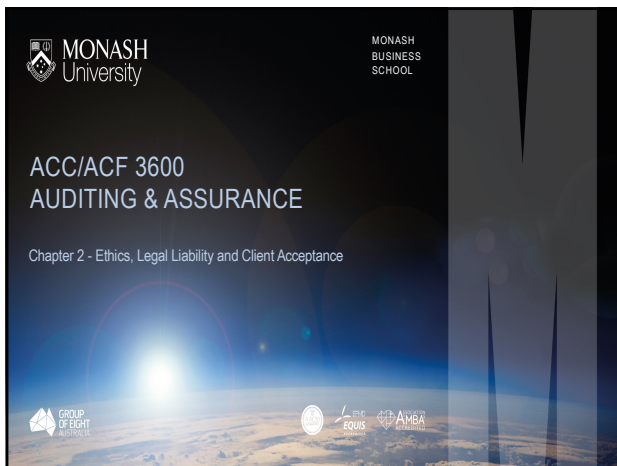
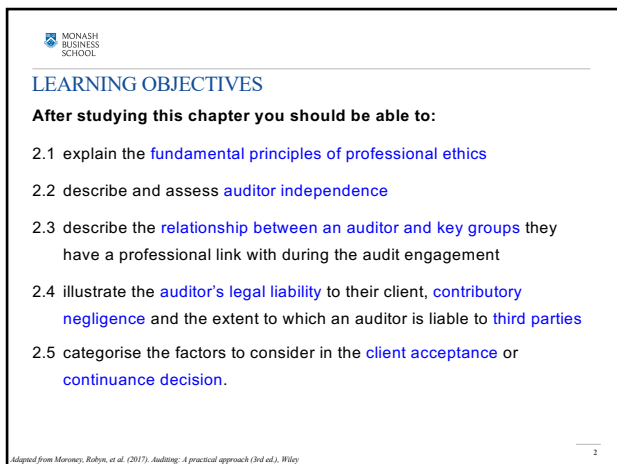
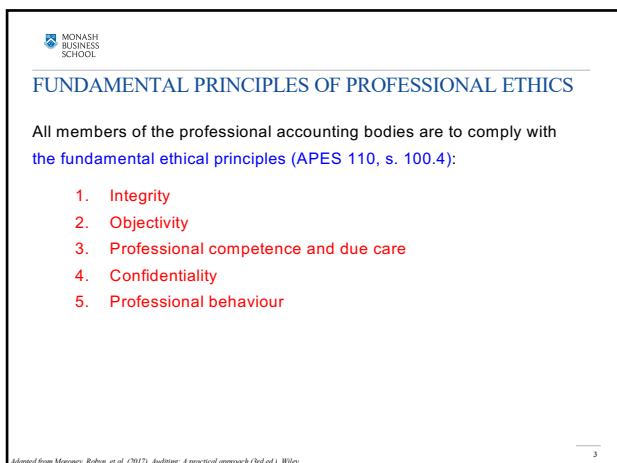




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Professional Ethics

- Integrity
 - Straightforward, honest, do not mislead
- Objectivity
 - Personal feelings, bias, prejudice, undue influence
- Professional competence/due care
 - Knowledge, skill, due care/diligence
- Confidentiality
 - Disclosure – deliberate, inadvertent
- Professional Behaviour
 - Compliance, claims, undermine reputation

Adapted from Messier, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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Question 1

Andrew Nottle is an auditor with the accounting firm of Peter and Jensen. He is involved with the audit of RoadCap Ltd. RoadCap has just appointed a new Chief Executive Officer (CEO), Michael Burrows. Michael and Andrew are close friends. They have known each other for 20 years.

Required
For each situation:

(a) Indicate which of the fundamental principles of the Code of Ethics for public accountants is implicated in the details provided.

(b) Indicate whether you believe there has been a violation of the principle listed in (a). Explain your answer.




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(i) It was Andrew's birthday. Michael offered free Australian Grand Prix tickets for Andrew and his family as a birthday gift. Andrew accepted the gift.




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(ii) Michael wanted to increase company sales but he was having some difficulties in finding new customers. He asked Andrew for his advice. Andrew had the names and contact details of some companies that might be interested in buying RoadCap's products. Andrew's list of companies and their contact details was made up of customers of a previous client. Andrew gave the list to Michael.

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(iii) RoadCap implemented a new information technology system. The new system was developed and designed according to the specific needs of RoadCap. Andrew assigned an audit assistant who was a new graduate to examine the new system and document how it operates. Andrew told the audit assistant that since information technology systems are much the same as each other, it should not be difficult to document how it operates.

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(iv) The accounting firm of Peter and Jensen decided to attract more audit clients. They advertised their firm on the newspaper claiming: 'There is no one who can do a real audit besides us'.

9



AUDITOR INDEPENDENCE

- **Independence** is the ability to act with **integrity, objectivity and with professional scepticism** (questioning mind)
- Lack of auditor independence impacts on **credibility** and **reliability** of the financial report
- The auditor **must be, and be seen to be**, independent

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley
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AUDITOR INDEPENDENCE

- **INDEPENDENCE OF MIND** –
 - ☐ ability to act independently
 - ☐ ability to make a decision free from bias
 - ☐ personal belief and client pressures
- **INDEPENDENCE IN APPEARANCE** –
 - ☐ belief that independence of mind has been achieved

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley
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AUDITOR INDEPENDENCE THREATS

1. Self-interest
2. Self-review
3. Advocacy
4. Familiarity
5. Intimidation

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley
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AUDITOR INDEPENDENCE THREATS

Self-interest threat:

- Can occur if the audit firm or its staff **have financial interest** in audit client.
- Examples:
 - ❑ **Bank account** held with the client.
 - ❑ **Shares owned** in the client.
 - ❑ **A loan** to or from the client.
 - ❑ **Fee dependence**, where the fees from a client form a significant proportion of all fees of the firm.
 - ❑ **Close business relationship** with the client.

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR INDEPENDENCE THREATS

Self-review threat:

- Can occur when the assurance team need to form an opinion **on their own work or work done by others in their firm**.
- Examples:
 - ❑ Assurance team member has recently been **an employee or director of the client**.
 - ❑ **Preparing information for the client** that is then assured.
 - ❑ **Performing services for the client** that are then assured.

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR INDEPENDENCE THREATS

Advocacy threat:

- Can occur when an audit firm or assurance staff act, or is believed to act, **on behalf of assurance client**.
- Can lead to **questioning of auditor's objectivity**.
- Examples:
 - ❑ **Encouraging others** to buy client's shares or bonds.
 - ❑ **Representing client** in negotiations with third party.
 - ❑ **Representing the client** in a legal dispute.

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR INDEPENDENCE THREATS

Familiarity threat:

- Can occur when **close relationship** exists or develops between assurance firm and client, or firm and client personnel.
- Assurance staff can become **too sensitive to needs of client** and lose objectivity.
- Examples:
 - ❑ **Long association** between assurance firm and client.
 - ❑ **Long association** between assurance firm and client personnel.
 - ❑ **Close personal relationships** between assurance firm staff and senior client personnel.
 - ❑ **Former partner** of assurance firm holding senior position at the client.
 - ❑ **Acceptance of gifts** by members of assurance team from their client (other than minor tokens).
 - ❑ **Acceptance of hospitality** by members of assurance team from client (other than minor gestures).

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR INDEPENDENCE THREATS

Intimidation threat:

- Can occur when member of assurance team **feels threatened** by the client's staff or directors.
- Assurance team member **unable to act objectively, fearing negative consequences**.
- Examples:
 - ❑ Threat that client will **use different assurance firm** next year.
 - ❑ **Undue pressure** to reduce audit hours to reduce fees paid.

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 2

Jerry is the auditor in charge of ABC Company in 2017. During the audit, Jerry found that his ex-girlfriend Mary is the CEO of ABC Company. Jerry loves Mary so much and fully trusts Mary. One day, Jerry found that some of the sales invoices were missing. Mary told him that these invoices were stored in other offices and there should be no problems related to these invoices. Jerry believed that and simply ignored those invoices.

Questions: Identify the threat to auditor independence in this case

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 3

You are the auditor in charge of XYZ Company. During the audit, you found that one junior staff, Kevin, has invested a lot of money in XYZ Company. Kevin also asked many of his friends and family members to buy shares of XYZ Company. Currently, Kevin is in charge of confirming cash account.

Questions: Identify the threat to auditor independence in this case

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 4

Sam is the auditor in charge of AAA Company. During the audit, Sam found that many of the sales invoices were missing and intended to issue disclaimer of audit opinion. However, the CEO of AAA Company refused to provide details of these invoices and asked Sam to ignore these invoices and to issue unqualified audit opinion. Otherwise, AAA Company will either pay lower audit fees or change auditor next year. Sam followed the advices by the CEO of AAA Company.

Questions: Identify the threat to auditor independence in this case

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR INDEPENDENCE SAFEGUARDS

1. Created by profession, legislation or regulation

- Quality control standards
- Code of ethics
- Legislative requirement to be independent

2. Created by clients

- Corporate governance
- Policies and procedures – to safeguard auditors independence

3. Created by accounting firms

- Quality control procedures –to ensure quality of service
- Client acceptance and continuance

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR'S RELATIONSHIPS WITH OTHERS

SHAREHOLDERS

- Audit report addressed to them
- Attendance at AGM
- Formal responsibility for auditor appointment

BOARD OF DIRECTORS

- Represents shareholders
- Executive and non-executive directors
- Large companies have committees made up of several directors to deal with specific issues

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR'S RELATIONSHIPS WITH OTHERS

AUDIT COMMITTEE

- A special committee of the board of directors
- Acts on behalf of board in **financial reporting** and **audit matters**
- **Top 500** listed companies must have audit committee, **top 300** must follow ASX guidelines
- **Aid to auditor independence**
- **Non-executive directors, majority independent**
- Financial accounting knowledge desirable
- Meets with external and internal auditors

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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AUDITOR'S RELATIONSHIPS WITH OTHERS

INTERNAL AUDITORS

- Viewed by external auditor as **part of client**
- External auditor can reduce scope of testing **if effective internal audit function** (ASA 610: ISA 610).
- Depends on internal auditor's:
 - » **Objectivity**
 - » **Technical competence**
 - » **Due professional care**
 - » **Communication with external auditors**

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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RESPONDING TO QUESTIONS AT AN ANNUAL GENERAL MEETING (AGM)

- External auditor is required to attend **listed** company's **AGM** (Corp Act 2001, section 250RA)

Guidance GS 010:

- Written questions to the auditor before the AGM
 - For shareholders (entitled to cast vote) of listed companies
 - About the content of the **audit report** or the **conduct of the audit**
- Questions to the auditor at the AGM
 - Additional possible topic for questions are **accounting policies** of the company and **independence** of the auditor
- Auditor to be involved in the AGM planning process to discuss whether there are issues likely to be of interest for the AGM participants.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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LEGAL LIABILITY

- External auditor must exercise **due care**, be **diligent** in **applying standards** and **documenting work**
- Auditor can be found negligent and liable for damages under tort law **if it is established that:**
 - A duty of care was owed by the auditor
 - There was a breach of the duty of care
 - A loss was suffered as a consequence of that breach

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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LEGAL LIABILITY

LEGAL LIABILITY TO CLIENTS:

- Liability under either **contract** or **tort law**
- Negligence:** failed in performance of audit by being careless and breaching duty of care
- Contract:** failed duty of care implicit in acting as auditor and explicit in engagement letter
- Case law shows change in **definition of 'reasonable' care** and skill over time as standards change

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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LEGAL LIABILITY

LEGAL LIABILITY TO CLIENTS

Key cases:

- London and General Bank Ltd (1895)
- Kingston Cotton Mill (1896)
- Pacific Acceptance (1970)
- HIH Royal Commission Report (2003)
- Centro Properties Group (2011-12)

Adapted from Maroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley
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LEGAL LIABILITY

Contributory negligence applied in **AWA (1992)** case

If directors are also negligent, auditor and client (management) is held accountable **in proportion** to their guilt

Adapted from Maroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley
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LEGAL LIABILITY

LEGAL LIABILITY TO THIRD PARTIES

- No contract between auditor and third parties, they must rely on **tort law** and show duty of care
- **Duty of care less likely with third parties**

Adapted from Maroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley
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LEGAL LIABILITY

LEGAL LIABILITY TO THIRD PARTIES

Key cases:

Candler (1951) - auditors liable to third parties that the auditors know their clients will show the accounts to

Scott Group (1978) - auditors liable to third parties that they can reasonably foresee may rely on the financial report of their client

Caparo (1990) - reasonable proximity between auditor and third parties, auditor must be aware of third party group and the decisions they intend to make

Columbia Coffee and Tea (1992) - audit firm had manual stating they acknowledge that third parties would rely on audited accounts

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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LEGAL LIABILITY

LEGAL LIABILITY TO THIRD PARTIES

Esanda (1997) - Judge argued against Columbia finding: Australian High Court ruled that for a third party to establish duty of care, they must show:

- 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

Third parties can request **privity letter**

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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LEGAL LIABILITY

AUDITOR CAN TAKE STEPS TO AVOID LITIGATION

- Hire competent staff, regular training
- Comply with ethical and auditor regulations
- Implement policies and procedures:
 - » **Client acceptance**
 - » Staff allocation
 - » Ethical and independence issue identification and rectification
 - » Adequate work **documentation**
 - » Gather **adequate** and **appropriate evidence** to support opinion

Adapted from Maroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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LEGAL LIABILITY

AUDITOR CAN TAKE STEPS TO AVOID LITIGATION

- Meet with client's **audit committee** to discuss significant issues arising in audit
- Follow up any **significant weaknesses** in client's **internal control procedures** from previous year audit

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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CLIENT ACCEPTANCE AND CONTINUANCE

The **FIRST STAGE** in any AUDIT is
CLIENT ACCEPTANCE or **CONTINUANCE DECISION**

- **Step 1: Assess client integrity**
- **Step 2: Assess audit firm's ability to meet ethical requirements, service client**
- **Step 3: Prepare client engagement letter**

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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CLIENT ACCEPTANCE AND CONTINUANCE

Client integrity - Auditor should consider:

- **Reputation** of client, management, directors, key stakeholders
- Client's **reason for switching** auditor
- Client's **attitude to risk** exposure and management
- Client's **attitude to using internal controls** to mitigate risk
- Appropriateness of the client's **interpretation of accounting rules**
- Client's willingness to allow auditor **full access** to information required to form an opinion
- Client's attitude and willingness to **pay fair amount** for audit work

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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CLIENT ACCEPTANCE AND CONTINUANCE

Auditor can obtain information from:

- Prior auditor (with client's permission, APES 110),
- Client personnel,
- Third parties,
- Key competitors
- Review of press articles

Adapted from Maroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley

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CLIENT ACCEPTANCE AND CONTINUANCE

ETHICAL REQUIREMENTS

- Consider if any threats to fundamental principles arise from appointment (APES 110 s.210)
- Auditor must ensure it has **sufficient staff available** with required knowledge to complete audit (professional competence and due care)
- Consider potential independence threats, safeguards and remedies
- **Decline** appointment **if threat insurmountable**

Adapted from Maroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley

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CLIENT ACCEPTANCE AND CONTINUANCE

ENGAGEMENT LETTER (ASA 210; ISA 210)

- Prepared by auditor, acknowledged by client
- Form of contract, can expand on obligations in Corporations Act
- Explains **scope** of audit, **timing** of various aspects of audit, overview of **client responsibilities**
- Confirms auditor's right of **access to information, independence considerations**
- Sets **fees**
- See figure 2.1 for example

Adapted from Maroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.), Wiley

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STRUCTURE OF THE ENGAGEMENT LETTER (ASA 210)

- Addressees: Directors of the company
- Objective and scope of the audit
 - Obtain reasonable assurance that FS is free from material misstatements
- Responsibilities of the auditor
 - Assessment of the risk of material misstatement
 - No opinion on the effectiveness of the internal control system
 - Appropriateness of accounting policies used by management
 - Appropriate use of the going concern assumption by management

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STRUCTURE OF THE ENGAGEMENT LETTER (ASA 210)

- Responsibilities of the management
 - Preparation of the financial report
 - Suitability of the internal control system for the preparation of the financial report
 - Provide access to all FS related documents and to all persons within the entity
 - Write and sign representation letters upon request
- Fee arrangements
- Other Matters under the Corporations Act 2001
 - Independence
 - Annual general meetings: pass on written questions
- Presentation of Audited Financial Report on the Internet

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