CHAPTER 2

ETHICS, LEGAL LIABILITY AND CLIENT ACCEPTANCE

SUMMARY OF QUESTIONS BY LEARNING OBJECTIVES

Item	LO	Item	LO	Item	LO	Item	LO	Item	LO	Item	LO	Item	LO
True-False Statements													
1.	1	3.	2	5.	2	7.	4	9.	4	11.	4	13.	5
2.	2	4.	2	6.	1	8.	4	10.	4	12.	5	14.	5
Multiple Choice Questions													
15.	1	20.	2	25.	1	30.	2	35.	2	40.	3	45.	4
16.	2	21.	2	26.	1	31.	2	36.	2	41.	3	46.	5
17.	2	22.	3	27.	1	32.	2	37.	2	42.	4	47.	5
18.	2	23.	4	28.	2	33.	2	38.	3	43.	4		
19.	2	24.	5	29.	2	34.	2	39.	3	44.	4		
Short Answer Questions													
48.	2,4,5	49.	1	50.	2	51.	2	52.	5				
Essay Questions													
53.	3	54.	4	55.	2								
Case													
56.	4,5												

SUMMARY OF LEARNING OBJECTIVES BY QUESTION TYPE

Item	Type	Item	Type	Item	Type	Item	Type	Item	Type	Item	Type	Item	Type
Study Objective 1													
1.	TF	6.	TF	15.	MC	25.	MC	26.	MC	27.	MC.	49.	SA
Study Objective 2													
2.	TF	16.	MC	20.	MC	30.	MC	34.	MC	48.	SA		
3.	TF	17.	MC	21.	MC	31.	MC	35.	MC	50.	SA		
4.	TF	18.	MC	28.	MC	32.	MC	36.	MC	51.	SA		
5.	TF	19.	MC	29.	MC	33.	MC	37.	MC	55.	ES		
Study Objective 3													
22.	MC	38.	MC	39.	MC	40.	MC	41.	MC	53.	ES		
Study Objective 4													
7.	TF	9.	TF	11.	TF	42.	MC	44.	MC	48.	SA	56.	Ca
8.	TF	10.	TF	23.	MC	43.	MC	45.	MC	54.	ES		
Study Objective 5													
12.	TF	14.	TF	46.	MC	48.	SA	56.	Ca				
13.	TF	24.	MC	47.	MC	52.	SA						

Note: TF = True-False SA = Short Answer ES = Essay
MC = Multiple Choice Ca = Case

CHAPTER STUDY OBJECTIVES

1. ***Describe the fundamental principles of professional ethics and list some of the specific rules professional accountants are required to follow*.** Each of the three professional accounting bodies has a code of professional conduct and each has the same fundamental principles of professional ethics: integrity (being straightforward and honest); objectivity (not allowing personal feelings or prejudices to influence professional judgement); 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). There are also specific rules that incorporate the guiding ethical principles, and which are enforceable. Some of these rules concern: fees and pricing, advertising, contact with predecessor auditors, firm names, and professional contact.

2. ***Define and explain auditor association and independence.*** Association is the term used to indicate a public accountant's involvement with financial information. Public accountants should not be associated with anything false and misleading; therefore, they should take care to communicate the level of their involvement with the information. Independence is the ability to make a decision that is free from bias, personal beliefs, and client pressures. An external auditor must not only be independent of their client, they must also appear to be independent of their client. Threats to auditor independence include self-interest, self-review, advocacy, familiarity, and intimidation threats. A self-interest threat can occur when an auditor has a financial interest in a client. A self-review threat can occur when an auditor must form an opinion on their own work or work done by others in their firm. An advocacy threat can occur when an auditor acts on behalf of their client. A familiarity threat can occur when there is a close relationship between the auditor and their client. An intimidation threat can occur when an auditor feels threatened by their client. Safeguards to auditor independence include the code of ethics, legislation, the establishment of audit committees by clients, client acceptance, and continuance procedures, partner rotation policies, and education within accounting firms.

3. ***Explain the relationship between an auditor and key groups they have a professional link with during the audit engagement*.** Auditors report to their clients' shareholders. These are the owners who rely on the audited financial statements when evaluating the performance of their company. The board of directors represents the shareholders and oversees the activities of the company and its management. It is the directors' responsibility to ensure that the financial statements being audited are fairly presented. The audit committee is responsible for liaising between the external auditor, the internal auditor, and those charged with governance to aid the board of directors in ensuring that the financial statements are fairly presented and that the external auditor has access to all records and other evidence required to form their opinion. The external auditor may use the work performed by the internal auditors after considering the function's objectivity, technical competence and due professional care, and the effectiveness of communication between internal and external auditors.

4. ***Explain the auditor's legal liability to their client, contributory negligence, and the extent to which an auditor is liable to third parties*.** Contributory negligence is where a client is found to be negligent and to have contributed to the loss suffered by the plaintiff. To successfully sue an auditor, a plaintiff must prove that a duty of care was owed by the auditor, there was a breach of that duty, and a loss was suffered as a result of that breach. Several cases are discussed in the chapter in relation to an auditor's liability to third parties. To establish that an auditor owes them a duty of care, a third party must now establish that the auditor was aware that the third party was going to use the financial statements and that the users relied on the financial statements for the purpose they were prepared.

5. ***Identify the factors to consider in the client acceptance or continuance decision*.** Factors to consider include the integrity of a client, such as the client's, reputation and attitude to risk, accounting policies, and internal controls. An auditor will gain an understanding of the client through communication with the client's previous auditor (in the case of a client acceptance decision), staff , management, and other relevant parties. The final stage in the client acceptance or continuance decision process involves the preparation of an engagement letter, which sets out the terms of the audit engagement to avoid any misunderstandings between the auditor and their client.

TRUE-FALSE STATEMENTS

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

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

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

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

5. When auditors divest themselves of shares owned in a client company, they are eliminating their self-review threat to independence.

6. Objectivity refers to the obligation that all members of the professional bodies be straightforward and honest.

7. The key difficulty for third parties in successfully claiming against the auditor is establishing that the client's management contributed to the third party's loss.

8. Ensuring compliance with auditing regulations will *not* assist auditors in avoiding litigation.

9. Third parties are anyone other than the client and its shareholders that use the financial statements to make a decision.

10. Being negligent means *not* exercising due care.

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

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

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

14. An engagement letter does *not* include an overview of the client's responsibility for the preparation of the financial statements.

ANSWERS TO TRUE-FALSE STATEMENTS

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
1.	T	3.	T	5.	F	7.	F	9.	T	11.	T	13.	T
2.	F	4.	T	6.	F	8.	F	10.	T	12.	T	14.	F

MULTIPLE CHOICE QUESTIONS

15. Pete Marsh wrote up an advertisement for his firm. In his draft to the local newspaper he indicated that the firm was able to provide services that he knew it could not deliver. Which part of the profession's standards or codes of conduct was Pete breaking?
    a. objectivity
    b. professional behaviour
    c. confidentiality
    d. communication

16. Cliff Marsden has been an audit manager at Copeland & Cahoon, CA's the past ten years. Two years ago he performed human resources and internal audit functions for 9 months while his client underwent a major restructuring. His firm has a policy of changing audit partners and managers every five to seven years. He is reluctant to take on the audit because he believes there is an independence threat. Which threat is in play?
    a. integrity threat
    b. familiarity threat
    c. self-review threat
    d. advocacy threat

17. Luanne Phong just joined the firm of Moses, Denson, and Etchevery (MDE). She found out that she owns shares in a client company of MDE. She is going to divest herself of these shares. Which threat to her independence will she be eliminating?
    a. self-interest threat
    b. self-review threat
    c. familiarity threat
    d. advocacy threat

18. Jae Williams, CA lives in the same neighbourhood as one of her major clients. She and her children are involved in the Lord Reading Yacht Club, as are many of her client's management employees. How would her independence threat best be described?
    a. self-interest threat
    b. self-review threat
    c. advocacy threat
    d. none of these

19. Shayna Kirschfield audits a company that has market capitalization of $20,000,000. There is also a requirement that the partners in her firm be rotated every seven years and the audit committee must pre-approve all services provided to the client by Shayna's firm. What kind of client is this?
    a. small business
    b. diversified
    c. reporting issuer
    d. partnership

20. When Joe Girardi, CA tried to collect last year's audit fees, he was told that he would receive the fees for the previous year and the current year upon finishing this year's work and issuing a "clean" audit opinion. This was non-negotiable and he was told that if he did not want to go along with it, the client would get another auditor. When he decided to leave his client, what threat to his independence did he mitigate?
    a. self-interest threat
    b. self-review threat
    c. advocacy threat
    d. none of these

21. The firm of McMaster and Martin, CA's is concerned that its client's current corporate culture may have an impact on the firm's independence. What kinds of safeguards can the client introduce or create to reduce the threat to independence?
    a. introduce appropriate corporate governance mechanisms such as the establishment of an audit committee
    b. ensure that the responsibility for the appointment and removal of an auditor rests with independent directors on the audit committee or the board
    c. both a and b
    d. none of the above

22. When the external auditors perform work they are responsible for auditing the financial statements. Which users are the auditors least likely to deal with in fulfilling their duties?
    a. executive directors of the board
    b. audit committee of the board
    c. shareholders
    d. internal auditors

23. Brenda Beauchamp withdrew from a client engagement. The client sued her for not fulfilling the understanding in the engagement letter and can establish that Brenda owed him a duty of due care. How can this be done using legal means?
    a. the client can sue the auditor for breach of contract
    b. the client can claim that the auditor failed to take reasonable care in the performance of the audit
    c. both a and b
    d. none of the above

24. Rob Wood has reviewed the engagement letter his firm has prepared for a client. Which of these elements would he be surprised to find?
    a. unrestricted access to persons within the entity in order to obtain audit evidence
    b. references to Canadian generally accepted auditing standards
    c. management's responsibilities
    d. previous year's internal control issues

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

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

26. Professional behaviour refers to the obligation that all members of the professional bodies:
    a. ensure that they do not harm the reputation of the accounting profession.
    b. not allow their personal feelings or prejudices to influence their professional judgment.
    c. refrain from disclosing information to people outside of their workplace that is learned as a result of their employment.
    d. be straightforward and honest.

27. Objectivity refers to the obligation that all members of the professional bodies:
    a. be straightforward and honest.
    b. refrain from disclosing information to people outside of their workplace that is learned as a result of their employment.
    c. not allow their personal feelings or prejudices to influence their professional judgment.
    d. ensure that they do not harm the reputation of the accounting profession.

28. Auditor independence is:
    a. defined as acting with integrity, objectivity and professional scepticism.
    b. essential when complying with the ethical principles to act with integrity and objectivity.
    c. both a and b.
    d. not fundamental to every audit.

29. Independence in appearance is:
    a. the ability to act with integrity, objectivity and professional scepticism.
    b. the belief that independence of mind has been achieved.
    c. the ability to make a decision that is free from bias, personal beliefs and client pressures.
    d. also referred to as actual independence.

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

31. A self-interest threat refers to the threat that can occur when an accounting firm or its staff:
    a. is threatened by the client's staff or directors.

b. has a financial interest in an audit client.
c. needs to form an opinion on their own work or work performed by others in the firm.
d. acts on behalf of its assurance client.

32. Which of the following is an example of a familiarity threat to independence?
    a. a bank account held with the client
    b. performing services for the client that are then assured
    c. both a and b
    d. a former partner of the assurance firm holding a senior position with the client

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

34. Intimidation threats to independence include:
    a. the threat that that the client will use a different assurance firm next year.
    b. a close business relationship with the client.
    c. representing the client in a legal dispute.
    d. preparing information for the client that is then assured.

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

36. An example of a safeguard to independence created by accounting firms is:
    a. the establishment of a code of ethics.
    b. legislation that requires that an auditor be independent.
    c. the existence of client acceptance and continuation procedures.
    d. the establishment of an audit committee.

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

38. The main recipients of the financial statements and the attached audit report are acknowledged as:
    a. the board of directors.
    b. the shareholders or members.
    c. the audit committee.
    d. the provincial stock exchanges.

39. Examples of board committees include the:
    a. risk committee.
    b. nomination committee.
    c. compensation committee.
    d. all of the above.

40. It is the responsibility of the board of directors to:
    a. ensure that the financial statements are fairly presented.
    b. provide an opinion on the fair presentation of the financial statements.
    c. direct the auditors to audit specific financial statement accounts.
    d. none of the above.

41. Executive directors are:
    a. part of the company's management team.
    b. full-time employees of the company.
    c. not members of the company's board of directors.
    d. a and b.

42. Management failed to put in a system of adequate internal controls. The public accounting firm uncovered the weakness, but did not report it to the Board members of the company. What kind of liability, if any, would the auditors be exposed to?
    a. breach of contract
    b. contributory negligence
    c. a and b
    d. no liability

43. The principles established by Justice Moffitt in the *Pacific Acceptance* case do *not* include:
    a. auditors are watchdogs but not bloodhounds.
    b. auditors must properly document procedures used.
    c. auditors have a duty to use reasonable skills and care.
    d. auditors must audit the whole year.

44. Under tort law, to prove that an auditor has been negligent the plaintiff must establish:
    a. there was a breach of the duty of care.
    b. a loss was suffered as a result of the breach of duty of care.
    c. a duty of care was owed by the auditor.
    d. all of the above.

45. Auditors can avoid litigation by:
    a. ensuring compliance with ethical regulations.
    b. meeting with the client's nomination committee to discuss any significant audit issues.
    c. training their staff and regularly updating their knowledge.
    d. a and c.

46. An auditor's assessment of their client's integrity would *not* include:
    a. whether the auditor has sufficiently competent staff to complete the audit.
    b. the client's attitude to audit fees and its willingness to pay a fair amount.
    c. the client's attitude to risk exposure and management.
    d. the reputation of the client and its management.

47. The final stage in the client acceptance and continuance decision process involves:
    a. the auditor obtaining a management representation letter from the client.
    b. the auditor preparing an independence declaration statement.
    c. the client's audit committee meeting with the auditor.
    d. the preparation of an engagement letter.

ANSWERS TO MULTIPLE CHOICE QUESTIONS

Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.	Item	Ans.
15.	b	20.	d	25.	d	30.	d	35.	d	40.	a	45.	d
16.	c	21.	c	26.	a	31.	b	36.	c	41.	d	46.	a
17.	a	22.	c	27.	c	32.	d	37.	d	42.	b	47.	d
18.	d	23.	a	28.	c	33.	a	38.	b	43.	a		
19.	c	24.	d	29.	b	34.	a	39.	d	44.	d		

SHORT ANSWER QUESTIONS

SA 48

Indicate whether you agree or disagree with the following statements and explain your reasoning.

a) To ensure that it is independent of prospective and continuing clients, an audit firm must review the threats to independence, and make certain that safeguards are put in place to limit or remove those threats.

b) The final stage in the client acceptance and continuance decision process involves assessing independence threats.

c) By signing the engagement letter, management is not necessarily considered to be responsible for the financial statements.

d) To successfully sue an auditor, a plaintiff must only prove that a duty of care was owed by the auditor.

Solution:

a) Agree. An audit firm should always assess independence before the client acceptance or continuance decision is made.

b) Disagree. The final stage in the client acceptance and continuance decision process involves the preparation of an engagement letter. An engagement letter is prepared by an auditor and acknowledged by a client before the commencement of an audit.

c) Disagree. Management is considered to be responsible for the financial statements and acknowledges this responsibility when they sign the engagement letter.

d) Disagree. To successfully sue an auditor, a plaintiff must prove not only that a duty of care was owed by the auditor, but also that there was a breach of that duty, and a loss was suffered as a result of that breach.
To establish that an auditor owes them a duty of care, a third party must now establish that the auditor was aware that the third party was going to use the financial statements and that the users relied on the financial statements for the purpose they were prepared.

SA 49

Explain the five fundamental principles of professional ethics.

Solution:

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. Integrity refers to the obligation that all members of the professional bodies be straightforward and honest. Objectivity refers to the obligation that all members of the professional bodies not allow their personal feelings or prejudices to influence their professional judgment. Professional competence and due care refers to the obligation that all members of the professional bodies maintain their knowledge and skill at a level required by the professional bodies. Confidentiality refers to the obligation that all members of the professional bodies refrain from disclosing information to people outside of their workplace that is learned as a result of their employment. Professional behaviour refers to the obligation that all members of the professional bodies comply with rules and regulations and ensure that they do not harm the reputation of the profession.

SA 50
Distinguish between independence of mind and independence in appearance.

Solution:
Independence is essential when complying with the ethical principles to act with integrity and objectivity. Independence of mind is the ability to act with integrity, objectivity and professional scepticism. It is the ability to make a decision that is free from bias, personal beliefs and client pressures. Independence of mind is also referred to as actual independence. Independence in appearance is the belief that independence of mind has been achieved. It is not enough for an auditor to be independent of mind; they must also be seen to be independent.

SA 51
Describe the three categories of safeguards to an auditor's independence.

Solution:
Safeguards are mechanisms that have been developed by the accounting profession, legislators, regulators, clients and accounting firms. The accounting profession, legislation and regulation have created a range of safeguards including education of accountants about the threats to independence, the establishment of a code of ethics, and legislation that requires that an auditor be independent. Clients can put in place appropriate mechanisms that will reduce the threat to independence. These include having appropriate corporate governance mechanisms, such as the establishment of an audit committee and establishing policies and procedures dedicated to ensuring that the financial statements are true and fair. Accounting firms also have in place a range of safeguards to ensure independence such as policies and procedures to ensure the quality of their service and providing continuing education for their staff regarding these policies and procedures.

SA 52
Explain the purpose and major contents of an engagement letter between the auditor and their client.

Solution:
The engagement letter is a form of contract between an auditor and their client. Its purpose is to set out the terms of the audit engagement, to avoid any misunderstandings between the auditor and their client. The letter confirms the obligations of the client and the auditor. It also includes an explanation of the scope of the audit, the timing of the completion of various aspects of the audit, an overview of the client's responsibility for the preparation of the financial statements, the requirement that the auditor have access to all information required, independence considerations and fees.

ESSAY QUESTIONS

ES 53
Audit committees have been widely recommended as being an important mechanism for enhancing the external auditor's independence. What are the important characteristics of audit committees and discuss why these characteristics are considered so important to a committee's effective and efficient operation.

ES 54
The key difficulty for third parties in legal action against auditors has been establishing that a duty of care was owed to them by their auditor. Explain the development of the relevant legal principles relating to an auditor's duty of care to third parties with reference to specific case law.

ES 55
Independence is considered one of the key characteristics of auditors. Explain why auditor independence is so important to the effectiveness of an audit and explain the various threats to an auditor's independence.

CASE

Ca 56

The WRI Audit Committee has a policy of changing audit firms every five years to ensure that they receive fresh approaches from different audit firms. Accordingly, the WRI Board has asked Morgan Faustini, & Feaster to replace its previous audit firm.

WRI is a manufacturer and distributor of wire ropes, industrial cables, and rigging cables and has a reputation for its ability to fill special orders and to ship across Canada from its Thunder Bay facility on time and at competitive prices. They have a reputation among their customers for going the extra mile and have kept a loyal customer base for over a century.

Jack Bonami, a new partner at Morgan, Faustini & Feaster, a growing CA firm in northern Ontario, is excited about WRI becoming a potential new client. The previous week he met with the Canadian President of WRI, Bob Rooper.

Jack Bonami quickly decided that Bob Rooper was a man of integrity and his frank and open opinions would make it a pleasure to deal with him. He also appeared to have a competent management team in place.

Jack also wanted to make an impression on his new firm by bringing in several new clients in the next year or two, as a good portion of his future compensation will be derived from new business.

He is also aware that any negligence on his part during the client acceptance phase would reflect on his professional judgment and open the firm to possible litigation.

The senior partner, Bob Morgan, has invited Jack Bonami to join him in his office to discuss WRI.

Required:

a) You are Bob Morgan, the Senior Partner at Morgan, Faustini & Feaster. What would be on your "checklist" of client acceptance questions? Prepare an exhaustive inventory of all the questions you would ask Jack before deciding to accept or reject WRI.

b) The firm recently lost a lawsuit and has parted ways with the partner-in-charge of the aggrieved client. What can Bob Morgan do to avoid litigation?

Solution:

a) The first step involves the assessment of client integrity. When assessing client integrity, the auditor will consider the following questions:

1. What is the reputation of the client, its management, directors, and key stakeholders
2. What are the reasons provided for switching audit firms (client acceptance decision)
3. What is the client's attitude to risk exposure and management
4. What is the client's attitude to the implementation and maintenance of adequate internal controls to mitigate (minimize) identified risks
5. To what extent is the client's interpretation of accounting rules appropriate
6. To what extent is the client willing to allow the auditor full access to information required to form their opinion
7. What is the client's attitude to audit fees and its willingness to pay a fair amount for the

work completed.

Here is a possible checklist of questions with regard to the firm's possible existing prohibitions that would preclude the firm or any staff member from performing the engagement:

8. We would ask about the prohibitions listed below:
   - A. Financial interests in entity.
   - B. Loans and guarantees to/from client.
   - C. Close business relationships with client.
   - D. Family and personal relationships with client.
   - E. Future or recent employment with entity serving as officer, director, or company secretary of client.
   - F. Provision of non-assurance services such as corporate finance or legal services that involve dispute resolution.
   - G. Performance of management functions for the client.
   - H. Making journal entries or accounting classifications without first obtaining management's approval.
   - I. Acceptance of gifts or hospitality from client (other than clearly insignificant).
   - J. Fee quote that is considerably less than market price for the engagement.
   - K. Provision of legal services.
   - L. Preparation of source documentation.
   - M. Provision of corporate finance services.

Are we satisfied there are no significant "threats" to independence? Address each of the following threats in relation to the firm and any member of the engagement team:

- A. Self-interest (i.e., where loss of client fees would be material).
- B. Self-review (i.e., the nature and extent of bookkeeping services required or where a judgment from a previous engagement needs to be evaluated in reaching conclusions).
- C. Advocacy (i.e., acting as an advocate on behalf of client in litigation or in share promotion).
- D. Familiarity (i.e., being too sympathetic to the client's interests).
- E. Intimidation (i.e., being deterred from acting objectively and exercising professional scepticism).

Bob Morgan would also ask about whether there are any safeguards to reduce the above threat(s) to independence identified to an acceptable level.

b) One of the ways that an auditor can avoid litigation is to follow up on any significant weaknesses in the client's internal control procedures in a previous year's audit. There are a number of ways that an auditor can avoid litigation. These include:

- A. hiring competent staff
- B. training staff and updating their knowledge regularly
- C. ensuring compliance with ethical regulations
- D. ensuring compliance with auditing regulations
- E. implementing policies and procedures that ensure:
  - – appropriate procedures are followed when accepting a new client
  - – 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

F. meeting with a client's audit committee to discuss any significant issues identified as part of the audit

G. Following up on any significant weaknesses in the client's internal control procedures in a previous year's audit.