Exam

Name___________________________________

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

1) In the *Columbia Coffee and Tea* case, the auditors were found to owe a duty of care to a third party because: 1) ________

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
Explanation: A)
B)
C)
D)

2) A privity letter: 2) ________

A) sets out the terms of a contractual audit engagement.
B) is a written acknowledgement of a third party's reliance on audited financial statements.
C) can be used to disclaim liability in a statutory audit.
D) must be sent to management when control deficiencies are discovered during an audit.

Answer: B
Explanation: A)
B)
C)
D)

3) The judgement in the *Caparo* case decreed no auditor liability to a third party because: 3) ________

A) no loss was suffered.
B) a duty of care could not be established.
C) causation could not be established.
D) a breach of duty of care could not be demonstrated.

Answer: B
Explanation: A)
B)
C)
D)

4) 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: 4) ________

A) specialists called upon to provide technical information to the public accounting firm.
B) employees of the public accounting firm.
C) employees of the client.
D) other public accounting firms engaged to do part of the work.

Answer: C
Explanation: A)
B)
C)
D)

5) To succeed in an action against the auditor, the client must be able to show that: 5) ________

A) there is a close causal connection between the auditor's breach of the standard of due care and the damages suffered by the client.
B) there was a written contract.
C) the auditor was fraudulent.
D) the auditor was grossly negligent.

Answer: A
Explanation: A)
B)
C)
D)

6) While performing services for their clients, auditors, as professionals, have a duty to provide a level of care which is: 6) ________

A) greater than the average auditor.
B) superior to that of other auditors.
C) reasonable.
D) free from judgement errors.

Answer: C
Explanation: A)
B)
C)
D)

7) It is a criminal offence for an auditor to: 7) ________

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
Explanation: A)
B)
C)
D)

8) 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: 8) ________

A) was involved knowingly in the presentation of false financial statements.
B) employed a negligent assistant.
C) caused a financial loss to an innocent third party.
D) was negligent.

Answer: A
Explanation: A)
B)
C)
D)

9) In which case was it held that an auditor did not owe a duty of care to potential shareholders? 9) ________

A) *Cambridge Credit*
B) *London and General Bank*
C) *Nelson Guarantee Corp Ltd*
D) *Caparo*

Answer: D
Explanation: A)
B)
C)
D)

10) The Auditing and Assurance Standards Board is a committee of: 10) ________

A) AARF employees.
B) FRC appointees.
C) regulators.
D) auditors.

Answer: B
Explanation: A)
B)
C)
D)

11) Statutory regulation affects what areas of auditing? 11) ________

A) Auditor resignation
B) Auditor appointment
C) Auditor independence
D) All of the above

Answer: D
Explanation: A)
B)
C)
D)

12) 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? 12) ________

A) Purpose of reliance must be known
B) Prevailing community standards
C) Intention to induce
D) User must be known

Answer: C
Explanation: A)
B)
C)
D)

13) Section 324CE-CH lists specific conditions of contraventions of the independence requirements. The specific conditions include circumstances where the auditor: 13) ________

A) is an audit-critical employee of the client company.
B) is an officer of the client company.
C) has an investment in the company.
D) all of the above

Answer: D
Explanation: A)
B)
C)
D)

14) The *Columbia Coffee and Tea* judgement: 14) ______

A) was applied by the High Court in its *Esanda* decision.
B) sought to apply a common sense approach.
C) endorsed the judgement made in the *AGC* case.
D) all of the above

Answer: B
Explanation: A)
B)
C)
D)

15) Auditing standards are produced under authority of the: 15) ______

A) AARF.
B) ASX.
C) CPA Australia and the ICAA.
D) FRC.

Answer: D
Explanation: A)
B)
C)
D)

16) Statutory offences of auditors can arise through: 16) ______

A) failing to take reasonable steps to ensure that a statement is not false or misleading.
B) making or authorising false or misleading statements.
C) both of the above
D) none of the above

Answer: C
Explanation: A)
B)
C)
D)

17) In connection with the examination of financial statements, an independent auditor could be responsible for failure to detect a material fraud if: 17) ______

A) the auditor planned the work in a hasty and inefficient manner.
B) the auditor performing important parts of the work failed to discover a close relationship between the treasurer and the cashier.
C) statistical sampling techniques were not used on the audit engagement.
D) the fraud was perpetrated by one trusted client employee, who circumvented the existing internal controls.

Answer: A
Explanation: A)
B)
C)
D)

18) 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. The criteria for registration by ASIC include: 18) _______

A) An individual must satisfy requirements in relation to his or her educational qualifications.
B) 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
Explanation: A)
B)
C)
D)

19) Auditors are liable to their clients for: 19) _______

A) presentation of the financial statements.
B) failure to perform the audit with due care.
C) the efficient operations of the audit clients reporting function.
D) errors of judgement made in good faith.

Answer: B
Explanation: A)
B)
C)
D)

20) Which one of the following is not one of the four areas of liability in auditing? 20) _______

A) Criminal liability
B) Professional liability
C) Liability under statutory law
D) Liability under common law

Answer: B
Explanation: A)
B)
C)
D)

21) Which of the following is a defence an auditor may argue to reduce a damages claim from an audit client? 21) _______

A) Negligent performance by the auditor
B) Contributory negligence by management
C) A duty of care was owed
D) Plaintiff suffered losses

Answer: B
Explanation: A)
B)
C)
D)

22) When the auditor issues an erroneous opinion as the result of an underlying failure to comply with the requirements of Australian auditing standards, it results in: 22) ______

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

Answer: D
Explanation: A)
B)
C)
D)

23) The *reasonable person* concept establishes in law that: 23) ______

A) the courts do not require that the auditor become the insurer or guarantor of the accuracy of the statements.
B) the public accounting firm is not expected to be infallible.
C) 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.
D) All three of the above are true.

Answer: D
Explanation: A)
B)
C)
D)

24) What constitutes reasonable care, skill and caution in an audit depends on the: 24) ______

A) level of audit risk involved.
B) integrity of management.
C) particular circumstances of each case.
D) auditing standards existing at the time.

Answer: C
Explanation: A)
B)
C)
D)

25) The duty to inform management was discussed in which case? 25) ______

A) The *AWA* case
B) The *WA Chip & Pulp Co* case
C) The *Pacific Acceptance* case
D) All of the above

Answer: D
Explanation: A)
B)
C)
D)

26) Auditing is highly regulated, subject to many regulatory influences, including: 26) ______
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
Explanation: A)
B)
C)
D)

27) Which one of the following was NOT set out as a test for establishing a duty of care in *Al Saudi Banque*? 27) ______

A) Proximity
B) Reasonableness
C) Foreseeability
D) Intention to induce

Answer: D
Explanation: A)
B)
C)
D)

28) Many of the major legal cases against public accountants have dealt with: 28) ______

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
Explanation: A)
B)
C)
D)

29) The *Sarbanes-Oxley Act 2002,* enacted in the United States, applies to all companies registered with the Securities and Exchange Commission and has which of the main consequences for auditors? 29) ______

A) Specific auditor independence requirements
B) Established the Public Company Accounting Oversight Board (PCAOB)
C) Mandatory registration
D) All of the above

Answer: D
Explanation: A)
B)
C)
D)

30) In the *Scott Group* case, the auditors were found to owe a duty of care to: 30) ______
A) the body of shareholders as a whole.
B) the contractual parties only.
C) existing creditors.
D) a totally unknown third party.

Answer: D
Explanation: A)
B)
C)
D)

31) A privity letter should NOT be provided: 31) ______
A) if the audit is being conducted under the Corporations Act.
B) if the third party seeking it fails to acknowledge in writing the potential inadequacy of the audit report for its purpose.
C) under any circumstances.
D) if reliance is foreseeable.

Answer: B
Explanation: A)
B)
C)
D)

32) Mandatory audit rotation applies to: 32) ______
A) listed companies only.
B) all entities who owe money to the Australian Taxation Office.
C) listed companies and other disclosing entities.
D) charities and other nonprofit organisations only.

Answer: A
Explanation: A)
B)
C)
D)

33) The *WA Chip and Pulp Co.* case reaffirmed: 33) ______
A) the importance of auditor independence.
B) the duty to conduct the audit with reasonable care and skill.
C) the duty to investigate suspicions of fraud regardless of its materiality.
D) the duty to inform management if there is a suspicion of a material fraud.

Answer: C
Explanation: A)
B)
C)
D)

34) In the *Caparo* case, it was stated that the purpose of the audit report is to: 34) ______

A) provide information to third parties.
B) only provide information to the company and its shareholders.
C) report on the accuracy of the financial statements.
D) all of the above

Answer: C
Explanation: A)
B)
C)
D)

35) The *London and General Bank Ltd (No.2)* case found that: 35) ______

A) auditors have a duty to report to shareholders.
B) auditors have a duty to report to anyone who may rely on the audited financial reports.
C) auditors have a duty to report to directors and shareholders.
D) auditors have a duty to report to the directors and ASIC.

Answer: A
Explanation: A)
B)
C)
D)

36) Audit reports are an insufficient basis for financing decisions by a diligent financier because: 36) ______

A) an inappropriate audit opinion might be issued as a result of not complying with auditing standard.
B) an unqualified audit opinion might be issued when the financial statements are materially misstated.
C) the auditor might be negligent.
D) the audit report is out of date by the time of publication.

Answer: D
Explanation: A)
B)
C)
D)

37) Tort actions against public accounting firms are more common than breach of contract actions because: 37) ______

A) the person suing need prove only negligence.
B) the amounts recoverable are normally larger.
C) there are more torts than contracts.
D) the burden of proof is on the auditor rather than on the person suing.

Answer: B
Explanation: A)
B)
C)
D)

38) 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? 38) ______

A) Deal only with clients possessing integrity
B) Hire qualified auditors and train and supervise them
C) Perform quality audits
D) Sanction other firms for improper conduct and performance

Answer: D
Explanation: A)
B)
C)
D)

39) Auditors should understand their obligations to clients and third parties under: 39) ______

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
Explanation: A)
B)
C)
D)

40) Professionals have long had a legal duty to provide a reasonable level of care while performing work for those they serve because: 40) ______

A) it is an implied part of the contract entered into by any professional and his or her client.
B) the criminal law of fraud requires it.
C) professional standards require it.
D) all of the above

Answer: A
Explanation: A)
B)
C)
D)

41) The statutory requirements for independence mean an auditor is prohibited from engaging in audit activity if: 41) ______

A) there is a conflict of interest situation in relation to the client of which the auditor is not aware and doesn't take all reasonable steps to resolve.
B) there is a breach of the ethical requirements.
C) there is a conflict of interest situation in relation to the client of which the auditor is aware but doesn't take all reasonable steps to resolve.
D) there is a breach of the auditor registration requirements.

Answer: C
Explanation: A)
B)
C)
D)

42) The activities and duties of auditors may be subject to considerable statutory direction or influences, including: 42) _______

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

Explanation: A)
B)
C)
D)

43) In the *AGC* case, the court held the view that communication between AGC and the auditor: 43) _______

A) was evidence of a necessary special relationship.
B) established proximity.
C) indicated that reliance was reasonable.
D) did not bring about a relationship giving rise to a duty of care.

Answer: D

Explanation: A)
B)
C)
D)

44) Which one of the following statements is correct about criminal actions brought against auditors in Australia? 44) _______

A) They have often failed due to lack of causation.
B) They have resulted in substantial damages being awarded when they have been successful.
C) None has resulted in prison sentences.
D) They have been few in number.

Answer: D

Explanation: A)
B)
C)
D)

45) Which one of the following was NOT a finding in the *Pacific Acceptance* case? 45) _______

A) The auditors were entitled to rely on management representations.
B) Certain discoveries should have been communicated by the auditors to the board of directors.
C) Audit programs should be updated each year.
D) The auditors failed to use appropriate vouching procedures.

Answer: A

Explanation: A)
B)
C)
D)

46) An auditor's examination performed in accordance with Australian auditing standard *ASA 240* generally should: 46) ______

A) be relied upon to disclose violations of client confidentiality.
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) guarantee that illegal acts will be detected.

Answer: B
Explanation: A)
B)
C)
D)

47) The notion of proximity: 47) ______

A) is separate from consideration of reasonable reliance.
B) is not separate from foreseeability.
C) can relate to nonspecific third parties.
D) has a precise legal definition.

Answer: B
Explanation: A)
B)
C)
D)

48) In the *Esanda Finance Corporation Ltd v Peat Hungerfords* case, the court: 48) ______

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
Explanation: A)
B)
C)
D)

49) A common way for a public accounting firm to ensure the respective obligations of the client and auditor are understood is by use of: 49) ______

A) a letter of recommendation.
B) an engagement letter.
C) a confirmation letter.
D) an expert witness' testimony.

Answer: B
Explanation: A)
B)
C)
D)

50) The monitoring of auditors is the primary legal function of: 50) _______

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
Explanation: A)
B)
C)
D)

51) Which one of the following is a NOT a method to reduce auditors' legal liability? 51) _______

A) Perform quality audits
B) Employ qualified personnel
C) Include a disclaimer paragraph in the audit report
D) Exercise professional scepticism

Answer: C
Explanation: A)
B)
C)
D)

52) The *Pacific Acceptance* case was significant because it: 52) _______

A) dealt with auditors' liability to shareholders
B) allowed contributory negligence as a defence for audit failure.
C) dealt with aspects related to auditors' duties.
D) established that liability might exist to third parties.

Answer: C
Explanation: A)
B)
C)
D)

53) A function of the Financial Reporting Council (FRC) is to: 53) _______

A) require information from a professional body about reviews of a particular audit of disciplinary actions against any particular person.
B) monitor individual audits and auditors.
C) review particular audits.
D) all of the above

Answer: A
Explanation: A)
B)
C)
D)

54) In third-party suits, which of the auditor's defences contends lack of privity of contract? 54) _______

A) Lack of duty
B) Absence of causal connections
C) Non-negligent performance
D) Contributory negligence

Answer: A
Explanation: A)
B)
C)
D)

55) Which of the following is an illustration of auditor's liability to a client? 55) _______

A) Bank sues auditor for not discovering that borrower's financial statements are misstated.
B) Federal government prosecutes auditor for knowingly issuing an incorrect audit report.
C) Client sues auditor for not discovering a theft of assets by an employee.
D) Combined group of stockholders sue auditor for not discovering materially misstated financial statements.

Answer: C
Explanation: A)
B)
C)
D)

56) The auditor's duty to inform management about irregularities regardless of materiality was established in which one of the following cases? 56) _______

A) *WA Chip and Pulp Co*
B) *Kingston Cotton Mills*
C) *AWA*
D) *Pacific Acceptance*

Answer: A
Explanation: A)
B)
C)
D)

57) The Financial Reporting Council's functions include monitoring the adequacy of systems to ensure the adequacy of: 57) _______

A) professional bodies disciplinary procedures.
B) auditor independence.
C) professional bodies quality assurance reviews.
D) all of the above

Answer: D
Explanation: A)
B)
C)
D)

58) A 'negligence calculus' has four components. Which of the following is NOT a component? 58) _______

A) Taking precautions to avoid the harm
B) Taking out insurance against causing harm
C) Probability of harm occurring
D) Likely seriousness of harm

Answer: B
Explanation: A)
B)
C)
D)

59) Auditors are affected by laws that have been developed by passage through governmental agencies. These are referred to as: 59) ______

A) federal law. B) common law. C) statutory law. D) judicial law.

Answer: C

Explanation: A)
B)
C)
D)

60) Which of the following is an illustration of criminal liability? 60) ______

A) Auditors fail to report to ASIC a contravention of the *Corporations Act* by a client.
B) Client sues auditor for not discovering a theft of assets by an employee.
C) Bank sues auditor for not discovering that borrower's financial statements are misstated.
D) Combined group of stockholders sue auditor for not discovering materially misstated financial statements.

Answer: A

Explanation: A)
B)
C)
D)

61) It is clear from s. 199A of the *Corporations Act* that auditors: 61) ______

A) have the defence of contributory negligence available to them.
B) can design clauses in letters of engagement to exempt or indemnify an auditor from or against any legal liability that would otherwise attach are valid.
C) cannot contract out of their duty to client companies.
D) all of the above

Answer: C

Explanation: A)
B)
C)
D)

62) Which one of the following statements is correct about *Candler v Crane, Christmas & Co*? 62) ______

A) There was no liability for financial loss. B) A special relationship did not exist.
C) Losses were not foreseeable. D) All of the above

Answer: A

Explanation: A)
B)
C)
D)

63) Contributory negligence: 63) ______

A) has been interpreted very widely by Australian courts.
B) cannot be used in cases involving a breach of statutory duty.
C) failed as a defence in the *AWA* case.
D) was successfully argued in the *Pacific Acceptance* case.

Answer: B
Explanation: A)
B)
C)
D)

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

64) Explain how an auditor might be able to use a disclaimer of liability. 64) ______________

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:

65) Identify the four tests that a plaintiff must satisfy in order to recover damages against the auditor. 65) ______________

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.

Explanation:

66) What is the role of the FRC in monitoring the audit profession? 66) ______________

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:

67) There are four common sources of auditor's legal liability. One source is liability to the audit client under common law. Briefly summarise the other three sources. 67) ______________

Answer: The other three sources of auditor's liability are:
· Liability to third parties under common law
· Liability to shareholders under statutory law
· Criminal liability.

Explanation:

68) Does the auditing profession in Australia register public company auditors? 68) ____________

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:

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

69) When the auditors have followed Australian auditing standards yet still fail to discover immaterial fraud, courts will find them liable. 69) ______

Answer: ✔ True False
Explanation:

70) A tort is a civil wrong, of which negligence is a good example. 70) ______

Answer: ✔ True False
Explanation:

71) Liability to third parties is a contentious issue in auditing. 71) ______

Answer: ✔ True False
Explanation:

72) 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. 72) ______

Answer: True ✔ False
Explanation:

73) Common law generally allows auditors to withhold information from the courts by claiming such information is privileged. 73) ______

Answer: True ✔ False
Explanation:

74) In *Al Saudi Banque*, a duty of care was found not to be owed to prospective lenders. 74) ______

Answer: ✔ True False
Explanation:

75) 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. 75) ______

Answer: True ✔ False
Explanation:

76) Legal liability of auditors in Australia, particularly in relation to third parties, was expanded by the *Esanda* case in 1997. 76) ______

Answer: True ✔ False
Explanation:

77) The standard of due care to which the auditor is expected to be held is referred to as the reasonable person concept. 77) _______

Answer: ✔ True False
Explanation:

78) If an auditor's suspicion of fraud is aroused, investigations should be extended. 78) _______

Answer: ✔ True False
Explanation:

79) An auditor holds office for a period of twelve months, with reappointment required annually. 79) _______

Answer: True ✔ False
Explanation:

80) A contributory negligence defence succeeded in the *AWA Ltd v Daniels* case. 80) _______

Answer: ✔ True False
Explanation:

81) Legal liability and the cost of defending actions have been a significant problem for the auditing profession in Australia. 81) _______

Answer: ✔ True False
Explanation:

82) 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. 82) _______

Answer: True ✔ False
Explanation:

83) The auditor's duty to inform management extends to nonmaterial irregularities. 83) _______

Answer: ✔ True False
Explanation:

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

84) 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.

85) 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.

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.

87) 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 including:

· 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.

88) 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.

89) 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.

AGS1014 advises auditors to either:

· provide an unequivocal statement that the audit report is intended for use only by the body of shareholders, or

· if the auditor acknowledges responsibility to the specific third party, he 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.

Answer Key
Testname: C2

1) B
2) B
3) B
4) C
5) A
6) C
7) D
8) A
9) D
10) B
11) D
12) C
13) D
14) B
15) D
16) C
17) A
18) D
19) B
20) B
21) B
22) D
23) D
24) C
25) D
26) D
27) D
28) C
29) D
30) D
31) B
32) A
33) C
34) C
35) A
36) D
37) B
38) D
39) D
40) A
41) C
42) B
43) D
44) D
45) A
46) B
47) B
48) B
49) B
50) A

51) C
52) C
53) A
54) A
55) C
56) A
57) D
58) B
59) C
60) A
61) C
62) A
63) B
64) 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.
65) 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.
66) 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.
67) The other three sources of auditor's liability are:
    · Liability to third parties under common law
    · Liability to shareholders under statutory law
    · Criminal liability.
68) 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.
69) TRUE
70) TRUE
71) TRUE
72) FALSE
73) FALSE
74) TRUE
75) FALSE
76) FALSE
77) TRUE
78) TRUE
79) FALSE
80) TRUE
81) TRUE
82) FALSE
83) TRUE

84) 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.

85) 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.

86) 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.

87) There are many steps individual practitioners can take to minimise legal liability including:
· 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.

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