraud and error

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.7. Describe the auditor's responsibilities for detecting and reporting fraud and error.

59)

An auditor's examination performed in accordance with Australian auditing standard *ASA 240* generally should:

A)

guarantee that illegal acts will be detected.

B)

ensure a review of conditions and events that increase the risk of irregularity.

C)

encompass a plan to search actively for illegalities which relate to environmental reporting.

D)

be relied upon to disclose violations of client confidentiality.

Answer:

B

Diff: 2

Topic: Fraud and error

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.7. Describe the auditor's responsibilities for detecting and reporting fraud and error.

60)

The *WA Chip and Pulp Co.* case reaffirmed the:

A)

importance of auditor independence.

B)

duty to investigate suspicions of fraud regardless of its materiality.

C)

duty to conduct the audit with reasonable care and skill.

D)

duty to inform management if there is a suspicion of a material fraud.

Answer:

B

Diff: 3

Topic: Fraud and error

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.7. Describe the auditor's responsibilities for detecting and reporting fraud and error.

61)

There are a number of things that audit firms can do to reduce their exposure to lawsuits. Which one of the following is

NOT such an item?

A)

Perform quality audits.

B)

Hire qualified auditors and train and supervise them.

C)

Deal only with clients possessing integrity.

D)

Sanction other firms for improper conduct and performance.

Answer:

D

Diff: 1

Topic: Managing individual legal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.8. Discuss how individual auditors and firms can manage legal liability exposure.

62)

The respective obligations of the client and auditor are outlined in:

A)

a letter of recommendation.

B)

an expert witness's testimony.

C)

an engagement letter.

D)

a confirmation letter.

Answer:

C

Diff: 2

Topic: Managing individual legal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.8. Discuss how individual auditors and firms can manage legal liability exposure.

63)

Which one of the following is a NOT a method to reduce auditors' legal liability?

A)

Exercise professional scepticism.

B)

Perform quality audits.

C)

Include a disclaimer paragraph in the audit report.

D)

Employ qualified personnel.

Answer:

C

Topic: Managing individual legal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.8. Discuss how individual auditors and firms can manage legal liability exposure.

TRUE/FALSE. Write 'T' if the statement is true and 'F' if the statement is false.

64)

Liability to third parties is a contentious issue in auditing.

Answer:



True

False

Diff: 1

Topic: Audit regulation

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.1. Describe the main elements of the complex and dynamic regulatory environment in which auditors practise.

65)

Legal liability and the cost of defending actions have been a significant problem for the auditing profession in Australia.

Answer:



True

False

Diff: 1

Topic: Audit regulation

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.1. Describe the main elements of the complex and dynamic regulatory environment in which auditors practise.

66)

Proportionate liability is the risk an auditor takes that an entity will fail, and he or she is liable for all losses incurred by the entity.

Answer:

True



False

Explanation:

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

67)

An auditor holds office for a period of twelve months, with reappointment required annually.

Answer:

True



False

Explanation:

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

68)

A specific provision of the *Corporations Act* which could lead to a conflict of interest is the auditor having a loan from the audit client of more than \$10,000.

Answer:

True



False

Explanation:

Diff: 2

Topic: Statutes and auditors' liability

AACSB: Written and Oral Communication

Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

69)

The standard of due care to which the auditor is expected to be held is referred to as the reasonable person concept.

Answer:



True

False

Explanation:

Diff: 1

Topic: Legal concepts affecting liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.4. Define the primary legal concepts affecting auditors' liability.

70)

An example of auditor legal liability to third parties under common law would be the federal government prosecuting an auditor for knowingly issuing an incorrect audit report.

Answer:

True



False

Explanation:

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

71)

The auditor's duty to inform management extends to nonmaterial irregularities.

Answer:



True

False

Explanation:

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

72)

A contributory negligence defence succeeded in the *AWA Ltd v Daniels* case.

Answer:



True

False

Explanation:

Diff: 2

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

73)

A tort is a civil wrong, of which negligence is a good example.

Answer:



True

False

Explanation:
Diff: 2

Topic: Liability to clients
AACSB: Ethical Understanding and Reasoning
Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

74)

Common law generally allows auditors to withhold information from the courts by claiming such information is privileged.

Answer:

True



False

Explanation:
Diff: 2

Topic: Liability to clients
AACSB: Ethical Understanding and Reasoning
Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

75)

In *Al Saudi Banque*, a duty of care was found not to be owed to prospective lenders.

Answer:



True

False

Explanation:
Diff: 2

Topic: Liability to third parties under common law
AACSB: Ethical Understanding and Reasoning
Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

76)

Legal liability of auditors in Australia, particularly in relation to third parties, was expanded by the *Esanda* case in 1997.

Answer:

True



False

Explanation:

Diff: 2

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

77)

When the auditors have followed Australian auditing standards yet still fail to discover immaterial fraud, courts will find them liable.

Answer:



True

False

Explanation:

Diff: 2

Topic: Fraud and error

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.7. Describe the auditor's responsibilities for detecting and reporting fraud and error.

78)

If an auditor's suspicion of fraud is aroused, investigations should be extended.

Answer:



True

False

Explanation:
Diff: 2

Topic: Fraud and error
AACSB: Ethical Understanding and Reasoning
Objective: LO 2.7. Describe the auditor's responsibilities for detecting and reporting fraud and error.

SHORT ANSWER. Write the word or phrase that best completes each statement or answers the question.

79)

Does the auditing profession in Australia register public company auditors?

Answer:

No. To be appointed as a registered auditor, an applicant must apply to ASIC and satisfy its requirements. These include requirements as to character, experience, competence and educational qualifications. Membership of one of the professional bodies is effectively mandatory, but membership of the profession in itself does not qualify for registration with ASIC.

As of 1 July 2004, a company can be registered if it satisfies the criteria contained in s. 1299B of the *Corporations Act*. The criteria relate to (1) ownership and control of the company, and (2) professional indemnity insurance.

Explanation:

Topic: Statutes and auditors' liability
AACSB: Written and Oral Communication
Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

80)

What is the role of the Financial Reporting Council (FRC) in monitoring the audit profession?

Answer:

The FRC can require a professional body to provide information regarding its code of professional conduct (and any proposed changes), its planning and performance of quality assurance reviews, and its investigation and disciplinary procedures (s. 225A). Note that the FRC doesn't monitor individual auditors or engagements.

Explanation:
Diff: 3

Topic: Statutes and auditors' liability
AACSB: Written and Oral Communication
Objective: LO 2.2. Describe the main elements of statutory regulation relevant to auditors and auditing.

81)

There are four common sources of an auditor's legal liability. One source is liability to the audit client under common law. Briefly summarise the other three sources.

Answer:

The other three sources of an auditor's liability are as follows:

- liability to third parties under common law
- liability to shareholders under statutory law
- criminal liability

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

82)

Explain how an auditor might be able to use a disclaimer of liability.

Answer:

The *Corporations Act* prevents auditors using disclaimers to contract out of liability to auditee companies. However, it is likely that disclaimers could be used effectively in relation to third party liability.

Explanation:

Diff: 3

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

83)

Identify the four tests that a plaintiff must satisfy in order to recover damages against the auditor.

Answer:

1. The auditor owed a duty of care to the plaintiff.
2. The duty of care was breached.
3. The plaintiff suffered a loss.
4. The loss resulted, at least in part, from the auditor's breach of duty.

Diff: 1

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

ESSAY. Write your answer in the space provided or on a separate sheet of paper.

84)

Explain what the following terms mean:

1. reasonable person
2. proximity

Answer:

1. It is expected that an auditor conduct the audit with due care. This does not require the auditor to be perfect; however, auditors are expected to bring a reasonable degree of professional skill and care to each engagement. The auditor undertakes in good faith and integrity but not infallibility.
2. To establish proximity, a third party must show that the auditors knew or ought to have known that a particular third party would rely on the auditor's work or opinion and that their purpose in doing so was reasonable.

Topic: Legal concepts affecting liability , Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objectives: LO 2.4. Define the primary legal concepts affecting auditors' liability.

LO 2.6. Describe the auditor's liability to third parties under common law.

85)

Explain the significance of the statement that an auditor is 'a watchdog but not a bloodhound'.

Answer:

This statement, made in the judgement in the *Kingston Cotton Mills* case, refers to the auditor's duty to detect fraud and irregularities. It means that the auditor is not expected to track down every possible fraudulent activity or irregularity but, more reasonably, to act as a watchdog by planning an audit such that there is a reasonable expectation of detecting fraud and error.

Diff: 3

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

86)

Discuss the distinction between contractual and tortious liability in actions by clients against auditors.

Answer:

The distinction between contractual and tortious liability in actions by clients against auditors is economically significant. The main difference lies in the remedies available to the plaintiff. An action in contract allows the plaintiff to recover losses suffered or profits forgone. An action in tort allows the claim of restoration to the plaintiff's position in the absence of the negligent conduct. Therefore, many legal actions involving clients are based in torts rather than contract actions, because the amount recoverable in tort is often larger.

Topic: Liability to clients

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.5. Describe the auditor's liability to clients and duties to management.

87)

Discuss the purpose of a privity letter and how the auditor should respond to such a request.

Answer:

A privity letter is a letter from a third party requesting that the auditor acknowledge the third party's reliance on the audited financial report for decision making.

AGS 1014 advises auditors to do one of the following:

- Provide an unequivocal statement that the audit report is intended for use only by the body of shareholders.
- If the auditor acknowledges responsibility to the specific third party, the auditor should obtain written representation from the third party identifying the scope and nature of the audit and acknowledging the potential inadequacy of the audit report for the third party's purposes.

Diff: 2

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

88)

What is the likelihood of an investor making a takeover bid succeeding in an action for negligence against the auditor of the takeover target?

Answer:

Given the precedent set in the *AGC* case and affirmed in *Esanda*, it is very unlikely that the courts would consider that a duty of care was owed to this third party because of the 'intention to induce' principal. The auditors would argue their intention was merely to fulfil statutory and legal obligations and not to induce the third party to act in reliance on the audited financial statements.

Diff: 3

Topic: Liability to third parties under common law

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.6. Describe the auditor's liability to third parties under common law.

89)

Discuss some of the steps individual practising auditors can take to minimise their legal liability.

Answer:

There are many steps individual practitioners can take to minimise legal liability:

- Deal only with clients possessing integrity.
- Hire qualified personnel and train and supervise them properly.
- Follow the standards of the profession.
- Maintain independence.
- Understand the client's business.
- Perform quality audits.
- Document the work properly.
- Obtain an engagement letter and a representation letter.
- Maintain confidential relations.
- Carry adequate insurance.
- Seek legal counsel.

Diff: 1

Topic: Managing individual legal liability

AACSB: Ethical Understanding and Reasoning

Objective: LO 2.8. Discuss how individual auditors and firms can manage legal liability exposure.