

Solutions Manual

to accompany

Auditing: A Practical Approach

Chapter 2 – Ethics, legal liability, and client acceptance

SOLUTIONS TO REVIEW QUESTIONS

REVIEW QUESTION 2.1

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.

The requirement to act in the public interest means that auditors should consider how their actions impact the client and their employer. They must also consider the impact of their actions on others such as the client's employees, investors, credit providers, and those without direct financial interests in the client such as the broader business and financial community and members of the public. All these people could be reliant on the quality of the auditor's work, even though they are not party to the contract between the client and the audit firm.

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

REVIEW QUESTION 2.2

Both aspects of independence are important. If an auditor has independence of mind the auditor will act independently. Acting independently means that the auditors are free of the clients' influence and will perform their duties as required by the auditing standards and codes of ethics, even if the clients do not agree. Acting independently is essential for a high quality audit.

REVIEW QUESTION 2.2 (Continued)

However, despite how independently the auditors may act, the audit reports will not be credible if the outside parties do not believe that the auditors acted independently. That is, the outside parties do not believe the audit reports have any credibility because they believe that the clients have influenced the auditor. Therefore, the auditor must be seen to be independent by outside parties. That is, the auditor must be independent in appearance for the audit report to be believed.

If the auditor is seen to be independent but is really not independent, then the audit reports will have credibility, but if later events reveal that the auditor did not act independently, the outside parties could suffer a loss from relying on an inappropriate audit opinion. Therefore, both independence of mind and independence in appearance are required for effective auditing.

REVIEW QUESTION 2.3

An auditor has a self-interest problem if the outcome of the audit (and/or the success of the company) affects the auditor's (i.e., the audit firm or the auditor as an individual) financial interests. The closeness in this case is manifested through the auditor's share ownership in the client, the client producing a very large part of the audit firm's audit or other services revenue, or the existence of loans or other financial interests between the auditor and the client. It is a problem for the audit's value because the auditor knows that a qualified audit report could adversely affect the client's share price, or a tough audit decision (e.g., requiring the client to write down the value of its assets) could encourage the client to seek another auditor. These concerns could prompt the auditor to act inappropriately during the audit.

The self-review problem arises when the auditor, as part of the audit, has to test transactions or systems that were recorded or provided by another part of the audit firm or by a previous employee of the audit firm, or the testing is performed by a previous employee of the client. The closeness is manifested by the fact that self-review means that there is too little separation between the client and the auditor with respect to that part of the audit, that is, the auditor is testing or reviewing itself. It is a problem for the audit because self-review impairs the primary source of value of a financial statements audit, that is, the independence of the auditor from the client. The lack of independence could mean that the auditor acts inappropriately during the audit.

Familiarity refers to a general closeness between the auditor (including the whole audit team) and the client. The closeness in this case is manifested in a relationship that is more one of friendship than that between independent auditor and client. The auditor could lose their objectivity during the audit and act inappropriately.

REVIEW QUESTION 2.4

The audit report is addressed to the shareholders of the audited company. However, there is very little contact between an auditor and the shareholders. One exception is that the auditor is required to attend the company's Annual General Meeting where there could be some dialogue between the members and the auditor. In addition, the auditor could meet large shareholders, for example those on the board of the directors or who work for the company.

Shareholders are responsible for the appointment and removal of the auditor, but in practice the selection of the auditor is done by the board who then recommend the appointment to the shareholders for their approval. It would be more realistic to regard the board of directors as the auditor's client because they are in charge of the company's governance. The CEO or CFO will be in charge of the client's financial reporting process and the auditor may have most contact with them and the finance department, but they are not the client to whom the auditor reports.

REVIEW QUESTION 2.5

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

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

REVIEW QUESTION 2.6

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

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

REVIEW QUESTION 2.7

A client may bring an action against an auditor under contract or tort law. The contract is between the client and the auditor. Damages under a breach of contract can only be claimed by a party to the contract.

Tort law allows any party to bring an action for negligence, provided the following three conditions are established:

- A duty of care was owed by the auditor
- There was a breach of the duty of care
- Loss was suffered as a consequence of that breach.

Therefore, tort law allows another party to bring an action (not just a party to the contract) if it can be shown that there was a duty of care to that party. This means that the client and other parties could potentially bring an action for negligence. The first condition appears to be the most difficult to prove.

For example in the Pacific Acceptance case report, it was noted that the auditor could owe a duty of care to the client and its shareholders. The report discusses the problems facing plaintiffs when seeking to establish that the client or shareholders had suffered a loss as a result of the auditor's negligence. To ascertain a causal relationship between the negligent act and the loss suffered, reasonable foreseeability must be proven. This means that the auditor must have been aware that any negligence on their part could cause a loss to the client or their shareholders.

REVIEW QUESTION 2.7 (Continued)

In Hercules Management Ltd. (1997) the courts ruled that for a third party to be able to establish that an auditor owes them a duty of care, they would need to show the following:

- The report was prepared on the basis that it would be communicated to a third party.
- The report was likely to be relied upon by that third party.
- The third party ran the risk of suffering a loss if the report was negligently prepared.

The judgement in the Hercules case provided some relief for auditors as it made it far more difficult for a third party to establish that a duty of care was owed by the auditor. Today, it is advisable that a third party take steps to establish proximity before using an audited report to make a decision. They can request that an auditor provide them with a privity letter, which can be used to prove that a duty of care was owed to them.

The plaintiff must also show that the auditor breached its duty of care, for example, by conducting a poor quality audit. Mere non-compliance with auditing standards may not be sufficient to show a breach of the duty of care. Finally, the plaintiff must establish that they suffered loss as a result of the breach of the duty of care. For example, the plaintiff must show that they relied on the audit report to make their investment which subsequently lost value.

REVIEW QUESTION 2.8

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

REVIEW QUESTION 2.9

Client acceptance and continuance procedures are performed for the purpose of evaluating whether the auditor can service the client and still meet the relevant ethical and legal requirements. This is to protect the client and the auditor as well as those who will rely on the audit report. The client needs to be assured that the auditor has the appropriate skills and capacity to provide the audit at the appropriate level of quality and within the required time frame. The auditor needs to be sure that it can service the client in this way and protect itself from any conflicts of interest that could arise during the engagement. The public and other parties need to be assured that the audit was conducted appropriately and the auditor was able to exercise the required level of independence.

An auditor will not accept every client, even if it has capacity, because they would not be able to provide the required level of expertise to service the client's needs. Refusal to accept a client (or continue with an existing client) does not mean that the client is not auditable or lacks integrity. Another auditor could be better able to service the client because of capacity or expertise issues. However, the auditor's right to refuse a client means that the more difficult to audit clients find it hard to get an auditor and so have the incentive to either improve their systems and/or integrity, or go out of business. As such, the quality of financial reporting across the economy is likely to be higher.

REVIEW QUESTION 2.10

An engagement letter is the contract between the client and the auditor. It contains clauses that make the responsibilities of each party clear, and can provide a method of handling disputes. *CAS 210 Agreeing the Terms of Audit Engagements* provides guidance on the preparation of engagement letters. An engagement letter is prepared by an auditor and acknowledged by a client before the commencement of an audit.

The purpose of an engagement letter is to set out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client. The letter will confirm the obligations of the client and the auditor in accordance with the various standards. While the engagement letter can expand upon the requirements that appear in legislation and standards, it cannot limit or contradict those requirements.

An engagement letter includes an explanation of the scope of the audit, the timing of the completion of various aspects of the audit, an overview of the client's responsibility for the preparation of the financial statements, the requirement that the auditor have access to all information required, independence considerations and fees.

SOLUTIONS TO PROFESSIONAL APPLICATION QUESTIONS

PROFESSIONAL APPLICATION 2.1 – Ethical principles

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 (according to the code of professional conduct for the appropriate professional body).

Charles overstates his importance at the audit firm – he states that he is a partner but he is a ‘senior’ (which is less senior than a partner). This is a breach of integrity.

Charles tells William that the patriarch (male leader of the family) is having an affair with his personal assistant – this is gossip. Even if it is true, it is not professional behaviour to reveal private matters about a client to another party. Charles also states that he has his ‘doubts’ about this person – this apparently means that Charles believes that the person is dishonest or unethical or incompetent (it is not clear what he means but he is saying something negative). Once again, this is not professional behaviour.

Charles tells William that the family has increased its shareholding in another company, with potential benefits to the company. This information appears to have been gained as part of the audit so revealing it to William is a breach of confidentiality. It is not relevant that William works for a bank which lends to the client, Charles does not have the client’s permission to discuss this matter.

PROFESSIONAL APPLICATION 2.2 – Receiving shares through inheritance

Prior to the uncle’s death, the shares were not held by Kerry or his wife – the connection through her uncle is too remote for a self-interest threat to have existed prior to his death.

After the uncle’s death, Kerry’s wife is the owner of the shares, which appears to give her material ownership in the client, creating a potential self-interest threat for Kerry. Therefore now that Kerry is aware of the inheritance, he should inform the partner for this engagement in writing. The shares should be disposed of, or Kerry removed from the audit. If Kerry stays on the audit, additional safeguards should be considered such as discussing the matter with the client’s audit committee or having Kerry’s work reviewed by another member of the firm that has not been a member on the Darcy Industries engagement team. Kerry will not get fired from the audit firm provided he follows the above procedures.

PROFESSIONAL APPLICATION 2.3 – Provision of non-audit services to audit clients

(a)

It is possible that increasing the profitability of the audit firm would increase Elise's reputation within the firm. However, if the growth in revenue creates any conflicts of interest or other ethical problems it could damage Elise's reputation. If providing of non-assurance services creates a threat to the auditor's independence, safeguards would need to be applied to eliminate or reduce the threat.

(b) As Hertenstein Ltd, is a large public company, there are additional prohibitions. Prohibited services also include legal services, management functions human resources services, corporate financial services, litigation support, or expert service. Generally it is not acceptable for the auditor to act as a manager of the entity. It is also not appropriate for Elise to suggest providing bookkeeping, actuarial, internal audit valuation, financial statement systems design and implementation where the results of these services will be audited.

(c)

Yes. Auditors can provide more non-audit services to a private company than to a listed public company. As mentioned in Part B, there are additional prohibited services for firms with listed entities.

Auditors of private companies may perform accounting, bookkeeping, and payroll services provided that these services are routine in nature. If a self-review threat presents itself as a result of performing these services, it must be reduced to an acceptable level. Possible safeguards to reduce such a threat are:

- Ensure the Audit Client approves all account classifications
- Having the client sign off on all adjusting journal entries
- Ensuring the client understand and takes responsibility for the financial statements

PROFESSIONAL APPLICATION 2.4 – Unpaid audit fees

If fees are outstanding the auditor could be perceived to have a conflict of interest because the auditor is more likely to be paid if the client survives and is happy with the auditor. In these cases, the auditor could be perceived as being more interested in the client's survival than an accurate audit report. Therefore, this gives rise to a self-interest threat.

The auditor should take steps to have the fees paid before the next audit. Other possible safeguards include advising the audit committee of the outstanding fees, or have another auditor review the engagement file. If the fees are significant and outstanding long enough that they may be consider similar to a loan, the firm should consider removing itself from the audit.

PROFESSIONAL APPLICATION 2.5 – Using the work of internal auditors

The internal audit department focuses on efficiency and effectiveness of production (i.e. operational or performance auditing) and compliance with government regulations (compliance auditing). The head of the internal audit department is a Chartered Professional Accountant and a member of the Institute of Internal Auditors and the other members of the department have performance auditing and compliance relevant experience and qualifications. The internal audit department is highly regarded within the business, reports to the board of directors as well as the CEO, and the reports appear to be acted upon. All these factors suggest that the internal audit department is well run and effective. However, they also suggest that it does not concentrate on issues directly relevant to financial reporting and auditing.

The external auditors are likely to review the internal audit department's work, particularly where it is relevant to operational indicators which are reflected in the accounts. They are likely to review the internal auditor's reports and their evaluations of internal control systems, particularly in production and inventory issues and general management issues. However, most of the internal audit department's findings on waste regulations and efficiency matters will not be directly relevant to the external auditors' audit of accounting transactions and balances.

PROFESSIONAL APPLICATION 2.6 – Legal implications of client acceptance

(a)

Steps to take to avoid the threat of litigation (in addition to the client continuation decision issues in part (b) below) include:

- Hiring competent staff
- Training staff and updating their knowledge regularly
- Ensuring compliance with ethical regulations
- Ensuring compliance with auditing regulations
- Implementing policies and procedures that ensure:
 - Appropriate procedures are followed when accepting a new client (or client continuance)
 - Appropriate staff are allocated to clients
 - Ethical and independence issues are identified and dealt with on a timely basis
 - All work is fully documented
 - Adequate and appropriate evidence is gathered before forming an opinion
- Meeting with a client's audit committee to discuss any significant issues identified as part of the audit
- Following up on any significant weaknesses in the client's internal control procedures in a previous year's audit.

PROFESSIONAL APPLICATION 2.6 (Continued)

(b)

The client continuation decision is critical. Rebecca should evaluate and document the firm's ability to service the major client, Carolina Company Ltd., and any other major clients for the coming year. Canadian Standard on Quality Control (CSQC 1) "Quality control for firms that perform audits and reviews of financial statements, and other assurance engagements" and CAS 220 *Quality Control for an Audit of Financial Statements* provide guidance on the procedures to be followed when making the client acceptance or continuance decision.

The key factors to be evaluated are client integrity and any threats to the auditor's compliance with the fundamental principles of professional ethics (integrity, objectivity, professional competence and due care, confidentiality and professional behaviour). Although Carolina Company Ltd. has been a client of the firm for several years, its integrity must still be re-evaluated. Rapid growth can create pressures within the client that could compromise its integrity. This is particularly so in the case of Carolina Company Ltd. because there is already evidence of difficulties in its financial systems.

A major problem confronting the audit firm is its ability to comply with the fundamental principles of professional ethics.

PROFESSIONAL APPLICATION 2.7 – Independence safeguards

1. Having the client approve proposed journal entries provides evidence that the client has reviewed and accepts responsibility for the adjustments (and the resulting changes to the financial statement balances). Therefore in having the client take responsibility for adjustments, it is a safeguard for a *Self Review Threat*.
2. By having staff review a client list, it ensures they are aware of engagement clients they may not be assigned to. As firm members should limit and disclose the shares they hold in an audit client, this is a safeguard for the *Self Interest Threat*.
3. By participating in the same engagement over a number of years, the auditor may develop a close relationship with the client and client staff. This may lead to a *familiarity threat*. Therefore, rotating staff is a safeguard to a *Familiarity Threat*.
4. By having a policy indicating it is not acceptable for engagement staff and client personnel to establish close relationships; it reduces the likelihood of a *familiarity threat*.
5. Auditors should regularly review fees per client to total fees to identify if the fees from one client are so significant that it leads to a *Self Interest Threat*.
6. There should be a cooling off period before engagement staff becomes employed at a clients. This is to reduce the *Self Review Threat*.

PROFESSIONAL APPLICATION 2.8 – Independence threats and safeguards

(a)

Personal relationships between a partner of the audit firm and the two directors poses a familiarity threat. This applies even if the partner is not part of the engagement team

because the partner is a senior member of the audit firm.

(b)

KFP should prepare and adopt a Quality Assurance Manual (QAM), that specifies the firm's policies with respect to independence. The QAM should include how the firm will identify independence threats for all assurance engagements. It should also list acceptable safeguards to reduce any identified threats to an acceptable level. . The requirements of the Quality Assurance Manual should be explained to all firm members and compliance expected.

In this case, the relationship between the partner and the majority shareholders would be identified. The firm should not use Justin on the Featherbed engagement, and should not accept the audit Justin is required on the audit.

PROFESSIONAL APPLICATION 2.9 – Independence threats and safeguards

Issues raised in the case:

ISSUE # 1

(a)

The client's internal audit department is headed by an ex-partner of KFP.

The rules of professional conduct generally place restrictions on audits where a former audit partner has a senior role within the client. The restrictions include a cooling off period, which is usually a two to five year period after the leaving the audit firm and the current audit. On this basis, there does not appear to be a contravention of the rules of professional conduct. In addition, the restriction sometimes applies to ex-auditors who become an officer of the company. In the case of Securimax, Rydell Creek does not appear to be an officer of the company (e.g., a director or senior manager) – he is the head of the internal audit department. This would certainly include the CFO or CEO, but it is unlikely to include the head of the internal audit department.

(b)

Safeguards:

- Ensure that Rydell Creek is not regarded as able to exert direct and significant influence over the subject matter of the external audit.
- Ensure that there wasn't a significant and personal relationship between Rydell Creek and the other members of the audit team based on their previous association as colleagues (to deal with the general familiarity threat).

PROFESSIONAL APPLICATION 2.9 (Continued)

An excerpt from the rules of professional conduct states that examples of circumstances that may create familiarity threats include, but are not limited to:

- A former Partner of the Firm being a Director or Officer of the Client or an employee in a position to exert direct and significant influence over the subject matter of the Engagement.

ISSUE # 2

(a)

Clarke Field has been the partner for 5 years and will remain as review partner when Sally Woodrow is appointed as partner for the audit.

CPAB and many rules of professional conduct with respect to independence require rotation of senior audit personnel as follows stating that using the same:

- Lead Engagement Partner, or
- Audit Review Partner (if any), or
- Engagement Quality Control Reviewer on an audit over a prolonged period may create a familiarity threat.

This threat is particularly relevant in the context of a Financial Statement audit of a Listed Public Entity and safeguards should be applied in such situations to reduce such threat to an acceptable level. Accordingly in respect of the Financial Statement audit of Listed Public Entities: (a) The Lead Engagement Partner, the Audit Review Partner (if any) and the Engagement Quality Control Reviewer should be rotated after serving in any of these capacities, or a combination thereof, for a pre-defined period, no longer than five financial years within a seven year period; and, (b) Such an individual rotating after a pre-defined period should not participate in the Audit Engagement until a further period of time, no less than two years, since the end of the financial year following the end of the pre-defined period has elapsed.

(b)

Safeguards:

Clarke Field should not participate in the audit for two years.

ISSUE # 3

(a)

Appointment of Sally Woodrow to position of partner and as partner in charge of the Securimax audit.

Is Sally Woodrow experienced enough to lead the audit? She is being promoted to partner to enable her to take over the audit. If she is not sufficiently experienced and qualified to lead the audit there is a risk that the independence of the audit will be compromised.

PROFESSIONAL APPLICATION 2.9 (Continued)

(b)

Safeguards:

An independent (i.e., not previously involved with Securimax) senior audit partner should be appointed as review partner to assist Sally Woodrow.

Rebecca should be particularly concerned with the firm's ability to be objective given its dependence on the large client's fees. Although, Carolina Company Ltd. is only one of the major clients experiencing rapid growth, fee dependence arises when a client's fees form a significant proportion of the audit firm's overall revenue. Many professional accounting bodies' rules of professional conduct provide guidance about safeguards when this proportion reaches 15%.

Rebecca should also be concerned about the firm's ability to use professional competence and due care in audits for rapidly growing clients at a time when the audit firm is growing rapidly and the client is undergoing major changes to its reporting requirements. Does the audit firm have the expertise to audit listed clients? What sort of auditing difficulties are likely to be created by the stretched financial systems at Carolina Company Ltd.?

The client continuation decision must be properly documented and the engagement letter drafted to reflect the responsibilities of both parties.

PROFESSIONAL APPLICATION 2.10 – Ethics of accepting engagements

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

The CEO of TLCL has requested the auditor provide an opinion that the laser machines are fit for use without charging a fee as a gesture of goodwill, in the context of the future negotiations about the audit tender. There is an implicit invitation to provide a favourable opinion to ensure that the audit tender is awarded to Fellowes and Associates again.

If Tania provides the opinion without obtaining appropriate and sufficient evidence she would be compromising her integrity because the favourable opinion would not be honest, and her objectivity because her professional judgement would be influenced by the desire to win the tender again. There does not seem to be any threat to confidentiality, although her professional competence and behaviour on this particular engagement would be compromised because she would not be exercising her skill at an appropriate level (and she may not be qualified to provide the opinion on the lasers) and her actions could damage the profession's reputation.

PROFESSIONAL APPLICATION 2.10 (Continued)

Accepting an engagement without appropriate remuneration is also likely to create a conflict of interest. Fees should reflect the work involved and be set at a level that ensures that adequate staffing are assigned to the engagement and sufficient work done to complete the engagement.

PROFESSIONAL APPLICATION 2.11 – Independence issues in accepting engagements

One of the accountants intended to be part of the 2016 audit team owns shares in HCHG. The accountant's interest is not material to him.

Most rules of professional conduct and independence guidelines state that a financial interest in a client may create a self-interest threat. Owning shares in an engagement client creates a direct financial interest. Independence rules generally require the auditor to consider the nature of the financial interest in order to determine the significance of the threat and the appropriate safeguards. Matters to consider are whether the shareholding is direct or indirect, how material is the holding, and the role of the member of the assurance team.

Therefore, what duties does the member of the assurance team perform? How senior is his role? How much judgement will he be required to exercise? If the person is very junior and/or the amount of the financial interest is very small, the threat is lower and fewer safeguards are required. However, if the person is more senior and/or the amount of the financial interest is greater, the safeguards would need to be more significant.

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

"Self-Interest Threat" occurs when a firm or a member of the assurance team could benefit from a financial interest in, or other self-interest conflict with, an assurance client. An example is that may create such a threat is when an engagement member holds a direct financial interest or material indirect financial interest in an assurance client;

A financial interest in an assurance client may create a self-interest threat. In evaluating the significance of the threat, and the appropriate safeguards to be applied to eliminate the threat or reduce it to an acceptable level, it is necessary to examine the nature of the financial interest. This includes an evaluation of the role of the person holding the financial interest, the materiality of the financial interest and the type of financial interest (direct or indirect).

Most independence rules also state that if a member of the assurance team, or their immediate family member, has a direct financial interest, or a material indirect financial interest, in the assurance client, the self-interest threat created would be so significant

PROFESSIONAL APPLICATION 2.11 (Continued)

The only safeguards available to eliminate the threat or reduce it to an acceptable level would be to:

- (a) Dispose of the direct financial interest prior to the individual becoming a member of the assurance team;

- (b) Dispose of the indirect financial interest in total or dispose of a sufficient amount of it so that the remaining interest is no longer material prior to the individual becoming a member of the assurance team; or
- (c) Remove the member of the assurance team from the assurance engagement.

Fellowes and Associates was previously engaged by HCHG to value its intellectual property. The consolidated balance sheet (statement of financial position) as at June 30, 2016 includes intangible assets of \$30 million, which were valued by Fellowes and Associates on March 1, 2016 following HCHG's acquisition of the subsidiary Shady Oaks Centre. The intangibles are considered material to HCHG.

Independence rules generally address the issues surrounding the provision of valuation services to an assurance client. The problem arises because in a financial statement audit the auditor is required to gather evidence about the client's valuation of the assets. If the auditor provided the valuation to the client, then the auditor has to audit their own work.

A self-review threat may be created when an audit firm performs a valuation for an audit client that is to be incorporated into the client's financial statements. This is generally a problem if the valuation service involves the valuation of matters material to the financial statements and the valuation involves a significant degree of subjectivity. In this case, the self-review threat created could not be reduced to an acceptable level by the application of any safeguard, and the valuation services should not be provided, or alternatively, the auditor should withdraw from the audit engagement.

Therefore, the key questions are whether the item is material, whether there is a significant degree of subjectivity in the valuation service. The intangibles are stated to be material. Valuation of intangible assets is likely to be subjective, or at least more subjective than valuation of real property (land and buildings). This implies that Fellowes and Associates should withdraw from the audit or the client should obtain another independent valuation for the intangibles.

However, the question appears to state that the valuation services were provided prior to the audit engagement being accepted. If so, at this time, there was no conflict between Fellowes and Associates duties as valuator and auditor. However, now, as auditor, Fellowes and Associates is required to provide an opinion on the valuation which it previously provided.

PROFESSIONAL APPLICATION 2.11 (Continued)

Other safeguards that could apply to valuation situations include:

- Involving an additional professional accountant who was not a member of the assurance team to review the work done or otherwise as necessary;

- Confirming with the audit client their understanding of the underlying assumptions of the valuation and the methodology to be used and obtaining approval for their use;
- Obtaining the audit client's acknowledgement of responsibility for the results of the work performed by the firm, and
- Making arrangements so that personnel providing such services do not participate in the audit engagement.

At a minimum, Fellowes and Associates should apply the safeguards with respect to the intangible assets valuation. The valuation should be reviewed by an additional professional accountant, who is outside the audit team, they should obtain the client's acknowledgement of responsibility for the valuation, and should not use the personnel involved in the valuation of the financial statement audit. However, it is likely that these safeguards would not be enough, given the high level of subjectivity in the intangible assets valuation. Therefore, the client will either have to obtain another independent valuation or Fellowes and Associates should withdraw from the audit.

In the future, the audit firm should not perform valuations for audit clients that are likely to be the subject of a financial statement audit, unless they are immaterial and/or have a very low degree of subjectivity.

PROFESSIONAL APPLICATION 2.12 – Principles and rules of the code of professional conduct

(a)

This case indicates a violation of the confidentiality principle. An auditor should not disclose client information to others outside the organization.

Joan has bought shares in her client, there may also be a self-interest threat (impairment of independence). Furthermore, she used insider information to buy these shares, which is not legal.

(b)

There is a violation as the advertising is making an unsubstantiated claim in indicating the firm is the "premier" accountants. There is also a fee issue as contingency fees based on the outcome of the engagement are not appropriate. Fees are to be based on an estimate of the work to be performed.

PROFESSIONAL APPLICATION 2.12 (Continued)

(c)

This scenario presents a self-review threat, as Sue is planning to prepare the tax provision and then audit it, therefore she would be providing assurance over her own work. Also, there is a prohibition on providing bookkeeping services to reporting issuers.

(d)

In this case the client is a private company and therefore it may be possible for Sue to propose adjusting journal entries and remain independent. Sue must be careful to ensure that the preparation of the journal entries does not cause a self-review threat where she is auditing her own work.

If the journal entries are for simple bookkeeping entries, the self-review threat would not be significant. However, Sue should review the entries with management and ensure management understands them. Management should sign their approval of the entries and this documentation should be kept in the audit file.

If however the entries involved complex accounting issues requiring significant judgement, the self-review threat would be significant. Sue would then have to ensure safeguards were in place to reduce the self-review threat to an acceptable level. She could do this by consulting with another professional accountant to confirm the accounting treatment proposed is appropriate, thereby reducing the self-review threat to an acceptable level.

(e)

For compilation engagements, the preparation of routine journal entries or the provision of routine bookkeeping services do not create a self-review threat. As best practice, Sue should, review the journal entries with management and obtain their written approval. However, the absence of management approval does not create an independence issue — except in Quebec. In Quebec, this situation would need to be disclosed, unless the entries were basic mechanical and posting type entries.

(f)

There is no self-interest threat provided the loan is within the bank's normal lending terms.

(g)

This presents a familiarity threat where with a close relative (Jack's father-in-law) holds a senior position as CEO at Canada Bank.

(h)

This may represent a threat if the fees are significant. If the fees are significant, they may be considered in substance a loan to the client and therefore create a self-interest threat for Frank.

PROFESSIONAL APPLICATION 2.12 (Continued)

(i)

There are many issues with this scenario.

- The first is the referral fee, as referral fees are not permitted.
- Second, she must ensure she exercises due care and conducts the engagements in accordance with the current standards. As she has not performed any audit engagements in the last four years, it is unlikely she is up to

date with generally accepted auditing standards (GAAS), as new auditing standards were introduced in 2010.

- Alison also failed to demonstrate due care when she accepted the client without performing any of the required client acceptance procedures.
- She did not exercise due care when she concludes she will perform a substantive based audit and therefore ignore controls altogether.

(j)

Independence is not required for compilation engagements, but Matt should disclose the fact that he is not independent in his written report accompanying the financial statements. The disclosure should indicate the nature of the relationship.

PROFESSIONAL APPLICATION 2.13 – Engagement Ethics

The *Code of Professional Conduct* applies to students as well as members.. Jules' manager would also be subject to a professional code of ethics. Four issues in this scenario include:

- An intimidation threat because Jules was told that his employment could be affected if he disclosed the error.
- Both Jules and his manager would be associating themselves with false information if the error is not corrected.
- By agreeing not to disclose the error, Jules would bring the CPA association into disrepute and therefore harm the reputation of the profession
- By doing nothing, both members would not be acting professionally

PROFESSIONAL APPLICATION 2.14 – Auditor legal liability

(a)

Since there is no contract with Xing Investments Inc. it is questionable if the auditor owes this third party user a duty of care. Especially since Ahmad & Partners were not aware that Xing Investments Inc. was a user of the financial statements. However, Ahmad & Partners did have a contract with Canada Bank, therefore they did owe the bank a duty of care.

PROFESSIONAL APPLICATION 2.14 (Continued)

(b)

Defences that Ahmad & Partners could use are:

- They did not owe Xing Investments a duty of care as they were not a foreseen user.
- They conducted their audit in accordance with generally accepted auditing standards (GAAS), therefore there was no negligence on their part.
- They could question whether the Xing Investments actually relied on the statements before investing in Chan Corporation.

PROFESSIONAL APPLICATION 2.15 – Breaches to the principles and rules of the code of professional conduct

(a)

No violation. Susanne is free to set the audit fee based on the amount of audit work required and there are no restrictions on the performance of taxation services for the client or the client's key executives.

(b)

No violation. Aziz has acted appropriately in designing the audit plan for this client. Exceptionally high revenue growth may well suggest that the financial statements are being manipulated by management to increase reported profit. Also, Aziz is correct in his assessment that overstated profit may be accomplished through an overstatement of asset values and/or an understatement of recorded liabilities. Finally, Aziz is justified in considering resigning from the engagement if evidence of fraud is discovered during the audit.

(c)

Violation. There is no problem with Mandip compiling the financial statements for this closely held company, nor do the compiled financial statements need to include footnotes or other disclosures (GAAP is not required for compiled financial statements). However, by agreeing to receive company shares as payment for his services, Mandip is not independent of the company. While a professional accountant (for example, consider Mandip to be a CPA) who is not independent can still perform compilation services for a client, the lack of independence must be disclosed in the notice to reader communication. Finally, Mandip should not perform a ratio analysis in conjunction with his compilation. Ratio analysis and related inquiries of management are a major part of a review of financial statements, which is designed to provide a moderate level of assurance that recorded amounts are not materially misstated. In a compilation, no assurance is provided and a professional accountant (for example, a CPA in this illustration) should not be trying to determine that recorded amounts are plausible. Doing so serves to distort the nature of the service being provided to the client.

Note that Mandip cannot ethically perform a review for this client since a review requires that Mandip be independent — he cannot be a shareholder in the firm.

PROFESSIONAL APPLICATION 2.16 – Auditor legal liability

The elements of negligence would apply to this case as follows:

1. There must be a duty of care owed to the party suing the auditor. In this case, HHH Corporation hired the auditors, therefore the auditors owe duty of care to the shareholders.
2. There must be a breach of duty of care (failure to follow GAAS which would lead to a negligent audit). In this case, the shareholders would have to show that the auditors were negligent in their audit, that is, the auditor issued an unmodified report even though there is a misstatement in the financial statements.

3. There must be proof that the party suffered a loss or damage. In this case, HHH Corporation lost its investment in the commodities. The loss must be the direct result of the breach of the duty. In this case, HHH Corporation shareholders would have to show that they suffered the loss due to the auditor's negligence.

PROFESSIONAL APPLICATION 2.17 – Ethical Issues and Consequences

(a)

- Roy cannot audit the financial statements for his former company, as this gives rise to a self-review threat. A self-review threat occurs when any product or judgment from a previous assurance engagement needs to be re-evaluated in reaching conclusions on the assurance engagement; or when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct and significant influence over the subject matter of an assurance engagement. In this case, the prior year balances and the resulting financial statements were under Roy's complete influence. Roy cannot audit the financial statements for his neighbour's company as this gives rise to a familiarity threat. A familiarity threat results when a member, firm, or member of the assurance team becomes too sympathetic to the client's interests, by virtue of a close relationship with an assurance client, its directors, officers, or employees. Arranging for other staff to perform the engagement does not mitigate this risk. Particularly as Roy is a Partner and therefore can override and influence the work of other members in the firm.
- Roy cannot promise or suggest an unmodified opinion before he obtains and reviews sufficient appropriate evidence to support the opinion.
- Roy cannot accept an audit fee of zero or of a percentage of the client's net income.

(b)

The audit firm is not negligent to issue the audit report if the audit evidence shows that the opinion issued is supported. Roy had sufficient appropriate audit evidence that the bank loan was in default, therefore if this supported a going-concern comment in the report, the audit firm would not be negligent.

PROFESSIONAL APPLICATION 2.18 – Quality assurance

(a)

Most firms use their last names to ensure they are not misleading or self laudatory. They must also be in good taste.

(b)

Advertising must be in good taste. It cannot be false or misleading or make unsubstantiated claims. Some suggestions for advertising may include:

- Word of mouth – referrals
- Friends and family
- Signage on office property

- Advertising that is in good taste, identifying services offered
- Networking and joining organizations such as the Board of Trade, Chamber of Commerce, or local Business Improvement Associations.

(c)

A sample table of contents for a quality assurance manual would be:

1. Leadership Responsibility to promote a culture of quality
 - Tone at the Top
2. Ethical requirements, independence, and privacy
3. Client Acceptance and Continuance to ensure firms perform engagements within their competencies and that they have adequate resources available
4. Human Resource policies to ensure personnel are capable, competent, and ethical
 - Hiring/ Staffing/ Supervision
 - Confirmation of independence re: Client list
 - Professional Development Requirements
5. Engagement Risk
 - Client acceptance and continuance
 - File Documentation
 - Performing and documenting Engagement Quality Reviews
6. Monitoring.
 - Internal-ongoing compliance
 - External

(d)

File quality reviews are more commonly known as second partner reviews. They are required for all listed public entities. For non-listed entities, firms need criteria to assess the need for a file quality review. Common factors used to determine if a file quality review is required are:

1. Assurance fees greater than \$10,000,
2. More than 10 stakeholders, and
3. The engagement is assessed as high risk.

PROFESSIONAL APPLICATION 2.18 (Continued)

File quality reviews involve a review of the financial statements, the work performed, and an evaluation of the opinion formed.

There are two requirements a firm must meet with respect to monitoring. First, a firm must perform an ongoing assessment of its compliance with the policies and procedures set out in its quality assurance manual. Second, every one to three years, a firm should have a “Monitor” (someone not involved in the engagements) review a selection of assurance files as well as assess the quality control activities of the firm. A report should be issued identifying any weaknesses or deficiencies.

PROFESSIONAL APPLICATION 2.19 – Professional conduct

- (a) Arun Sidhu was the auditor of Red Brick Ltd. and issued a clean audit opinion despite the fact that the depreciation expense of the client was materially misstated due to a calculation error.
- Failure to act with Due Care
- (b) Jason Crane was became a CPA in 2014. He is now glad to be finished his education as he does not plan to take any further accounting courses.
- Failure to maintain professional competence
- (c) Samantha Summers received a letter from Brown and Rudolph, another accountant firm, asking if there is any reason they should not accept the audit engagement of her biggest client, Franks Plumbing Inc. Samantha was so upset about losing the client, she threw the letter away and decided not to reply
- Must respond to predecessor auditor.
- (d) Samantha Summers received a letter from Brown and Rudolph, another accountant firm, asking if there is any reason they should not accept one of her client's, Franks Farm Ltd. Because she had disputes with management of Frank's Farm's she was glad to see them go. She called Brown and Rudolph right away and told them about all of the issues she had.
- Failure to maintain client information confidential
- (e) William White decided to start his own CPA firm. In order to attract new clients he started cold calling businesses in his neighbourhood.
- Solicitation- can't cold call- need to wait until contacted by potential client.

PROFESSIONAL APPLICATION 2.19 (Continued)

- (f) Alan Reed discovered his long time client, the Daily Diner was in financial distress. He decided to lend the Diner \$20,000 and he had the owner sign a note payable. He informed Canada Bank, primary user of the financial statements of this loan after the audit report was issued.
- Cannot have financial interest in the business- not independent. Informing the user is not an acceptable safe guard.

Case Study — Cloud 9

(a)

Client acceptance decision issues:

- The relationship between David Collier and P.S. Nethercott is described as distant. Rules of professional conduct and independence rules discuss familiarity threats which can occur because of a close relationship, such as a member of the assurance team having an immediate family member or close family member who is a director or officer of the assurance client, or an employee in a position to exert direct and significant influence over the subject matter of the assurance engagement. In this case, P.S. Nethercott is not on the assurance team (and is not likely to be), and although the relationship is with a person in a position to be involved in the subject matter of the audit, the relationship is distant. There would be no threat to independence.
- The potential consulting fees are twice the size of the audit fee, creating a significant business relationship between the audit firm and the client, and potentially an undue dependence on the fees from this client (relative to total fees from all clients). According to rules of professional conduct and independence rules a self-interest threat to the auditor's independence could arise from this relationship. In general, firms would limit the size of non-assurance service fees relative to the size of assurance fees for any one client, through either limiting the amount of non-assurance services provided or refusing to perform both for the same client. In addition, it is possible that a self-review threat could arise if the IT installation was relevant to the financial data that would be the subject matter of the audit in future periods. The non-assurance service (IT installation) in itself should also give risk to consideration of the threats to independence. In general, the self-review threat is likely to be too significant to allow both services to be provided by the same firm, except if the audit client clearly takes all management decisions with respect to the installation of the IT project, and non-assurance and assurance staff at the audit firm are kept separate.
- Purchases of products in the normal course of business and on an arm's-length basis, such as shoes from stores, is acceptable and is not an independence threat.
- Members of the IT department at the audit firm could be involved in the audit. As such, their financial interests need to be considered. In this case, the shareholdings are in retailers that sell the audit client's products, and the shareholdings are material and have been disclosed to the audit firm. The shareholdings are not in the audit client, and the relationship does not allow the members of the IT department to influence management decisions at either the retailers or the audit client. There is no independence threat to the audit of Cloud 9.

Case Study — Cloud 9 (Continued)

- This point does not relate to independence issues. In this case, the newspaper article suggests that the management of Cloud 9 Inc., the parent firm of the audit client, is engaged in illegal and/or unethical behaviour. The auditor is required to consider client integrity in the client acceptance decision (CSQC1 and CAS 220 *Quality control for an audit of financial statements*). In addition, the auditor is required to consider any threats to the fundamental principles. Such a threat could occur if the prospective client is dishonest or involved in illegal activities. The management of Cloud 9 Inc. have denied the allegations and invited international human rights groups to visit their factories. Cloud 9 Inc. is not the prospective client of W&SPartners, so it could be argued that the auditors are not concerned with this issue. However, a lack of integrity at the parent company could indicate a lack of integrity at the local level, and/or create other issues for the auditors related to dealings between the companies. The auditors could raise the issue with Cloud 9 Ltd. management, and if still concerned, also visit the factories.

(b)

Other issues to be considered in making the client acceptance decision include:

- Other issues relating to client integrity, such as reasons for the audit switch, client attitudes to risk, internal controls, accounting standards, full access to information, and payment of fees.
- Obtaining permission from the client to communicate with the previous auditor, third parties such as bankers and lawyers, and client personnel.
- Review press articles and other company disclosures.
- Any potential threats to other fundamental principles, such as professional competence and due care through lack of auditor expertise in the client industry or insufficient audit staff.

(c)

Prepare client engagement letter as per example in text (figure 2.5).

Research Question 2.1 – Accounting expertise on audit committees

(a)

Arguments for and against allowing former audit firm partners and/or employees to join audit committees:

Advantages:

- expertise of former auditors being available to client, should lead to an improvement in their financial statements which benefits the client, its stakeholders, and the general public (through a general increase in reporting quality),
- ex-auditors understand the problems facing the auditors and can help their new colleagues at the client respond appropriately to the auditor's requests.

Disadvantages:

- loss of auditor independence arising from close personal relationships between these former auditors and their former colleagues in the audit firm,
- audit committee might lose its independence when selecting audit firms (preference for their old firm) and in dealing with disputes

(b)

Former audit partners might be recruited by the client in order to help the audit process by:

- improving their systems and financial statements based on the ex-auditor's intimate knowledge of good control systems and financial reporting.

However, they could also be recruited and hinder the audit process by:

- encourage the audit firm to be 'soft' on their friends,
- use the expertise of the former auditors to 'get around' the system, that is, they know what the auditors will be looking for in terms of 'red flags' and thus better able to hide the problems,
- share their knowledge of audit sampling methods could be used to hide errors in items that are not likely to be sampled.

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