# 4 Professional Judgment and Ethics

As highlighted in Chapter 2, sound quality control practices—coupled with auditors who are competent, ethical, and independent; act with due care; and exercise professional skepticism and professional judgment—help firms provide high quality audits. In this chapter, we will introduce a framework for professional judgment and a framework for ethical decision making, which can assist individual auditors in meeting their responsibility to perform a high quality audit and (hopefully) in avoiding lawsuits.

## LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Explain the auditors' professional judgment process and apply it to audit issues.
2. Explain judgment tendencies and their impact on the professional judgment process.
3. Explain the auditors' ethical reasoning framework and apply it to resolving an ethical dilemma.
4. Explain the impact of rationalizations and ethical blind spots on auditors' ethical reasoning.
5. Examine the role of the rules of professional conduct in encouraging PA ethical behaviour. Apply rules of professional conduct to case facts and identify violations.
6. Understand the potential threats to independence. Apply the threats and safeguards approach to resolving conflicts of interest.

## It's a Matter of Professional Judgment—The Livent Audits

**"It's a matter of professional judgment" was the Deloitte partners' response to the Institute of Chartered Accountants of Ontario (the ICAO, now CPA Ontario) during a disciplinary committee hearing regarding charges of professional misconduct in relation to their performance of the Livent audits, which involved fraudulent financial reporting. However, the disciplinary committee disagreed and concluded that three of the four Deloitte partners were guilty of professional misconduct.**

At its peak, Livent was the largest live theatre company in North America, producing hits such as *The Phantom of the Opera*. In 1998, after the 1997 audit was completed and filed with the OSC, new owners took over and soon discovered that the financial statements were a fraud. The misstatements involved improper recognition of revenue and the improper deferral and capitalization of expenses. Later that year, Livent filed for bankruptcy. Several senior members of Livent management were found guilty of fraud and the two founders, Garth Drabinsky and

*continued >*

*continued*

Myron Gottlieb, served time in prison. Both were paroled in 2012. It's estimated that investors lost $500 million when Livent collapsed in 1998.

When commenting on the disciplinary case, Bruce Jenkins, the deputy chief of Deloitte at the time, asked, "What constitutes professional misconduct? Is the fact that you did not get it right professional misconduct? We do not believe so. We don't believe there is a right or wrong answer regarding accounting."

He further explained: "The fraud involved the manipulation of Livent's accounting and computer records, particularly to make their shows look differently than they actually were in terms of their profitability. But such manipulation had nothing to do with the way we handled the four accounting transactions we audited."

Jenkins contended that Deloitte followed GAAS: "We considered this engagement as high risk," says Jenkins, "We had a number of partners involved and had a lot of consultation. We all knew this thing was a major challenge."

However, the ICAO disciplinary noted in its decision: "It is not sufficient for auditors to identify the risks and make appropriate plans to deal with them. The audit must be properly executed." The disciplinary committee noted that the auditors were aware senior management was deceptive in its explanations of certain accounting transactions; however, the auditors failed to consider the broader implications of that deception and failed to exercise appropriate professional judgment and skepticism.

The committee further explained: "The proper exercise of professional judgment requires the auditor to reach a correct conclusion. It is not enough for the auditor to have an appropriate process, to identify the issues, and to correctly set out what should be done."

As you read through the chapter, consider the following questions:

- What is professional judgment in the context of the audit process? (LO 1)
- What individual and contextual factors can impede and enhance auditors' professional judgment? (LO 2, 3, 4)
- How do auditors ensure that their professional judgment protects the public interest? (LO 5, 6)

Sources: Ken Mark, "Deloitte will appeal ICAO ruling," *The Bottom Line*, 2008. "What was Livent Inc.?"*Globe and Mail,* March 24, 2009, accessed online March 12, 2015, at **http://www.theglobeandmail.com/report-on-business/what-was-livent-inc/article4281112/**. Institute of Chartered Accountants of Ontario Disciplinary Committee, "In the matter of Douglas Barrington, FCA, Peter Chant, FCA, Anthony Power, FCA, and Claudio Russo, CA, members of the Institute under Rule 206 of Rules of Professional Conduct, Decision and Reasons for Decision, February 11, 2007."

**PROFESSIONAL** judgment is the essence of auditing. In order to perform a quality audit, auditors must make quality judgments about evidence (e.g., Does the evidence support the existence of timber assets?), probabilities, and options (e.g., Which audit procedures to be performed?).

## A Framework for Professional Judgment

LO 1 Explain the auditors' professional judgment process and apply it to audit issues.

In its research report, *Professional Judgment and the Auditor*, the Canadian Institute of Chartered Accountants (now CPA Canada) said:

> Professional judgment in auditing is the application of relevant knowledge and experience, within the context provided by auditing and accounting standards and Rules of Professional Conduct, in reaching decisions where a choice must be made between alternative possible courses of action.[1]

The report further explained that **professional judgment** is analytical and systematic, objective, prudent, and carried out with integrity and recognition of responsibility to those affected by its consequences. This means that auditors must be able to justify a decision on the basis that it:

- Is well thought out;
- Is objective;
- Meets the underlying principles of GAAP and GAAS;
- Has evidence to support the decision;
- Maximizes the likelihood of "good" consequences;
- Is carried out with truthfulness and forthrightness; and
- Considers the impact on the financial statement users.

**Professional judgment**—an analytical and systematic decision process that involves the application of relevant knowledge and experience with the context of auditing and accounting standards and Rules of Professional Conduct. It is objective, prudent, and carried out with integrity and recognition of responsibility to those affected by its consequences.

As one can imagine, this type of decision making can be both complex and difficult. In order to assist auditors and firms, several professional associations—such as CPA Canada, the Institute of Chartered Accountants of Australia, and the Institute of Chartered Accountants of Scotland, as well as the American Center for Audit Quality—have issued professional judgment and professional skepticism frameworks that provide auditors with a methodical approach.

The approach depicted in Figure 4-1 is based upon those various frameworks. Although the framework may seem to be simple, such frameworks are considered to be effective tools in guiding thinking and encouraging auditors to be aware of their own judgment biases and traps and what can go wrong. We will discuss judgment biases and traps in more detail, when we consider the auditor mindset component of the framework.

### Identify and Define the Issue

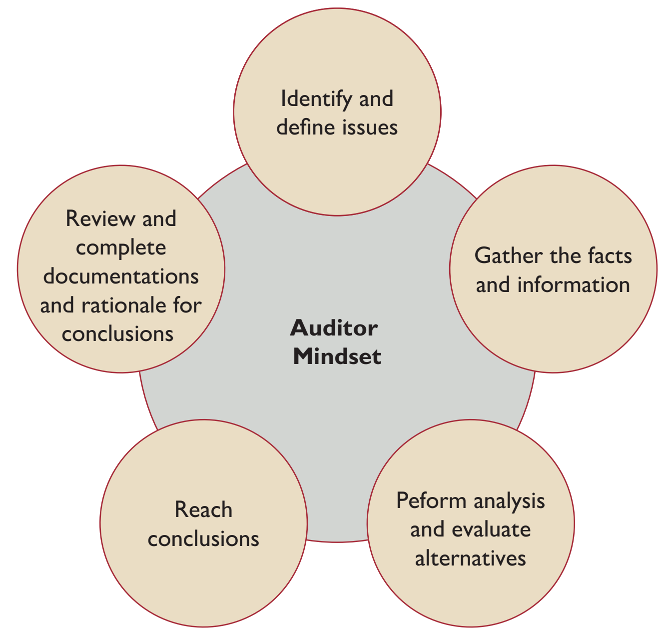
Although it seems to be rather straightforward, this is an important step. In simple terms, we must be clear about "what" we want to solve, or we may solve the wrong problem. This is often referred to as "framing the problem." A famous quote attributed to Albert Einstein explains why this is so important.

> If I had an hour to solve a problem and my life depended on the solution, I would spend the first 55 minutes determining the proper question to ask, for once I know the proper question, I could solve the problem in less than five minutes.

To help identify and define the issue, it is helpful to consider different perspectives (e.g., investors, lenders, management, regulators, other auditors, analysts, customers, or other parties affected by the transaction). This can help the auditor to focus on the real issue (or the "what"). By considering different viewpoints, the auditor can also consider the "why" of the issue. For example, when evaluating a management estimate, is the issue really the reasonableness of the estimate, or the implications of that issue on the client meeting its bank loan requirements?

[1] Canadian Institute of Chartered Accountants, *Research Report: Professional Judgment and the Auditor,* 1995, p. 5, accessed online March 13, 2015, at **https://docs.google.com/file/d/0B2ccgmZijI4UODkxODBjZDAtY2VmNC00YzBkLTkzOWMtN2Q5YmQwNjRkZTRm/edit?ddrp=1&hl=en#**.

Figure 4-1 A Framework for the Auditor's Professional Judgment




By considering different perspectives and thinking about the "why," auditors are more likely to apply the appropriate professional skepticism. For instance, junior auditors often do not understand the reason behind particular audit procedures they are performing. When this is the case, it is difficult to assess whether the evidence is sufficient or if the evidence that has been collected points to a problem. Framing also aids auditors in avoiding the judgment trap of rushing to solve the problem. This is particularly important since auditors often face considerable time pressures and may be too quick in accepting evidence and/or management's explanations.

## Gather the Facts and Information

This is a crucial step in auditing. It often involves evaluating the information that is readily available, as well as information that may need to be obtained from others (for example, a forestry expert). In order to obtain facts, it is important that the auditor understand the client's business. However, as highlighted in the Center for Audit Quality's *Professional Judgment Resource*,[2] gathering facts and information is more than getting the company's story through discussion only. It involves being alert for disconfirming information. It is also important that auditors do not overly rely upon information solely from accounting personnel, but rather include the right people who may be in sales, shipping, or human resources. Auditors also need to investigate potential management biases (e.g., are there management bonuses?) and how they impact the "facts." Related to gathering relevant facts is the need to identify the relevant accounting and auditing standards. And, with all judgments, auditors should consult with other auditors.

## Perform Analysis and Evaluate Alternatives

The auditors' ability to analyze the relevant facts and evaluate the alternatives is directly related to how well the issue was defined in the first place. In this step, the

[2] Center for Audit Quality, *Professional Judgment Resource*, 2014, available at: **www.thecaq.org/reports-and-publications/professional-judgment-resource**.

| Table 4-1 | Useful Questions: How Good Is Your Conclusion? |
|---|---|
| 1. Have I described the rationale for the alternative selected, including the reason why the selected alternative is preferred to other alternatives? | |
| 2. Where applicable, did I document how disconfirming evidence was considered? | |
| 3. Did I assess whether the audit work and the extent of the documentation is consistent with the significance and complexity of the professional judgment reached? | |
| 4. Have I documented relevant information for each of the steps of the process in sufficient detail to allow an experienced auditor to understand the issues, facts considered, and the bases for judgments and related conclusions? | |

Source: Center for Audit Quality, *Professional Judgment Resource*, 2014, p. 10, accessed March 14, 2015, at **www.thecaq.org/reports-and-publications/professional-judgment-resource**.

auditor should identify and evaluate all alternatives. However, the auditor must be careful in selecting the first available alternative. At this stage, the auditor should be mindful of potential judgment tendencies, traps, and biases that can limit auditors' ability to effectively evaluate alternatives. The auditor can avoid many of these judgment traps through consultation with others. This is consistent with the CPAB's conclusion that consultation and ongoing reviews improve audit quality.

### Reach and Document Conclusions

An important part of this step is the auditor's ability to take a "stand back" point of view and consider the issue within the broader context—How does it relate to other evidence in the file? What is its impact on the financial statements? Another key part is documentation. While documentation is often considered in light of the review process, documentation can drive quality decisions. Documentation of the auditors' thought process—why the auditor believes the conclusion is correct, why other options were considered, and why they were discarded—can be very useful in ensuring the auditor maintains objectivity. It can also safeguard against what is referred to as the confirmation bias (unconsciously giving an inordinate weight to evidence that supports the auditor's conclusion).

Table 4-1 lists some useful questions for an auditor to consider when assessing the reasonableness of his or her conclusion.

## Auditor's Mindset and Judgment Tendencies

**LO 2** Explain judgment tendencies and their impact on the professional judgment process.

At the centre of the professional judgment framework is the auditor's mindset. In Chapter 1, we learned that integrity, objectivity, and skepticism represent the art of auditing. These essential skills and qualities, which are the essence of the auditor's mindset, are necessary for each step of the judgment process.

The auditing standards note that **professional skepticism**—a "questioning mind"—is necessary for the critical assessment of audit evidence. This includes questioning contradictory evidence and the reliability of documents and responses from inquiries and other information obtained from management. Sound professional judgment also requires the auditor to exercise objectivity. Objectivity and professional skepticism are closely related. It is likely that a biased auditor will not use the appropriate level of professional skepticism.

**Professional skepticism**—a questioning mind and a critical examination of audit evidence. The appropriate level of professional skepticism varies depending upon the risks of the particular situation.

Like good art, appropriate professional skepticism it is often difficult to define and recognize; however, it is easy to criticize. Table 4-2 summarizes some key traits or qualities that are associated with auditors' professional skepticism.

In their report, *Enhancing Professional Skepticism*, The Standards Working Group of the Global Public Policy Committee (available at **www.thecaq.org**), propose that a way to think about professional skepticism is as a continuum where the appropriate level of professional skepticism varies depending upon the risks of the

| Table 4-2 | What Are Qualities of Professional Skepticism? |
|---|---|
| Questioning mind | The tendency to inquiry, with some sense of doubt |
| Suspension of judgment | Withholding judgment until you have appropriate evidence (i.e., not jumping to conclusions) |
| Search for knowledge | A desire to investigate beyond the obvious |
| Interpersonal understanding | Recognition that people's motivations and perceptions can lead to biased decisions. |
| Autonomy | The conviction to decide on your own rather than being influenced by others. |
| Self-esteem | The self-confidence to resist persuasion and to challenge assumptions |

Source: Kathy Hurtt. 2010. "A Development of a Scale to Measure Professional Skepticism." *Auditing: A Journal of Practice and Theory*: 29(1): 149–171.

particular situation. The opening vignette provides an example of the exercise of professional skepticism and its impact on audit quality. We will revisit professional skepticism throughout the text and will discuss application of the continuum in more depth when we discuss fraud risk and evidence collection.

While auditors need to be skeptical of audit evidence, auditors also need to be skeptical of their own judgment process.[3] In addition to using a judgment framework, awareness of **judgment traps** and biases (often referred to as judgment tendencies) can assist auditors and auditing students in making better judgments. Table 4-3 summarizes some of the common judgment tendencies.

**Judgment traps**—common systematic judgment tendencies and biases that can impede the quality of the professional judgment process.

## Confirmation Bias

This judgment tendency refers to the auditors' potential to put more weight on information that is consistent with their initial beliefs or preferences. The end result may be that the auditor does not adequately consider contradictory evidence. This bias is a common. Think about when you are analyzing an accounting case in one of your courses. After reading the case, you come up with a preliminary recommendation and

**Table 4-3** Judgment Traps and How to Avoid Them

| Common Judgment Tendencies | Strategies to Avoid Them |
|---|---|
| Confirmation | • Make opposing case and consider alternative explanations<br>• Consider potentially disconfirming or conflicting information |
| Overconfidence | • Challenge opinions and experts<br>• Challenge underlying assumptions |
| Anchoring | • Solicit input from others<br>• Consider management bias, including potential for fraud or material misstatement |
| Availability | • Consider why something comes to mind<br>• Obtain and consider objective data<br>• Consult with others and make the opposing case |

Source: Center for Audit Quality, 2014. *Professional Judgment Resource*.

[3] Kathy Hurtt, Helen Brown-Liburd, Christine Early, and Ganesh Krishnamoorthy. "Research on auditor professional skepticism: Literature synthesis and opportunities for future research," *Auditing: A Journal of Practice and Theory*. 32(1): 45–97.

your analysis is focused on supporting that recommendation. You have fallen into the trap of confirmation bias.

## Overconfidence Bias

This judgment tendency is the potential for the auditor to overestimate his or her own ability to perform tasks or to make accurate risk assessments. This type of bias can lead to the inability to see different points of view or contradictory evidence. The auditor may also be reluctant or see no need to involve others in the analysis. Several past CPAB reports have noted that auditors often do not involve specialists at times when it seems they should or, if they do, they tend not to question their findings. It is possible that these auditors were susceptible to the overconfidence bias.

## Anchoring

This judgment tendency refers to when the auditor is "anchored" by the initial numerical number and not adjusting sufficiently when forming a final judgment. Auditors can be particularly susceptible to this since management provides them with preliminary figures and supporting documentation. It also occurs in the choice of auditing procedures. Auditors refer to the prior year's working papers, which increases the likelihood of using the same procedures as last year without reflecting on whether the procedures are appropriate.

## Availability

This judgment tendency can cause auditors to estimate or forecast the likelihood of an event based on how easily they can recall an example or instance of that event. This bias can dampen professional skepticism, particularly when the auditor is faced with a rare event. For example, although there is much discussion of fraudulent financial statements, for most auditors this is a rare event. This means that auditors do not have a vivid fraud client experience to draw upon and can potentially miss fraud when they come across it, or they do not consider fraud when accepting potential clients.

There are several other unconscious biases that affect judgment quality. As mentioned in our discussion of identifying the issue, sometimes auditors fall into the "rush to solve" trap. This often results in quick judgments and not enough effort in evaluating alternatives. Two other biases, which have important implications for objectivity, are motivated reasoning and the self-serving bias. Motivated reasoning refers to interpreting the information as the auditor expects it should be interpreted, rather than considering other alternatives. Closely related to motivated reasoning, the self-serving bias occurs because people are generally not very good at ignoring their self-interest when evaluating information. Much of the criticism surrounding the Enron and WorldCom audits was based upon the argument that the auditors succumbed to their self-serving biases.

In addition to individual biases, the general characteristics of the work environment, such as time pressures, can contribute to applying less than ideal professional skepticism. Engagement teams' and individual auditors' performance often include performance measures based upon time budgets. However, this type of pressure can lead auditors not to put in the increased effort that is required. Also, junior auditors may struggle with all the overwhelming technical details (firm policies, GAAS, terminology, audit methodology) and are focusing on simply trying to understand the issues. As one can imagine, it is certainly difficult to apply the appropriate level of professional skepticism in such a situation.

Throughout the textbook, we will emphasize professional judgment and skepticism along with judgment tendencies. We will apply these concepts in our discussion of key steps of the audit process and will include examples and problems to help you develop your own professional judgment and skepticism and think about your own judgment biases and tendencies.

**concept check**

C4-1 What are the four steps of the professional judgment framework and how is it a useful tool? What are some common judgment traps?

C4-2 Why is professional skepticism considered essential to the proper exercise of professional judgment?

LO 3 Explain the auditors' ethical reasoning framework and apply it to resolving an ethical dilemma.

# A Framework for Ethical Reasoning

Public accounting firms have a different relationship with users of financial statements than most other professionals have with the users of their services. Lawyers, for example, are typically engaged and paid by a client and have the primary responsibility to be an advocate for that client. Public accounting firms are engaged by management for private companies and by the audit committee for public companies. The structure of the auditor–client relationship has an inherent conflict of interest in that the company that issues the financial statements pays the PA; however, the primary beneficiaries of the PA's services (the audit opinion) are financial statement users. Often, the auditor does not know or have contact with those users but has frequent meetings and ongoing relationships with client personnel. Given the auditor's unique role and its public interest obligations, it is essential that users' trust in the auditors' professional and ethical behaviour is not misplaced. If users were to believe that public accounting firms lacked integrity, then the opinions they delivered would be worthless.

## Resolving Ethical Dilemmas

**Ethics**—a set of moral principles or values.

**Ethics** can be broadly defined as a set of moral principles or values. We use these values to guide us in how we should act in various situations. Each of us has such a set of values, although we may or may not have considered them explicitly. Philosophers, religious organizations, and other groups have, in various ways, defined ideal sets of moral principles or values. Examples of prescribed sets of moral principles or values at the implementation level include laws and regulations, church doctrines, professional codes of ethics for professional groups such as CPAs, and codes of conduct within individual organizations such as accounting firms, corporations, and universities.

The guiding principles of the CPA Ontario Rules of Professional Conduct, which are the basic ethical principles that guide Canadian auditors' ethical conduct, are summarized in Table 4-4.

**Table 4-4** Fundamental Ethical Principles—CPA Ontario Code of Professional Conduct

**The following list of ethical principles incorporates characteristics and values that are associated with CPAs' ethical behaviour.**

| | |
|---|---|
| Professional behaviour | Members conduct themselves at all times in a manner that maintains the good reputation of the profession and its ability to serve the public interest. |
| Integrity and due care | Members are expected to be straightforward, honest, and fair dealing in all professional relationships. They are also expected to act diligently and in accordance with applicable technical and professional standards when providing professional services. |
| Professional competence | The public expects the accounting profession to maintain a high level of competence. This underscores the need for maintaining individual professional skill and competence by keeping abreast of and complying with developments in the professional standards. |
| Confidentiality | Members have a duty of confidentiality in respect of information acquired as a result of professional, employment, and business relationships, and they will not disclose to any third party, without proper cause and specific authority, any information, nor will they exploit such information to their personal advantage or the advantage of a third party. |
| Objectivity | Members do not allow their professional or business judgment to be compromised by bias, conflict of interest, or the undue influence of others |

As highlighted in our definition of professional judgment, ethics play a key role in the judgment process. A well justified decision is not only well thought out but carried out with truthfulness and forthrightness. The ethical reasoning framework is similar to the professional judgment framework—it places an emphasis on a methodological approach and on considering different alternatives and stakeholders. However, the difference lies in the conflict among different values—personal, professional, organizational, and societal—and its focus is on evaluating ideas, actions, or characteristics as right or wrong relative to a set of values. It also recognizes that there is not always a direct link between ethical judgment (what one considers to be right or wrong) and ethical action. Some refer to this as "what you *should* do versus what you *would* do." Consider Qin's situation.

Qin is the senior auditor in charge of the September 30, 2015, financial statement audit of Paquette Forest Products Inc., a forest products company that produces lumber and paper products in northern Manitoba. The company employs 375 people and is the main employer in the remote town of Duck Lake, Manitoba; the other businesses in Duck Lake provide goods and services to Paquette Forest Products and its employees. In the course of the audit, Qin discovers that the company has had a number of failures of the equipment that removes the sulphuric acid from the paper production process and, as a result, thousands of litres of untreated water have been dumped into the Loon River and Duck Lake. Qin learns that the cost of replacing the equipment so that no further spills are likely would strain cash reserves. If ordered to replace the equipment by the environment ministry, the company would be forced to raise additional capital or cease operations. What should Qin do?

Qin is facing an **ethical dilemma**. He is aware that the situation or dilemma may affect the welfare of others. In addition to identifying the dilemma, he will need to evaluate the outcomes and determine what is right and wrong. In order to resolve the dilemma, he has to make a value assessment of the "right" choice versus other decision alternatives and decide upon the best course of action, and (hopefully) he will carry out the best course of action.[4]

**Ethical dilemma**—a situation in which a decision must be made about the appropriate behaviour.

Of course, this is not easy, as there are numerous stakeholders—Paquette and its employees, existing and potential investors, Qin's audit firm, the town of Duck Lake and its citizens, the natural environment, and the list goes on. If we consider the principles and values (his personal ones, the professional ethical principles, and the various others), again we can see that it is very complicated. Should Qin insist that Paquette disclose the issue in its financial statements? If it does, will that lead to its demise? Should the professional principle of confidentiality override the towns people's right to know the dangerous effects of the chemicals? What about the economic loss to the town of Duck Lake and Paquette's employees? And what about the public interest?

While most auditors will not face a dilemma as extreme as Qin's, auditors will face many ethical dilemmas over the course of their careers. Dealing with a client who threatens to seek a new auditor unless an unqualified opinion is issued presents a serious ethical dilemma. Deciding to confront a client who materially overstated departmental revenues in order to receive a larger bonus is tough to do. Deciding whether or not to report a supervisor's negligence to a partner is a problem you may face as a staff accountant.

## A Framework for Solving Ethical Dilemmas

Figure 4-2 presents the ethical decision making framework. It is a common framework, which has been adapted to incorporate the context of an audit professional. The Institute of Chartered Accountants of England and Wales (ICAEW, see **http://www.icaew.com**) developed the guiding questions to encourage reflection beyond the rules of professional conduct and to consider the broader implications of the issue.

[4] This reasoning process is based upon James Rest's Model of Ethical Action. Rest was an American psychologist well known for his research on cognition and morality.

**Figure 4-2** A Framework for Ethical Decision Making

| | |
|---|---|
| Obtain relevant facts and identify the issues | • Do you have all the relevant facts?<br>• Are you making assumptions? If so, can facts be identified to replace those assumptions?<br>• Is it really your problem? Can someone else help? |
| Identify the ethical issues | • What are the professional, organizational, and personal ethical issues?<br>• What fundamental ethical principles are affected?<br>• Are there threats to independence? If so, are there any safeguards?<br>• Would those ethical issues affect the reputation of the profession?<br>• Would those issues affect the public interest? |
| Identify who is affected and how each is affected | • Who are the individuals, the organizations, and other stakeholders?<br>• In which way are they affected?<br>• Are there conflicts between stakeholders? |
| Consider and evaluate courses of action | • Consider organizational policies, applicable laws and regulations, universal values and principles, consequences, and potential rationalizations.<br>• Test your proposed course of action.<br>• Would a similar course of action be used in a similar situation?<br>• Would the course of action stand up to the scrutiny of peers? |
| Implement the course of action | • When faced with an ethical issue, it may be in your best interests to document your thought processes, discussions, and other decisions taken. |

The ethical reasoning framework encompasses personal interests and consequences, the auditors' responsibilities, and societal values.

Ethical decisions are challenging. The first challenge, which we will discuss later, is recognizing that you are faced with an ethical issue. The second challenge is deciding which values matter most. The Framework for Ethical Decision Making is designed to address these challenges. The third challenge is putting the ethical decision into action, which some refer to as moral courage. When applying the framework, we incorporate some ideas from Mary Gentile's Giving Voice to Values(GVV) Approach.[5] Her approach is a post-decision analysis that is meant to aid the decision maker to put his or her ethical decision into action. Her approach emphasizes techniques the decision maker can use to overcome rationalizations, which often are a major obstacle in resolving an ethical dilemma as well as putting values into action.

**LO 4** **Explain the impact of rationalizations and ethical blind spots on auditors' ethical reasoning.**

## Auditors' Ethical Reasoning: Bryan's Ethical Dilemma

Consider Bryan Longview's ethical dilemma and apply the framework for ethical reasoning presented in Figure 4-2.

Bryan Longview has been working for six months as a staff assistant for De Souza & Shah, public accountants. Currently he is assigned to the audit of Reyon Manufacturing Corp. under the supervision of Karen Van Staveren, an experienced audit senior. There are three auditors assigned to the audit, including Karen, Bryan, and a more experienced assistant, Martha Mills.

[5] Gentile, M. C., and Hittner, J. 2010. *Giving Voice to Values: How to Speak Your Mind When You Know What's Right*. Yale University Press, New Haven. See **www.givingvoicetovaluesthebook.com**. See also Chappell, S., M. Edwards and D. Webb. 2011. *Giving Voice to Values: A means of shifting the teaching and practices of business ethics*, 18th Annual International Vincentian Conference Promoting Business Ethics, St, John's University, New York, October 26–28, 2011.

During lunch on the first day, Karen says, "It will be necessary for us to work a few extra hours on our own time to make sure we come in on budget. This audit isn't very profitable anyway, and we don't want to hurt our firm by going over budget. We can accomplish this easily by coming in a half hour early, taking a short lunch break, and working an hour or so after normal quitting time. We just won't write that time down on our time report."

Bryan recalls reading in the firm's policy manual that working extra hours and not charging for them on the time report is a violation of De Souza & Shah's employment policy. He also knows that seniors are paid bonuses instead of overtime, whereas staff are paid for overtime but get no bonuses.

Later, when Bryan discusses the issue with Martha, she says, "Karen does this on all of her jobs. She is likely to be our firm's next audit manager. The partners think she's great because her jobs always come in under budget. She rewards us by giving us good engagement evaluations, especially under the cooperative attitude category. Several of the other audit seniors follow the same practice."

We will now apply the ethical judgment decision making framework to Bryan's ethical dilemma.

## Obtain Relevant Facts and Identify the Ethical Issues

As in the professional judgment framework, in order to identify the issue, it is necessary to think about "what" the issue is. At first, this seems to be a fairly straightforward issue. Bryan recognizes that Karen's request violates firm policies. However, he is aware that this is common practice in the firm and that supervisors like Karen use this practice to meet the expected budget. He is also aware that Karen places high value on career advancement. If he reports, he is at risk of having a poor engagement evaluation.

But Karen's request has broader implications. Bryan also knows that these practices affect the firm's quality control, since budgeting and time management will not be accurate. By violating one firm policy, he and his other team members could be on the slippery slope to violating other practices, such as signing off incomplete work. As discussed in our professional judgment framework, it may also affect professional skepticism and the quality of work done by Bryan and his peers.

Given the facts, the ethical issue in this situation is not difficult to identify: ***Is it ethical for Bryan to work hours and not record them as hours worked?***

## Who Is Affected and How Is Each Affected?

Typically, more people are affected than might be expected in situations in which ethical dilemmas occur. The following are the key persons involved in this situation:

| *Who* | *How Affected* |
|---|---|
| Bryan | Being asked to violate firm policy.<br>Hours of work will be affected.<br>Pay will be affected.<br>Quality of work many be affected.<br>Performance evaluations may be affected.<br>Attitude about firm may be affected. |
| Martha | Same as Bryan. |
| Karen | Success on engagement (in terms of meeting budget) and in firm may be affected.<br>Hours of work will be affected.<br>Quality of audit engagement may be affected<br>Stated DeSouza & Shah firm policy is being violated.<br>May result in underbilling clients in the current and future engagements.<br>May affect firm's ability to realistically budget engagements and bill clients.<br>May affect firm's ability to perform quality audit engagements.<br>May affect the firm's ability to motivate and retain employees.<br>May result in unrealistic time budgets. |

*continued*

| | |
|---|---|
| Staff assigned Reyon Manufacturing in the future | May result in unfavourable time performance evaluations.<br>May result in poor quality audit work.<br>May result in pressures to continue practice of not charging for hours worked. |
| Other staff in firm | Following the practice on this engagement may motivate others to follow the same practice on other engagements.<br>Following such practices may send out message that making the budget is more important than performing thoughtful and careful work. |

In addition, to these key people, there is also the public accounting firm and the audit profession itself. We will consider them when we evaluate our alternatives.

## Consider and Evaluate Alternatives

Now, we will consider and evaluate the alternatives.

### BRYAN'S AVAILABLE ALTERNATIVES

- Refuse to work the additional hours.
- Perform in the manner requested.
- Inform Karen that he will not work the additional hours or will charge the additional hours to the engagement.
- Talk to Karen about his concerns about her request.
- Talk to a manager or partner about Karen's request.
- Refuse to work on the engagement.
- Quit working for the firm.

**POTENTIAL RATIONALIZATIONS** There are alternative ways to resolve ethical dilemmas, but care must be taken to avoid rationalizations of unethical behaviour. In Bryan's case, a rationalization that inhibits his ability to evaluate alternatives effectively is that "everyone is doing it"—Karen is following an accepted practice among her peers. Rationalizations, such as "If it's legal, it's ethical," "Who's to know?", "It's not hurting anyone," and "It's not my responsibility" act as justifications to rationalize questionable alternatives or to ignore the ethical dimension of the issue.

**WHAT ARE THE CONSEQUENCES?** In deciding the consequences of each alternative, it is essential to evaluate both the short- and long-term effects. Long-term effects are often difficult for people to visualize when making a decision. However, consequences should be considered in a broad context—both from a time perspective and from the various stakeholder perspectives. Bryan must think not only about himself, his peers, and the firm, but also about the profession and society at large.

There is a natural tendency to emphasize the short term because those consequences will occur quickly, even when the long-term consequences may be more important. For example, consider the potential consequences if Bryan decides to work the additional hours and not report them. In the short term, he will likely get good evaluations for cooperation and perhaps a salary increase. In the longer term, what will be the effect of not reporting the hours this time when other ethical conflicts arise? Consider the following similar ethical dilemmas Bryan might face in his career as he advances:

- A supervisor asks Bryan to work three unreported hours daily and 15 unreported hours each weekend.
- A supervisor asks Bryan to initial certain audit procedures as having been performed when they were not.
- Bryan concludes that he cannot be promoted to manager unless he persuades assistants to work hours that they do not record.
- Management informs Bryan, who is now a partner, that either the company gets an unqualified opinion for a $40 000 audit fee or the company will change auditors.
- Management informs Bryan that the audit fee will be increased $25 000 if Bryan can find a plausible way to increase earnings by $1 million.

| Table 4-5 | Bryan's Ethical Dilemma—The Consequences of Speaking Up | |
|---|---|---|
| **Stakeholder** | **If Bryan Speaks Up** | **If Bryan Does Not Speak Up** |
| Karen and other supervisors doing the same | • They have the option of changing their practices.<br>• They could be demoted or otherwise affected.<br>• They could receive a lower performance bonus. | • They are encouraged to employ these practices with other clients.<br>• They receive a larger performance bonus.<br>• They could be pressured into poor quality work that enables client management to receive higher performance bonuses. |
| Bryan and his team members | • They are able to record hours honestly.<br>• They receive a higher wage (overtime).<br>• They are motivated to produce high quality work since the time and effort spent is recognized and rewarded. | • They will be under pressure to do the same with other clients.<br>• They will receive a lower wage.<br>• They will be encouraged to follow the same practice when they become supervisors.<br>• They are motivated to leave the firm and go to an employer where this practice does not exist. |
| De Souza & Shah firm | • Quality control standards are followed.<br>• Jobs are properly billed and budgeted.<br>• Employee training can focus on encouraging good job practices and discouraging poor recording. | • May result in under billing clients in current and future engagements.<br>• May be unable to realistically budget other engagements.<br>• May result in poor quality audits (and potential negligence).<br>• May affect the firm's ability to motivate and retain employees.<br>• Firm could be sued for not following labour laws with respect to payment of overtime. |
| The audit profession | • The profession's reputation that members act with due care and integrity is maintained. | • These practices can lower audit quality.<br>• These practices lower the profession's reputation.<br>• These practices promote unfair competition among firms. |

When considering consequences of the potential action, we have incorporated some ideas from Gentile's GVV Approach into the analysis. Her approach would aid in "testing the plan of action" and moving the decision into action. Gentile maintains that many people recognize ethical dilemmas but they do not have the courage to stand up and voice their values. Given Bryan's position in the organization and that Karen is his supervisor, this is likely a major concern for Bryan. Using Gentile's GVV Approach, we consider in Table 4-5 the consequences of speaking up versus not speaking up.

As part of his analysis, Bryan thinks about and develops a list of inhibiting arguments, enabling arguments, and levers he can use to support his case. He lists the top four arguments in Table 4-6.

## Implement the Course of Action

Only Bryan can decide the appropriate option to select in the circumstances after considering his ethical values and the likely consequences of each option. At one extreme, Bryan can decide that the only relevant consequence is the potential impact on his career and choose to do nothing. Many of us may conclude that Bryan's emphasis on his self-interest (what is referred to as ethical egoism) is inappropriate and perhaps even unethical. At the other extreme, Bryan can decide to refuse to work for a firm that permits even one supervisor to violate firm policies. Many people consider such an extreme reaction naïve and not helpful in resolving the practice.

**Table 4-6** Extract of Bryan's Inhibiting Arguments, Enabling Arguments and Levers Relevant to Accurate Recording of Hours Worked

| Inhibiting Arguments | Enabling Arguments | Levers |
|---|---|---|
| *Obedience to supervisor:* It's not my responsibility; I'll get in trouble. | As an employee, it is everyone's job to ensure quality control. | Supervisors who change their practices to follow firm standards may be rewarded. |
| *Standard practice:* Everyone is doing this so it's standard practice. | Some supervisors are not doing this, and they are getting rewarded for good quality work. | A different supervisor on this engagement next year could detect the problem and cause problems for Karen. |
| *Lack of materiality:* It's just a few hours. It won't make any difference. | These hours add up over many engagements, and this affects our employer's profitability. | If the under billing is detected, it could cause practice inspection problems with our employer. |
| *Us versus them:* I'll be targeted as a troublemaker by all of the supervisors. | Supervisors who record their work honestly will support me, as will the quality control partner of our firm. | Karen and other supervisors will be supported by the quality control partner for recording time accurately. |

In the middle of those two extremes, Bryan decides to speak up. But, it is perhaps intimidating to speak directly to Karen and, if Karen reacts badly, it may not resolve the larger problem. Gentile's GVV Approach emphasizes asking questions, anticipating arguments, obtaining data, and speaking to others in order to develop a workable resolution to the dilemma. Whom should he speak with first? What data will he need to bring to each conversation?

Bryan decides that the first step is to talk to his university classmates. He finds out that one other person has been subjected to this same pressure at one of his clients, but that all of his other classmates have received peer mentor counselling at their firms. Apparently many firms are aware of this practice and want to stamp it out because it reduces the ability of junior employees to express themselves during engagements. He puts together a list of the firms with such programs and a summary of the benefits for such programs and the costs of not addressing these practices. Next, he talks confidentially to his provincial institute's peer support program and gains some valuable information and a sense of support for his intended strategy to raise this issue with Karen first.

Armed with this information, Bryan writes out an opening statement that clearly frames his conversation with Karen as an opportunity for learning and moving towards best audit practices. He then makes an appointment with Karen, so that he can talk to her before the weekly time sheets are due. The results? Only Bryan can tell us, but he is more likely to have a successful conversation with Karen that is businesslike and constructive.

## Ethical Blind Spots

**Ethical decision making process**—a methodological approach to resolving an ethical dilemma.

**Ethical blind spots**—unconscious judgmental tendencies that can hinder the ethical decision making process or cause the decision maker to fail to recognize the ethical dimension of a choice.

While an ethical reasoning framework can guide an auditor through the **ethical decision making process**, it is often difficult to turn the decision into action. Gentile's approach emphasizes being proactive and provides tools to assist the auditor in having the courage to stand up. However, her approach assumes that the person is able to identify the ethical issue. As in the case of professional judgment, decision makers are susceptible to judgment traps or what is referred to as **ethical blind spots**. We have already highlighted how rationalizations deter effective evaluation of alternatives. Ethical blind spots are perhaps worse than rationalizations since the decision maker is unaware of the blind spot and they can inhibit the auditor from even recognizing an ethical dilemma in the first place.

In their book, *Ethical Blindspots: Why We Fail to Do What's Right and What to Do About It*,[6] Max Bazerman and Ann Trenbrusel argue that unethical behaviour

[6] M. Bazerman and A. Trenbrusel, 2012. *Ethical Blindspots: Why We Fail to Do What's Right and What to Do About It.* Princeton University Press.

## audit challenge 4-1

### Some Ethical Violations Are More Severe Than Others

Bryan Longview's ethical dilemma involves a situation in which he is asked to work without regarding the time, which is sometimes called kitchen-tabling or eating time. One of the concerns with eating time is that it can lead to a more severe problem known as premature signoff, in which a staff person signs off as having completed work without performing the necessary procedures. Consider Tom Holton's situation below.

Tom Holton has far too busy a social life to work overtime. To make certain that work does not interfere with his other plans, he tests only part of the assigned sample. For example, if he is asked to test 25 cash disbursement transactions, he tests the first 15 but indicates that he has tested all 25. Why bother? Tom never comes across any problems.

A supervisor, curious about Tom's amazing ability to beat the time budget, decides to carefully redo Tom's work. The supervisor concludes that Tom is signing off procedures without completing them. She immediately reports this to the partner in charge of the audit engagement. The partner, with full support of his other partners, dismisses Tom that day—with no counselling out, and no two weeks' notice.

**APPLYING YOUR PROFESSIONAL JUDGMENT**

1. What do you think of the partner's decision to dismiss Tom?
2. If Tom's reason for not having time to perform the work was that he had a child who was extremely ill and he was the primary caregiver, what would you think of the partner's decision?

often occurs "because people are unconsciously fooling themselves." They explain this "unconscious fooling" in terms of what they refer to as ethical blind spots. One blind spot, which they label ethical fading, tends to eliminate ethics from the decision. For instance, when we frame the situation as doing what is required by the law or simply considering financial costs, we have elevated various stakeholders and consequences. In essence, we no longer frame it as an ethical dilemma. In the case of another blind spot, motivated blindness, we fail to see the ethical issue because it is in our self-interest not to notice. Some argue that the WorldCom and Enron audit failures can be attributed to auditors' strong bias toward their client's interest, which leads to the inability to see the ethical dilemma.

**concept check**

C4-3 Describe an ethical dilemma. How can you apply the ethical reasoning framework to an ethical dilemma?

C4-4 Why are ethical decisions so difficult? Consider the role of rationalizations and ethical blind spots.

## Professional Guidance on Ethical Conduct

LO 5 Examine the role of the rules of professional conduct in encouraging PA ethical behaviour. Apply rules of professional conduct to case facts and identify violations.

Both the professional judgment and ethical reasoning frameworks highlight that auditors' decisions are made with consideration of rules of professional conduct. The provincial accounting associations determine the rules of professional conduct for members and students, and have harmonized their rules of professional conduct so that, generally, the same set of rules applies to all PAs in Canada and serves both members and the public. It serves members by setting standards the members must meet and providing a benchmark against which to measure members' actions. The public is served because the code provides the standards that the members of the body should follow and helps determine expectations of members' behaviour.

The professional code of conduct in Canada is both principles-based and compliance-based. In our discussion of ethics, we highlighted the fundamental ethical principles that guide auditors' professional conduct. These fundamental principles emphasize the shared values of the profession and encourage doing the right thing. However, many critics of a principles-based code highlight that principles are difficult to enforce because there are no minimum standards of behaviour. Therefore the code also includes carefully defined rules. The advantage of this compliance-based approach is that the association is able to enforce minimum behaviour and performance standards. However, a disadvantage is the tendency of some practitioners to define the rules as maximum rather than minimum standards. A second disadvantage is that some practitioners may view the code as the law and conclude that if

**concept check**

C4-5 Explain the need for a code of professional ethics for PAs.

C4-6 What is meant by the statement, "The rules of professional conduct of a professional accounting organization should be regarded as a minimum standard"?

some action is not prohibited, it must be ethical. In other words, practitioners will say, "Show me where it says I can't do it." As the ethical reasoning framework emphasizes, a PA must consider the broader principles and values when deciding if a particular action is acceptable or not.

We will restrict the remainder of our discussion to rules of conduct of CPA Ontario (as an example of provincial rules of conduct).

LO 6 Understand the potential threats to independence. Apply the threats and safeguards approach to resolving conflicts of interest.

**Independence**—impartiality in performing professional services.

**Independence in fact**—the auditor's ability to take an unbiased viewpoint in the performance of professional services.

**Independence in appearance**—the auditor's ability to maintain an unbiased viewpoint in the eyes of others.

## Independence

The rules of professional conduct require members who are engaged in the practice of public accounting to be independent when they perform assurance services and specified auditing procedures (we will discuss this type of engagement in Chapter 20). PAs must be free of any influence, interest, or relationship that impairs professional judgment or objectivity. As we have learned from previous chapters and discussion of our professional judgment framework, **independence** in auditing is critical. The reason that many diverse users are willing to rely upon the PA's audit opinion as to the fairness of financial statements is their expectation of an unbiased viewpoint.

Independence is considered to encompass two dimensions: "independence in fact" and "independence in appearance." **Independence in fact** exists when the auditor is actually able to maintain an unbiased attitude throughout the audit. Judgment frameworks aid auditors in maintaining their objectivity. **Independence in appearance** is the result of others' interpretation of this independence. If auditors are independent in fact but users believe them to be advocates for the client, most of the benefit of the audit function will be lost. Specific rules of professional conduct tend to address independence in appearance. An example would be the specific rules regarding what additional services a financial statement auditor can perform.

The Canadian standard for independence, Rule of Professional Conduct 204, uses a systematic principles-based framework to assess independence for assurance engagements, including new services. It involves a four-step process of evaluating independence: (1) identify the threats, (2) evaluate the significance of the threat and determine if any safeguards can be applied to eliminate the threat, (3) determine if there are any specific prohibitions regarding the type of engagement, and (4) for each insignificant threat, document the rationale.

### Identify Threats

When providing either new or continuing assurance services, the PA is required to examine five threats to independence: self-interest threat, self-review threat, advocacy threat, familiarity threat, and intimidation threat. Table 4-7 lists and defines these threats to independence with examples.

**Self-interest threat**—a threat to independence where the member has a financial interest in the client or in the financial results of the client.

**Advocacy threat**—a threat to independence where the firm or member is perceived to promote (or actually does promote) the client's position.

**Self-review threat**—a threat to independence where the PA is in the position of having to audit his or her own work during the period.

Some of these threats affect overall independence. If you own shares in your client's business (**self-interest threat**) or are trying to help them obtain financing (**advocacy threat**), you stand to gain from the result of the financial statement audit. A self-interest threat can also exist when a significant portion of the firm's revenue comes from a single assurance client.

The **self-review threat** means that you are auditing your own work. Imagine that you have assisted the client in designing an information system that calculates the costs for an inventory system. The new system seems to be working well, and there are excellent reports that track inventory movement and out-of-stock situations. However, during the design phase, you neglected to put in controls to highlight when the system creates a negative inventory situation, either due to either clerical or programming error. What would you do during the audit? Perhaps you would be less likely to point out this error to the client in a management letter because it would imply that you did not properly perform your work during the system design. Alternatively, you might not detect the system inadequacy during your analysis of internal controls; you

**Table 4-7** Threats to Auditors' Independence

| Threat to Independence (defined) | Examples |
|---|---|
| **Self-interest threat**—when the member could receive a benefit because of a financial interest in the client or in the financial results of the client or due to a conflict of interest. | The firm or member owns shares in or has made a loan to the client. The client fees are significant in relation to the total fee base of the PA or of the firm. |
| **Self-review threat**—when the PA has made judgments in previous engagements that need to be evaluated in making conclusions on the assurance engagement (in other words, the PA is placed in the position of having to audit his or her own work or systems during the audit). | The PA might have prepared original data or records for the client as part of a bookkeeping engagement, or was an employee or officer of the organization. The PA could also have designed and implemented an accounting information system used to process client records. |
| **Advocacy threat**—when the firm or member is perceived to promote (or actually does promote) the client's position; that is, the client's judgment is perceived to direct the actions of the PA. | The PA is acting as an advocate in resolving a dispute with a major creditor of the client. The firm or PA is promoting the sale of shares or other securities for the client or is receiving a commission for such sales. |
| **Familiarity threat**—occurs when it is difficult to behave with professional skepticism during the engagement due to a belief that one knows the client well. | There is a long association between senior staff and the client (e.g., being on the engagement for 10 years). A former partner of the firm is now the chief financial officer of the client. |
| **Intimidation threat**—the client personnel intimidate the firm or its staff with respect to the content of the financial statements or with respect to the conduct of the audit, preventing objective completion of field work. | The client threatens to replace the audit firm over a disclosure disagreement. The client places a maximum upon the audit fee that is unrealistic with respect to the amount of work that needs to be completed. |

believe that it is such an excellent system that you do not need to complete a detailed analysis of internal controls. This example shows how a self-review threat can be very dangerous to the completion of a quality audit engagement.

With a **familiarity threat**, it may be that you were the audit junior on a job, worked as an assistant, then were promoted to supervisor and manager, and are now a partner. You have worked with the client for 15 years, and it seems that you know the strengths and weaknesses of all of the employees, juniors and executives alike. You may take it for granted that they are doing their jobs just as well this year as they did last year. However, you do not know that the controller is going through a messy divorce and the vice-president of finance has started gambling. They are both short of money, which gives them an incentive to manipulate the records and steal money from the company. The actual financial manipulation could lead to **intimidation threat**—where the senior accounting personnel expect you to overlook their manipulation or you may lose the audit. You have known these individuals for 15 years and think of them as friends, and what is a little financial statement manipulation among friends?

**Familiarity threat**—a threat to independence that occurs when it is difficult to behave with professional skepticism during the engagement.

**Intimidation threat**—a threat to independence that occurs when the client intimidates the public accounting firm or its staff with respect to the content of the financial statements or with respect to the conduct of the audit.

## Evaluate the Significance of the Threat

When the PA assesses the significance of the threat, she considers whether there are any safeguards that will eliminate or reduce the threat to an acceptable level. The Rules of Professional Conduct define an acceptable level as the level where a reasonable observer would likely conclude that independence is not compromised.

## Identify and Apply Safeguards

Required or prohibited actions and internal controls can serve as safeguards to eliminate or reduce threats to independence. When identifying safeguards, the PA should consider:(1) professional, legislative, or regulatory safeguards; (2) safeguards within the client; and (3) safeguards within the firm. Table 4-8 lists these safeguards with

| Table 4-8 | Safeguards to Independence |
|---|---|
| **Safeguard Category** | **Examples** |
| Created by the profession, legislation, or securities regulation | Education and training provided by the professional accounting body<br>Practice review conducted by the professional accounting body or by the CPAB<br>Periodic rotation of senior members on the engagement |
| Provided by the client | A qualified, independent audit committee<br>Corporate governance policies that restrict certain services with the external auditor<br>Corporate polices or ethical codes that stress ethical behaviour and provide channels to discuss ethical issues |
| Available within the firm's systems and procedures | Tone at the top encouraging high quality auditing and professional skepticism<br>Firm policies and procedures that promote awareness and ensure compliance for independence<br>Rotation of senior personnel on client engagements<br>Required consultation |

examples. Safeguards that the firm can identify and apply must either eliminate the threats or reduce them to an acceptable level.

**SAFEGUARDS BY THE PROFESSION AND LEGISLATION** Safeguards by the profession and legislation include rules regarding partner rotation, partner compensation, limits on the percentage of a firm's revenue from one client, and specific prohibited services. Other safeguards are independence reviews performed by the provincial practice inspectors and by CPAB inspectors. These reviews involve reviewing the quality control processes that the firms have in place as well as reviewing independence at the engagement level.

Prohibitions serve as an effective means to prevent independence threats from occurring. In Table 4-9, we summarize the various situations that are expressly prohibited by the Rules of Professional Conduct. Some rules apply to all assurance engagements (e.g., financial statement audits and reviews for businesses of all sizes), while others apply only to **listed entities**.

**Listed entities**—entities whose debts or shares are listed on a stock exchange and that have market capitalization and total assets greater than $10 million.

In addition to the situations described in Table 4-9, which indicate when a member or firm is not allowed to complete the engagement, there are situations when only the person affected must be excluded from the engagement team. These are situations where the student or member:

- Has made a loan to or guarantees a loan to the client.
- Has an immediate family member as a director, officer, or employee who can exert control over the engagement or who is in an accounting role.
- Was an employee with the client in a financial oversight position during the duration of the audit.

The Rules of Professional Conduct also require, for listed entities, mandatory rotation of key audit partners (with reinstatement provisions after two years). In addition, key audit partners cannot be compensated based on selling nonassurance services to their listed entity client. Key audit partners include the lead engagement partner, the engagement quality control reviewer, or other partner who makes key decisions or judgments with respect to the audit. The Rules of Professional Conduct and securities legislation also require that all services to a listed client must be approved by the audit committee. The Rules of Professional Conduct prohibit firms from performing the financial statement audit if 15 percent of the firm's total revenue comes from a listed entity for two consecutive years

It seems from Table 4-9 that it would be difficult for a PA to provide comprehensive services to a client! What if you work for a small practice where the bulk of

| **Table 4-9** | Prohibited Engagements | | | |
|---|---|---|---|---|
| **Independence Rule Situation** | **Audit of Listed Entity** | **Audit of Nonlisted Entity** | **Other Assurance Engagement (e.g., review)** | **Nonassurance Service** |
| Has direct or indirect financial interest | X | X | X | X |
| Audit fees represent more than 15 percent of firm revenue (unless disclosed to audit committee and practitioner not part of firm is responsible for engagement quality review) | X | – | – | – |
| Exerts control over the entity | X | X | X | |
| Has a loan from or has a loan guaranteed by the entity (except in normal course of business; e.g., a bank) | X | X | X | |
| Has close business relationship | X | X | X | |
| Engagement staff accepted financial-related position at client within the last year | X | | | |
| Temporary loan of engagement staff to client (unless short period of time or client staff directly supervises engagement staff) | X | X | X | |
| Member of firm is officer or director | X | X | X | |
| Management decisions were made related to the subject matter of the assurance engagement | X | X | X | |
| Prepared or changed originating source data or journal entry without management approval | X | X | X | |
| Accounting or bookkeeping services provided | X | | | |
| Valuation services provided | X | X | X | |
| Actuarial services provided | X | | | |
| Internal audit services provided | X | X | X | |
| Financial information systems design or implementation provided | X | X | X | |
| Expert opinion or service provided | X | | | |
| Legal services provided | X | X | X | |
| Human resources for senior positions provided | X | | | |
| Corporate finance services provided | X | X | X | |
| Tax planning and related advisory services that have material effect on financial statements | X | X | X | |
| Preparing tax calculations for purpose of preparing accounting entries | X | X | – | – |

Note: Not all situations are listed. Please consult the rules of conduct for your provincial professional accounting association for more details.

the work is accounting, bookkeeping, and review engagements? How is your work affected? Assuming that you and the other members of the firm have adequately addressed the five threats to independence, the primary practical concerns would be familiarity and self-review. Safeguards that the firm should put in place are periodic change of staff at a client, and, where possible all transactions and journal entries should be discussed with and approved by the client before being processed.

**SAFEGUARDS AT THE CLIENT** As illustrated in Table 4-9, safeguards at clients can include policies that prohibit certain services and/or that encourage ethical conduct as well as a variety of controls. Some of the key safeguards are related to the audit committee.

An **audit committee** is a subcommittee of a company's board of directors that serves as a forum independent of management for both external and internal auditors.

**Audit committee**—selected members of a client's board of directors, who liaise with and provide a forum for the auditors to remain independent of management.

Most audit committees are made up of three to five or sometimes as many as seven directors. Incorporating acts generally require that the audit committee must be independent outside directors (i.e., not part of company management). Access to an active audit committee by internal and external auditors is one of the indicators of a healthy corporate governance structure.

Organizations listed on a Canadian or American stock exchange (regardless of size) are required to have an audit committee consisting of at least three independent members who are also directors of the organization. Publicly accountable enterprises (e.g., universities, large hospitals) are required to have an audit committee. Although not required to, many large private companies have audit committees. Members of the audit committee are also required to be financially literate. The external auditor has the right to attend meetings of the audit committee and to call meetings if he or she feels they are necessary. A typical audit committee decides such things as which public accounting firm to retain and the scope of services the public accounting firm is to perform. As noted in Table 4-9, the audit committee must be informed if the audit fees represent more than 15 percent of the audit firm's total revenue. The audit committee also meets with the public accounting firm to discuss the progress and findings of the audit, and helps resolve conflicts between the public accounting firm and management.

At least annually, the auditor should inform the audit committee in writing of the following items: the level of the auditor's independence; all relationships between the auditor and his or her related business or practice and the entity and its related entities; and the total fees charged (separating out audit and non audit services).

**SAFEGUARDS AT THE FIRMS** Public accounting firms have in place a range of safeguards to ensure independence. These include employee training programs, peer reviews, client acceptance and continuance policies that help to identify threats, and engagement quality reviews. To ensure their effectiveness, as mentioned in Chapter 2, firms have monitoring mechanisms in place.

## For Each Identified Independence Threat, Document How it Was Resolved

**Independence threat analysis**—assessment of independence threats for a particular engagement.

For each new and ongoing assurance engagement, audit engagement management (such as the partner and the manager) are required to evaluate, in writing, the independence of the firm and the staff assigned to the engagement. This formal **independence threat analysis** forms part of the documentation for the engagement. The documentation should include the threat, a description of the safeguard to eliminate or reduce the threat to an acceptable level, and how that safeguard eliminates or reduces that threat to an acceptable level. If the conclusion is that there are no safeguards to adequately reduce the threats, then the only alternatives are to decline or discontinue the assurance engagement (or, if applicable, the non-insurance services that are creating the threat).

## Confidentiality

**Confidential or inside information**—client information that may not be disclosed without the specific consent of the client except under authoritative professional or legal investigation.

The rules of conduct for PAs state that members shall not disclose any confidential client information or employer information without the specific consent of the client or employer. The rules also prohibit using **confidential or inside information** to earn profits or benefits.

The rule against disclosure does not apply if the member is called upon to disclose the information by the courts. Communication between auditor and client is not privileged, as it is between lawyer and client; a court can require a PA to produce all files and documents held, including confidential advice provided. The rule against disclosure also does not apply if the member's professional body requires the confidentiality rule to be waived in connection with the body's exercise of its duties (e.g., when an auditor is called upon to produce working papers in connection with the disciplinary process, or to produce files as part of a practice inspection).

While the rules of professional conduct with respect to confidentiality are quite clear, the auditor may be confronted with a situation where he or she must choose between confidentiality and other rules of conduct or another course of action.

**NEED FOR CONFIDENTIALITY** During an audit or other type of engagement, practitioners obtain a considerable amount of information of a confidential nature, including officers' salaries, product pricing and advertising plans, and product cost data. If auditors divulged this information to outsiders or to client employees who had been denied access to the information, their relationship with management would become strained and, in extreme cases, would cause the client harm. The confidentiality requirement applies to all services provided by public accounting firms, including tax and management services.

Ordinarily, the public accounting firm's working papers can be provided to someone else only with the express permission of the client. This is the case even if a PA sells his or her practice to another public accounting firm or is willing to permit a successor auditor to examine the working papers prepared for a former client. Permission is not required from the client, however, if the working papers are subpoenaed by a court or are used as part of practice inspection. If the working papers are subpoenaed, the client should be informed immediately, as the client and the client's lawyer may wish to challenge the subpoena.

**PROFESSIONAL BEHAVIOUR** The rules of accounting bodies in Canada require their members to behave in the best interests of their profession and the public. This means accountants should not take advantage of the trust placed in them. An accountant should not be publicly critical of a colleague (i.e., by making a complaint about the colleague's behaviour to their professional body or by being critical, as a successor auditor, to the new client) without giving the colleague a chance to explain his or her actions first.

**INTEGRITY AND DUE CARE** The rules of conduct for professional accountants require members to act with integrity and due care. Integrity is one of the hallmarks of the profession. One of a professional accountant's most important assets is his or her reputation for honesty and fair dealing; if users of financial statements audited by or prepared by an accountant do not believe in the practitioner's honesty or fairness, the value of the financial statements or the audit is diminished. The professional accountant's behaviour with clients, colleagues, employers, and employees must be above reproach.

**COMPETENCE** Professional accountants, including PAs, have a responsibility to maintain their professional competence. The rules of conduct require practitioners to maintain competence; similarly, GAAS state the necessity of "adequate technical training and proficiency in auditing." The public expects that all professionals will strive to keep abreast of the latest techniques and methodologies. Professional accountants are required to attend a certain number of continuing professional education courses a year.

An auditor should not undertake an audit of a client unless that auditor has knowledge both of that client's business and industry and of the technical aspects of the audit. For example, the audit of an insurance company requires knowledge of auditing the policy reserves that form a significant part of the insurance company's liabilities. Many larger accounting firms form industry specialization groups within the firm that are responsible for all audits within their specialty.

**ADHERENCE TO PROFESSIONAL STANDARDS** PAs are required to comply with professional standards when preparing and auditing financial statements. These standards would include the standards of the professional body but, more importantly, accounting standards and GAAS as set out in the *CPA Canada Handbook*.

**ASSOCIATION AND FALSE AND MISLEADING INFORMATION** No members, whether in public accounting or industry, can sign or associate with false or misleading information (this includes letters, reports, and written or oral statements) or fail to reveal material omissions from financial statements. PAs can lose faith in management when information is withheld. Users of financial statements prepared by or audited by professional accountants are entitled to believe that the financial statements are complete and fairly present the financial position of the company, to believe that the financial statements are not false and misleading, and to rely on the integrity of the accountants involved.

### OTHER RULES

**Duty to report breaches of the rules** The rules of conduct of the professional accounting bodies require members who are aware of another member's rule breach to report to the profession's discipline committee after first advising the member of the intent to make a report. The bodies are self-regulating. It is important that the member be notified of the intent to report the breach in case there are mitigating circumstances of which the reporting member is not aware.

**Advertising and solicitation** A profession's reputation is not enhanced if the members openly solicit one another's clients or engage in advertising that is overly aggressive, self-laudatory, or critical of other members of the profession or that makes claims that cannot be substantiated. As a consequence, the professional accounting bodies in Canada either explicitly or implicitly prohibit solicitation of another PA's client and advertising that is not in keeping with the profession's high standards.

**Contingent fees** The charging of a fee based on the outcome of an audit, such as the granting of a loan by a bank, could easily impair the auditor's independence. Contingent fees are prohibited for audits, reviews, and any other engagements that require the auditor to be objective, and compilation engagements.

**Communication with predecessor auditor** The Rules of Professional Conduct require that a (potential) successor auditor, prior to accepting an appointment as auditor, communicate with the incumbent auditor to inquire if the incumbent is aware of any circumstances that might preclude the successor from accepting the appointment. The successor would ask the potential client to authorize the incumbent to provide the information requested. If the client refuses to do so, the successor should be reluctant to accept the appointment because it is likely that the client is hiding something.

The rules also require that the incumbent respond to the successor's request and be candid in responding. The communication between the incumbent and the successor is important because it prevents a successor from unknowingly accepting an appointment that might, if all the facts were known, be rejected. For example, if the incumbent resigned after finding that management of the client was dishonest and was engaged in fraud, it is unlikely that any public accounting firm would accept the client if the incumbent revealed that knowledge. In short, the required communication protects prospective successors, and thus the profession, from getting involved with undesirable clients. Review of the previous auditor's working papers is an important part of the audit process. We will discuss this further when we cover audit planning.

**Enforcement of the code of professional conduct** The rules of conduct for CPAs are established and administered provincially. As described in Table 4-10, the various professional bodies have the power to impose penalties ranging from public censure in the body's newsletter or requiring courses to be taken to upgrade skills to levying fines or expulsion. For instance, in the case of the Livent auditors, each of the three partners was levied a fine of $100 000 and was required to pay the investigation costs of $417 000.[7]

[7] K. Mark, "Appeal board upholds rules against partners," *The Bottom Line*, **http://www.thebottomlinenews.ca/index.php?section=article&articleid=375**.

**Table 4-10** For Whom the Bell Tolls

| Examples of Sanctions That Can Be Imposed Against PAs or Firms When Standards Are Violated |
|---|
| Publication of the name(s) of the violator(s) and the nature of the convicted offence |
| Sanctions from regulatory bodies such as the CPAB, OSC, or the SEC (e.g., refusal to accept new publicly listed clients for a period of time) |
| Refusal to renew PA licences for individuals or firms (with the CPAB) |
| Increased frequency of peer review |
| Appointment of an external monitor |
| Fines and/or payment of costs such as legal fees |
| Requirements to change quality control procedures |
| Mandatory education |
| Suspension of designation or expulsion from the professional association |

Since the professional accounting bodies are self-regulating, there is a danger that the public will perceive the disciplinary process as not being as stringent as it should be. This issue is dealt with by including laypersons on the disciplinary committees and being transparent regarding disciplinary committee proceedings. (All information pertaining to disciplinary proceedings are available to the public).

**concept check**

C4-7 What are the five threats to independence? Describe each and provide an example.

C4-8 List three categories of safeguards to independence. Provide an example of each.

C4-9 How does communication with the predecessor auditor improve audit quality?

## Summary

**1.** *What is the auditors' professional judgment process?* Auditors' professional judgment is the application of relevant knowledge and experience, within the context provided by auditing and accounting standards and Rules of Professional Conduct, in reaching decisions where a choice must be made between alternative possible courses of action.

**2.** *What are judgment tendencies and what is their impact on the auditors' professional judgment process?* Judgment tendencies are common judgment traps, which we often fall into when making a judgment. These traps are partially due to unconscious biases which are further exasperated due to situational factors such as tight deadlines. In the case of auditors, it may mean the auditor does not exercise appropriate professional skepticism or appropriately evaluate evidence or perform audit procedures. As a result, the auditor may reach the wrong conclusion.

**3.** *How can I work through an ethical dilemma?* The five-step framework provides a process to help the decision maker walk through an ethical dilemma.To enhance the chances of the decision maker "speaking up," the Giving Voice to Values approach provides a systematic way of working through overcoming potential arguments when attempting to voice one's concerns about unethical practices.

**4.** *How do rationalizations and ethical blind spots affect auditors' ethical reasoning?* Like judgment traps, rationalizations and ethical blind spots may lead auditors to make inappropriate judgments and conclusions. Rationalizations can inhibit an auditor's ability to evaluate alternatives effectively. Ethical blind spots can lead to auditors not recognizing the ethical dimension of the decision itself. As a result, the auditor may miss the potential harm of certain alternatives or, even worse, not even recognize that he or she is faced with an ethical dilemma.

**5.** *How are PAs different from other professionals?* PAs have a responsibility to protect the public interest and are responsible to users of financial statements such as shareholders and creditors. This is a more expanded responsibility than that of other professionals. Also, unlike other professionals who act as their client advocates, PAs are expected to be independent and objective.

*What is the role of a code of professional conduct in encouraging accountant ethical behaviour?* Such a code of conduct can have general statements of ideal conduct and specific rules that define unacceptable behaviour.

*What are some of the key rules of professional conduct and how they are enforced?* The key rule of professional conduct is independence. Other key rules include confidentiality, maintenance of the reputation of the profession, integrity and due care, and competence. Rules of professional conduct are enforced by the professional accounting associations.

**6.** *What are the threats to independence?* There are five areas where independence must be considered: self-interest, self-review, advocacy, familiarity, and intimidation.

*How does the auditor's relationship with the audit committee affect independence?* The audit committee helps the auditor remain independent of management by making the auditor retention decision, approving the services provided by the PA, discussing the audit progress and findings, and helping to resolve conflicts between the public accounting firm and management.

MyAccountingLab

Make the grade with MyAccountingLab: The questions, exercises, and problems marked in red can be found on MyAccountingLab. You can practise them as often as you want, and most feature step-by-step guided instructions to help you find the right answer.

## Review Questions

**4-1** 2 Consulting with others is an important step in making professional and ethical judgments. Explain how consultation can overcome judgment traps and ethical blind spots.

**4-2** 1 2 Explain how "framing the problem" can help overcome judgment traps when auditing subjective areas such as fair value estimates.

**4-3** 2 6 Why is an auditor's independence so essential? How can judgment traps affect auditors' independence?

**4-4** 3 4 What are the fundamental ethical principles for professional accountants? How can those principles aid in analyzing an ethical dilemma?

**4-5** 2 6 What consulting or non audit services are prohibited for auditors of public companies? Explain why it is generally agreed that prohibitions on consulting and non audit services will improve auditors' professional judgment and professional skepticism.

**4-6** 6 What is an independence threat analysis? When and why should it be completed?

**4-7** 5 The auditor's working papers usually can be provided to someone else only with the permission of the client. What is the rationale for such a rule? What are the exceptions to this rule?

**4-8** 2 4 Explain why documentation can improve auditors' professional and/or ethical judgment.

**4-9** 5 The rules of conduct of professional accountants require them to report a breach of the rules of conduct by a member to their profession's disciplinary body. What should they do before making such a report?

**4-10** 1 5 After accepting an engagement, a PA discovers that the client's industry is more technical than at first realized and that the PA is not competent in certain areas of the operation. What should the PA do in this situation?

**4-11** 5 Why is it so important that a successor auditor communicate with the incumbent before accepting an appointment as auditor? What should the successor do if the incumbent does not reply?

## Multiple Choice Questions

**4-12** 6 An auditor strives to achieve independence in appearance to
(1) comply with the auditing standards of fieldwork.
(2) become independent in fact.
(3) maintain public confidence in the profession.
(4) maintain an unbiased mental attitude.

**4-13** 5 In which one of the following situations would a CPA be in violation of the Code of Professional Conduct in determining the audit fee?
(1) A fee is based on whether the CPA's report on the client's financial statements results in the approval of a bank loan.
(2) A fee is based on the outcome of a bankruptcy proceeding.
(3) A fee is based on the nature of the service rendered and the CPA's expertise instead of the actual time spent on the engagement.
(4) A fee is based on the fee charged by the prior auditor.

**4-14** 5 Which Rule of Professional Conduct has most likely been violated in the following situation?

A single-partner CPA firm took on a new client in the uranium mining industry. Most of the firm's clients operate in the retail service sector and the firm had until then never dealt with any business operating in the uranium sector. The audit fees for the new client are significant and the partner has indicated that "the staff assigned to the audit should be quickly able to learn the ins and outs of uranium and be able to perform a quality audit."
(1) Association with false and misleading information
(2) Contingent fees
(3) Advertising and solicitation
(4) Competence

**4-15** 5 Which of the following is not a safeguard to independence?

(1) A qualified, independent audit committee
(2) Firm policies that limit direct communication between junior staff and the client's senior executives
(3) Tone at the top encouraging high quality auditing and professional skepticism
(4) Periodic rotation of senior members on the engagement

**4-16** 5 6 Zaspa Inc. is a public company that manufactures and sells tennis racquets. The company has expanded internationally and its auditors have resigned due to the fact that they have insufficient staff to meet the needs of the expanding business. In light of this fact, Zaspa has approached your firm, EA LLP, to take on the audit going forward.

For each EA LLP staff member below, identify any potential threat(s) to independence using information in Table 4-7.

| EA LLP Staff Member | Threat(s) to Independence (leave blank if none) |
|---|---|
| Toni Kowalsky, partner.<br>Toni and Zaspa's CEO, Roger, run a local summer tennis camp together. Toni and Roger became friends when they both worked at Zaspa. Toni left her role as finance VP at Zaspa 18 months ago. | |
| Patrick Sholer, senior manager.<br>Patrick is a big tennis enthusiast and bought Zaspa tennis racquets for himself and his family. | |
| Chris Washolc, manager.<br>Chris worked in Zaspa's internal audit department on review of payroll system controls, but left Zaspa two years ago. | |
| Sam Rivers, audit senior.<br>Sam owns 1000 shares in Zaspa, inherited from his father's estate. | |
| Yolanda Ladna, audit senior.<br>Yolanda plays on a semi-competitive volleyball team with four Zaspa employees. | |
| Anna Madras, audit junior.<br>Anne's father is a finance VP at Zaspa's parent company, which is listed on the TSX. | |

## Discussion Questions and Problems

**4-17** 3 Diane Harris, a PA, is the auditor of Fine Deal Furniture, Inc. In the course of her audit for the year ended December 31, 2015, she discovered that Fine Deal had serious going-concern problems. Henri Fine, the owner of Fine Deal, asked Diane to delay completing her audit.

Diane is also the auditor of Master Furniture Builders Ltd., whose year-end is January 31. The largest receivable on Master Furniture's list of receivables is Fine Deal Furniture; the amount owing represents about 45 percent of Master Furniture's total receivables, which, in turn, are 60 percent of Master Furniture's net assets. The management of Master Furniture is not aware of Fine Deal's problems and is certain the amount will be collected in full.

Master Furniture is in a hurry to get the January 31, 2016, audit finished because the company has made an application for a sizable loan from its bank to expand its operations. The bank has informally agreed to advance the funds based on draft financial statements submitted by Master Furniture just after the year-end.

**REQUIRED**

What action should Diane take and why?

**4-18** 5 6 The following situations involve the provision of non audit services.

**a.** Providing bookkeeping services to a listed entity. The services were preapproved by the audit committee of the company.
**b.** Providing internal audit services to a listed entity that is not an audit client.
**c.** Designing and implementing a financial information system for a private company.
**d.** Recommending a tax shelter to a client that is a publicly held listed entity. The services were preapproved by the audit committee.
**e.** Providing internal audit services to a listed entity audit client with the preapproval of the audit committee.
**f.** Providing bookkeeping services to an audit client that is a private company.

**REQUIRED**

For each situation, indicate whether providing the service is a violation of the rules of professional conduct for PAs. Explain your answer.

**4-19** **5** **6** Each of the following scenarios involves a possible violation of the rules of conduct.

**a.** John Brown is a PA, but not a partner, with three years of professional experience with Lyle and Lyle, Public Accountants, a one-office public accounting firm. He owns 25 shares of stock in an audit client of the firm, but he does not take part in the audit of the client and the amount of stock is not material in relation to his total wealth.

**b.** In preparing the corporate tax returns for a client, Phyllis Allen, PA, observed that the deductions for contributions and interest were unusually large. When she asked the client for backup information to support the deductions, she was told, "Ask me no questions, and I will tell you no lies." Phyllis completed the return on the basis of the information acquired from the client.

**c.** A private entity audit client requested assistance of Kim Tanabe, PA, in the installation of a computer system for maintaining production records. Kim had no experience in this type of work and no knowledge of the client's production records, so she obtained assistance from a computer consultant. The consultant is not in the practice of public accounting, but Kim is confident in her professional skills. Because of the highly technical nature of the work, Kim is not able to review the consultant's work.

**d.** Five small Moncton public accounting firms have become involved with an information project by taking part in an inter firm working paper review program. Under the program, each firm designates two partners to review the working papers, including the tax returns and the financial statements, of another public accounting firm taking part in the program. At the end of each review, the auditors who prepared the working papers and the reviewers have a conference to discuss the strengths and weaknesses of the audit. They do not obtain the authorization from the audit client before the review takes place.

**e.** Roberta Hernandez, PA, serves as controller of a Canadian company that has a significant portion of its operations in several South American countries. Certain government provisions in selected countries require the company to file financial statements based on international standards. Roberta oversees the issuance of the company's financial statements and asserts that the statements are based on international financial accounting standards; however the standards she uses are not those issued by the International Accounting Standards Board.

**f.** Bill Wendal, PA, set up a casualty and fire insurance agency to complement his auditing and tax services. He does not use his own name on anything pertaining to the insurance agency and has a highly competent manager, Renate Jones, who runs it. Bill frequently requests Renate to review with the management of an audit client the adequacy of the client's insurance if it seems underinsured. He feels that he provides a valuable service to clients by informing them when they are underinsured.

**g.** Michelle Rankin, PA, provides tax services, management advisory services, and bookkeeping services and conducts audits for the same private company client. She requires management to approve, in writing, transactions and journal entries. Since her firm is small, the same person frequently provides all the services.

**REQUIRED**

Indicate whether each is a violation and explain why you think it is or is not.

---

**4-20** **5** **6** Each of the following situations involves possible violations of the rules of conduct that apply to professional accountants.

**a.** Martha Painter, PA, was appointed as the trustee of the So family trust. The So family trust owned the shares of the So Manufacturing Company, which is audited by another partner in Martha's office. Martha owns 15 percent of the shares of the So Manufacturing Company and is also a director of the company, in the position of treasurer.

**b.** Marie Godette, LLB, has a law practice. Marie has recommended one of her clients to Sean O'Doyle, a PA. Sean has agreed to pay Marie 10 percent of the fee Sean receives from Marie's client.

**c.** Theresa Barnes, PA, has an audit client, Choi Inc., which uses another public accounting firm for management services work. Unsolicited, Theresa sends her firm's literature covering its management services capabilities to Choi on a monthly basis.

**d.** Alan Goldenberg leased several vehicles from his friend Norm. Norm said that he would give Alan a $200 commission for each referral. Alan referred to Norm several clients who were interested in leasing vehicles. After a few months, Alan was pleased to receive a cheque for $3000 in the mail. Several of his clients had decided to change automobile leasing companies.

**e.** Edward Golikowski completed for his client financial projections that covered a period of three years. Edward was in a hurry and inadvertently stated that they covered five years; so he redid the client's calculations, rather than checking assumptions and doing field work, even though he attached an assurance report.

**f.** Marcel Poust, a PA, has sold his public accounting practice, which includes bookkeeping, tax services, and auditing, to Sheila Lyons, a PA. Marcel obtained permission from all audit clients for audit-related working papers before making them available to Sheila. He did not get permission before releasing tax- and management services-related working papers.

**REQUIRED**

For each situation, state whether it is a violation. Where there is a violation, explain the nature of the violation and the rationale for the existing rule.

**4-21** 5 6 Ann Archer serves on the audit committee of JKB Communications Inc., a telecommunications start-up company. The company is currently a private company. One of the audit committee's responsibilities is to evaluate the external auditor's independence in performing the audit of the company's financial statements. In conducting this year's evaluation, Ann learned that JKB Communications' external auditor also performed the following IT and ecommerce services for the company:

**a.** Installed JKB Communications' information system hardware and software selected by JKB management.

**b.** Supervised JKB Communications' personnel in the daily operation of the newly installed information system.

**c.** Customized a prepackaged payroll software application, based on options and specifications selected by management.

**d.** Trained JKB Communications' employees on the use of the newly installed system.

**e.** Determined which of JKB Communications' products would be offered for sale on the company's website.

**f.** Operated JKB Communications' local area network for several months while the company searched for a replacement after the previous network manager left the company.

**REQUIRED**

Consider each of the preceding services separately. Evaluate whether the performance of each service is a violation of the rules of professional conduct.

---

**4-22** 5 6 The following are situations that may violate the general rules of conduct of professional accountants. Assume in each case that the PA is a partner.

**a.** Simone Able, a PA, owns a substantial limited partnership interest in an apartment building. Juan Rodriquez is a 100 percent owner in Rodriquez Marine Ltd. Juan also owns a substantial interest in the same limited partnership as Simone. Simone does the audit of Rodriquez Marine Ltd.

**b.** Horst Baker, a PA, approaches a new audit client and tells the president that he has an idea that could result in a substantial tax refund in the prior year's tax return by application of a technical provision in a tax law that the client had overlooked. Horst adds that the fee will be 50 percent of the tax refund after it has been resolved by Canada Revenue Agency. The client agrees to the proposal.

**c.** Chantal Contel, a PA, advertises in the local paper that her firm does the audit of 14 of the 36 largest drugstores in the city. The advertisement also states that the average audit fee, as a percentage of total assets for the drugstores she audits, is lower than that of any other public accounting firm in the city.

**d.** Olaf Gustafson, a PA, sets up a small loan company specializing in loans to business executives and small companies. Olaf does not spend much time in the business because he works full time in his public accounting practice. No employees of Olaf's public accounting firm are involved in the small loan company.

**e.** Louise Elbert, a PA, owns a material amount of stock in a mutual fund investment company, which, in turn, owns stock in Louise's largest audit client. Reading the investment company's most recent financial report, Louise is surprised to learn that the company's ownership in her client has increased dramatically.

**REQUIRED**

Discuss whether the facts in any of the situations indicate violations of the rules of conduct for professional accountants. If so, identify the nature of the violation(s).

## Professional Judgment Problems and Cases

**4-23** 5 6 Donna, a PA, is approached by the owner of one of her clients, for whom she normally compiles monthly and annual financial statements, to perform an audit of the company's inventories. The client, Fantastic Fashions Ltd., is a chain of retail clothing stores that operates in several local shopping malls.

The owner explains that he is seeking new bank financing that will be secured by the inventories as collateral for the loan, and that the bank has requested an audit of the recorded inventories as a condition of granting the loan. The bank insists that it will lend no more than 75 percent of the amount of inventories as shown on an audited schedule of inventories that the owner has been asked to submit.

Because the owner is in urgent need of cash, he offers to pay Donna an audit fee equal to 10 percent of the loan amount, and Donna agrees to these terms. She then performs an audit of the inventories in accordance with generally accepted auditing standards, and issues a standard unqualified audit opinion, except that the opinion paragraph reads as follows: "In my opinion, this schedule presents fairly, in all material respects, the inventories of Fantastic Fashions Ltd. as at March 31, 2016, in accordance with generally accepted accounting standards for private enterprises."

**REQUIRED**

**a.** Prepare an independence analysis of the owner's request. Should Donna have accepted the engagement? Why or why not?

**b.** Assess Donna's actions. Determine which judgment tendencies were most prevalent and what Donna could have done to reduce her bias.

**c.** Did Donna violate any rules of professional conduct? If so, identify which rules and explain.

(Extract from AU2 CGA-Canada Examinations developed by the Certified General Accountants Association of Canada © 2010 CGA-Canada. Reproduced with permission. All rights reserved.)

---

**4-24** 1 2 3 4 Aqua Inc. was a privately owned company that operated a marina business from two lakefront properties in northern Ontario. The company was started by two brothers. The company provided boat docking, sold gasoline and boating supplies, and was very successful.

Aqua's accountant, John Purd, was a PA who operated an accounting proprietorship in a nearby town. John offered only accounting, bookkeeping, and some investment counselling services. John's business had been successful, and he approached Aqua with a desire to purchase part of the Aqua business. John suggested that he would buy a one-third interest in the business by buying shares from the two brothers. The company could then issue a new class of nonvoting shares, and they would all become very wealthy, almost immediately, just from the sale of the shares. John explained that this plan would make the existing shareholders wealthy without giving up control of the business.

John explained that Aqua would have to have audited financial statements to encourage potential investors and that he could save the company money by conducting the audit himself. John had to thoroughly analyze Aqua's books anyway as part of his due diligence in buying the shares for himself, so he would charge Aqua only a small fee for his audit services.

The brothers agreed with John's suggestion, and John bought a third of the company. John conducted the audit by himself over the next two months. As John had promised, he gave an unqualified audit opinion on the financial statements. As soon as the audit was completed, John found one of his own clients, New Investments Ltd., to buy the shares. After expenses, John and each of the two brothers received approximately $800 000.

Unfortunately, Aqua's business failed in the following year, when it was discovered that Aqua did not own the lakefront properties, but had only leased them. When the leases expired, the landlord refused to enter a new lease and Aqua filed for bankruptcy. As the auditor, John was sued by Aqua's bank and by New Investments, both of whom claimed they had relied on the audited financial statements in their dealings with Aqua. John claimed that the two brothers had lied to him that the business owned the lakefront properties, so he was not responsible.

**REQUIRED**

**a.** Using the professional judgment framework, analyze John's decision to issue an unqualified audit opinion.

**b.** As the auditor, identify to which parties John owed a duty of care. Explain your answer by stating why John would owe a duty of care to each party you mention.

**c.** Identify ethical violations by John.

(Extract from AU1 CGA-Canada Examinations developed by the Certified General Accountants Association of Canada © 2011 CGA-Canada. Reproduced with permission. All rights reserved.)

---

**4-25** 1 2 3 4 Barbara Whitley had great expectations about her future as she sat at her graduation ceremony in May 2015. She was about to receive her Master of Accountancy degree, and the following week she would begin her career on the audit staff of Green, Thresher & Co., a public accounting firm. Things looked a little different to Barbara in February 2016. She was working on the audit of Delancey Fabrics Ltd., a textile manufacturer with a calendar year-end. The pressure was enormous. Everyone on the audit team was putting in 70-hour weeks, and it still looked as if the audit would not be done on time. Barbara was doing work in the property area, vouching additions for the year. The audit program indicated that a sample of all items over $10 000 should be selected, plus a non statistical sample of smaller items. When Barbara went to take the sample, Jack Bean, the senior, had left the client's office and could not answer her questions about the appropriate size of the judgmental sample. Barbara forged ahead and selected 50 smaller items on her own judgment. Her basis for doing this was that there were about 250 such items, so 50 was a reasonably good proportion of such additions. Barbara audited the additions with the following results: The items over $10 000 contained no errors; however, the 50 small items contained a large number of errors. In fact, when Barbara projected them to all such additions, the amount seemed quite significant.

A couple of days later, Jack Bean returned to the client's office. Barbara brought her work to Jack in order to inform him of the problems she found, and got the following response: "Barbara, why did you do this? You were supposed to look only at the items over $10 000, plus 5 or 10 little ones. You've wasted a whole day on that work, and we can't afford to spend any more time on it. I want you to throw away the schedules where you tested the last 40 small items and forget you ever did them."

When Barbara asked about the possible audit adjustment regarding the small items, none of which arose from the first 10 items, Jack responded, "Don't worry, it's not material anyway. You just forget it; it's my concern, not yours."

**REQUIRED**

**a.** In what way is this an ethical dilemma for Barbara?

**b.** Using the ethical decision making framework, analyze Barbara's ethical dilemma.

**c.** What should Barbara do to resolve the dilemma?

**4-26** 1 2 Refer to the opening vignette regarding the Livent case.

**REQUIRED**

**a.** Explain how this case illustrates the importance of framing the issue.

**b.** The ICAO disciplinary committee argues that professional judgment requires a correct conclusion. How do you reconcile this view with the common view that auditing and accounting are very subjective?

---

**4-27** 1 2 4 In the opening vignette of Chapter 2, the national assurance service line leader at Grant Thornton, Jeremy Jagt, commenting on the deficiencies the CPAB found in audits of companies in emerging markets, suggested that issues around cultural difference could account for differences in professional judgment.

Below is a summary of the various views from that article discussing audits in foreign jurisdictions.

- Critics argue that, given it was affiliates of the six major global networks that were under scrutiny in each of the CPAB reports and that they use the same methodology throughout the world, one would expect the same audit results.
- The OSC argued that the blame can be shared by both Canadian auditors and the auditors in the emerging market. Regarding the Canadian auditors: "Some appeared to have an insufficient understanding of the legal environment … and/or procedures to obtain licences and/or permits in the emerging market." Regarding the auditors located in the emerging market, the OSC also observed: "In some cases auditors appeared to accept certain information provided by management at face value without performing any procedures to support those representations with independent external information."
- Greg Shields, from CPA Canada, highlighted the problems with multi-jurisdictional audits: "Some companies may maintain key business relationships through actions that would be considered unethical or even illegal in Canada," said Shields. "Also, a company's governance structures and internal controls might not be as robust as would normally be expected in Canada. Pervasive issues of this nature, as well as many other potential issues associated with the way business is done in some jurisdictions, can be quite difficult for a Canadian auditor to deal with effectively."

**REQUIRED**

**a.** Based upon your understanding of the professional judgment process and judgment traps, what judgment traps do you think these auditors may have fallen into?

**b.** What types of processes can firms put in place to prevent these types of problems from occurring?

**c.** Comment on Shields's observation that what are considered to be ethical versus unethical practices is dependent upon national context.

Source: Gundi Jeffrey. 2014. "Audit quality improving, CPAB says." *The Bottom Line*, May: p. 17.

## Research Activity

**RA 4-1 More on Improving Professional Skepticism**

In Chapter 2, we discussed various audit quality initiatives. An example of an audit quality initiative is the Standards Working Group of the Global Policy Committee (comprising BDO, Deloitte Touche Tomatsu, Ernst & Young, Grant Thornton, KPMG, and PricewaterhouseCoopers). The Global Policy Committee is a committee of the International Forum of International Regulators.

**REQUIRED**

**a.** Refer to **https://www.ifiar.org/Working-Groups/GPPC-Working-Group.aspx**. What is this committee's mandate and what is the role of the six largest international audit networks? How do these type of groups contribute to audit quality?

**b.** In our chapter, much of the focus is on the individual decision maker; however, many other factors can affect professional skepticism. Download the Enhancing Professional Skepticism Report at **www.thecaq.org/docs/research/skepticismreport.pdf.** Refer to Exhibit 2 (pages 9 and 10).

**c.** Discuss how factors related to the engagement team and the audit firm can impact professional skepticism.

**d.** What actions can engagement teams and audit firms take to mitigate the impact of those factors?



M05_AREN5507_13_SE_C04.indd 91 31/07/15 4:37 PM