CHAPTER 1

Introduction to Auditing

SOLUTIONS FOR REVIEW CHECKPOINTS

1-1 Auditors add credibility to financial information provided by the accountable party such as management (i.e. auditors make the financial or other information more likely to be true). Other common ways of characterizing this property of audited numbers is that the numbers are more accurate, have higher assurance, or are more reliable. These relate to different dimension of truthfulness, as we discuss later in the text.

1-2 Auditing is the verification of numbers provided by others. To attest means to lend credibility or to vouch for the truth or accuracy of the statements that one party makes to another. The attest function is a term often applied to the activities of independent PAs when acting as auditors of financial statements.

Since financial statements are prepared by managers of an entity who have authority and responsibility for financial success or failure, an outsider may be skeptical that the statements are objective, free from bias, fully informative, and free from material error--intentional or inadvertent. The audit opinion of an independent-PA auditor helps resolve those doubts because the auditor's success depends upon his independent, objective, and competent assessment of the conformity of the financial statements with GAAP. The auditor's role is to lend credibility to the statements, hence the outsider will likely seek his independent audit opinion.

1-3 Client: the company, board of directors, agency, or some other person or group who retains (hires) the auditor. Usually the party who pays the fee.
Auditee: the entity (e.g., business firm, hospital, city government) whose financial information is under audit.
Auditors: report to the client on the auditee's financial or control information.

Three party accountability consists of the auditor, the accountable party of the auditee such as management of the auditee, and the users. Users include the client as defined above. Traditionally management hired the auditor so that there was some confusion as to who was the true client. New corporate governance concepts in part attempt to clarify this three party accountability.

1-4 Auditors performing auditing gather evidence related to the assertions management makes in financial statements and render a report. Accountants performing accounting record, classify, and summarize (report) a company's assets, liabilities, capital, revenue, and expense in financial statements. Accountants produce the financial statements, auditors audit them.

1-5 The conditions of complexity, remoteness and consequences produce demands by outside users for financial reports. They cannot produce the reports for themselves because of these conditions. Company managers and accountant produce them.

1-6 Students can refer to the AAA and CICA definitions in Chapter 1. Some instructors may want to extend the consideration of definitions to include the internal and governmental definitions.

In response to "what do auditors do," students can refer to Exhibit 1-2 and respond in terms of: (1) obtain and evaluate evidence about assertions management makes about economic actions and events, (2) ascertains the degree of correspondence between the assertions and GAAP, and (3) gives an audit report (opinion).

Students can also respond more generally in terms of "lending credibility" to financial statements presented by management (attestation).

1-7 The essence of the risk reduction theory is that audits of financial statements reduce the information risk (probability of materially misleading statements) to users to a socially acceptable level.

1-8 Self-regulation refers to the powers a professional group has in regulating its affairs without intervention by the government or government established external regulator. These affairs include setting of standards, codes of conduct, education requirements, certification, and disciplining of members.

Financial analysts and investors depend upon financial reports for making stock purchase and sale decisions.
Creditors (suppliers, banks, etc.) use them to decide whether to give trade credit and bank loans.
Labor organizations use them to help determine a company's ability to pay wages.
Government agencies and Parliament use them in preparing analyses of the economy and in making laws concerning taxes, subsidies, and the like.

These various users cannot take it upon themselves to determine whether financial reports are reliable, therefore low in the information risk scale. They do not have the expertise, resources, or time to enter thousands of companies to satisfy themselves about the veracity of financial reports. Thus they hire independent auditors to perform the attest function and reduce the information risk.

1-8 The Canadian board (CPAB) is more self regulatory in that the profession has more influence through having a higher percentage of board membership, the monitoring process is less public and more designed to help firms improve their practices. The CICA continues to set audit standards. The PCAOB, on the other hand, not only sets standards but also has a more confrontational an public approach in its monitoring process.

1-9 Forensic accounting is the broader term that includes fraud auditing. Forensic accounting is the use of accounting for legal or investigative purposes. Fraud auditing is the use of forensic accounting in criminal investigations involving allegations of fraud. Frauds that PAs are most interested in are misappropriation of assets and fraudulent financial reporting (misreporting).

1-10 Fraud is intentional deception resulting in injury to another. Frauds that PAs are most interested in are misappropriation of assets and fraudulent financial reporting (misreporting).

1-12 Operational auditing is the study of business operations for the purpose of making recommendations about the economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies.

The CICA views operational auditing as a type of management advisory service offered by public accounting firms.

1-13 The elements of comprehensive auditing include: (1) financial and compliance audits, (2) economy and efficiency audits, and (3) program results or effectiveness audits. Public sector is the part of the economy represented by all levels of government. Public companies are companies whose shares are traded on the stock markets.

1-14 A compliance audit involves a study of an organization's policies, procedures, and performance in following laws, rules, and regulations. An example is a company's compliance with environmental laws.

1-15 Other kinds of auditors: Revenue Canada agents/auditors, provincial and federal bank examiners, provincial insurance commissioner auditors.

1-16 Financial statement audits are intended to provide assurance there are no significant intentional or unintentional misstatements.

1-17 CA's, CGA's, and CIA's

1-18 Examples of attestation services:

Vote counts (Academy Awards)
Amount of prizes claimed to have been given in sweepstakes advertisements
Investment performance statistics
Characteristics claimed for computer software programs

1-19 Audits of financial statements?
Auditing Standards
Work on unaudited financial statements of public companies?
Review Engagement Standards
Work on unaudited financial statements of public companies?
Compilation Engagement Standards (SAS)

The three major areas of public accounting services:
Accounting and auditing
Taxation
Management advisory services (consulting)

1-20 The SEC site is more comprehensive but covers only Canadian companies cross listed on U.S. exchanges.

1-21 The IFAC site is at www.ifac.org and click on "standards and guidance."

SOLUTIONS FOR EXERCISES AND PROBLEMS

EP1-1 When the PA is hired by Hughes Corporation, he can no longer be considered independent with respect to the annual audit. The annual audit may then be unnecessary in a short-run view and unnecessary to the extent of services exclusive of the attest opinion. It is true that the in-house CPA can perform all the procedural analyses that would be required of an independent audit; however, it is extremely unlikely that he could inspire the confidence of users of financial statements outside the company. He cannot modify the perception of potential conflict of interest that creates demand for the independent audit. As a matter of ethics rules, this PA would be prohibited from signing the standard unqualified attest opinion.

EP1-2 You should point out that you will be unable to replace the independent audit with your own communication output as controller. Make the point that you can conduct an effect internal audit function and be of considerable service to management and can even assist the independent auditors with preparation of schedules and general cooperation (thus facilitating the independent audit).

Nevertheless, as a member of management, it would be impossible to be truly objective and unbiased about the financial results of management's decisions, hence the directors could not satisfy their obligations to the shareholders' interests. Neither could you issue an opinion to be used by outsiders.

Lacking an opinion on the financial statements, the company could find itself in noncompliance with audit requirements of a stock exchange, a Provincial Securities Commission, or the U.S. Securities and Exchange Commission.

EP1-3
a. risk of litigation needs offsetting lower information risk (for example, litigation due to share practice decline or failure to meet a bond covenant).
b. strength of internal controls (e.g., controls over financial instruments, controls over cash).
c. financial health of client (industry factors, economic factors).
d. management compensation system (management highly motivated to beat earnings targets, compensation tied to factors over which management has little control may motivate management to “manage earnings”).
e. private vs. public company (publicly held company owners are more reliant on financial statements for information about their investment).

EP1-4 Financial statements are prepared on basis of GAAP. Knowledge of GAAP is thus indispensable for determining if the financial statements are in conformity with GAAP. For example lease accounting consists of some very specific rules (bright line rules) that the auditor effectively tests compliance with. Unfortunately such detailed rule based accounting leads to what some refer to as a checklist mentality where the form is more important than the substance. Enron’s special purpose entity accounting also comes to mind.

EP1-5 Operational Auditing

Bigdeal cannot hire the OAG. This government agency does not perform operational audits for private industry.

One possibility is the management advisory services department of a large PA firm. The major advantage may be total objectivity. The PA firm has no stake in making a report reflect favorably or unfavorably on Smalltek (provided there are no prior relations of the PA firm with Bigdeal managers that may suggest a bias or with Smalltek). The possible disadvantage is that the PA firm may not possess the required expertise in Smalltek' type of business.

Another possibility is the Bigdeal internal audit department. The major advantage may be a thorough appreciation of Bigdeal's managerial effectiveness and efficiency standards and a longstanding familiarity with Bigdeal's business. The possible disadvantage could be that the internal auditors may not be independent enough from internal management pressures for making or breaking the deal for reasons other than Smalltek's efficiency and effectiveness.

Another possibility is a nonPA management consulting firm. The major advantage of objectivity would be similar to the PA firm, and such firms often have experts in manufacturing, sales, and research and development management. The major disadvantage could be a lack of appreciation and familiarity with Bigdeal's management standards (as possessed by the Bigdeal internal auditors).

EP1-6 The neighbor appears to be uninformed on the following points:

1- According to auditors' dogma, Price Waterhouse did not <u>prepare</u> the Dodge Corporation financial statements, and no auditor <u>prepares</u> a company's statements.	Inform your neighbor that Dodge management is primarily responsible for preparing the financial statements and deciding upon the appropriate accounting principles.
2. An unqualified opinion does not mean an investment is <u>safe</u>.	Tell your neighbor that the financial statements are <u>history</u>. The value of his investment depends on future events, including the many factors that affect market prices. Tell him the opinion only means that the statements conform to GAAP (and you can add that the auditor knows of no material fraud or error).

EP1-7 Identification of Audits and Auditors

The responses to this matching type of question are ambiguous. The engagement examples are real examples of external, internal and governmental audit situations. You might point out to students that the distinctions among compliance, economy and efficiency and program results audits are not always clear. The "solution" is shown below in matrix form, showing some engagement numbers in two or three cells. The required schedule follows.

Type of Audit

Kind of Auditor	Financial Statement	Compliance	Economy, Efficiency	Program Results
Independent PA	2, 10			
Internal Auditor		6, 8	4, 8	
Governmental (AGC)		3	1, 3, 9	1, 3
Revenue Canada Auditor	X	5	X	X
Bank Examiner	X	7	X	X

1.	FHA loan interest equity	Economy and Efficiency or Program Results	Governmental (AGC)
2.	Advertising agency financial statements	Financial statement	Independent CPAs
3.	Dept. of Interior policies	Compliance or Economy and Efficiency or Program Results	Governmental (AGC)

4.	Municipal services	Economy and Efficiency	Internal auditors
5.	Tax shelters	Compliance	Revenue Canada auditors
6.	Test pilot reporting	Compliance	Internal auditors
7.	Bank solvency	Compliance	Bank examiners
8.	Materials inspection by manufacturer	Compliance or Economy and Efficiency	Internal auditors
9.	Drug enforcement vehicle seizures	Economy and Efficiency	Governmental (AGC)
10.	Sports complex forecast	Financial statement	Independent PAs

EP1-8 Analysis and Judgment

This problem is one of Robert Ashton's cases on judgment and decision making (Accounting Review, January, 1984, pp. 78-97.) Ashton gives credit to Joyce and Biddle, "Anchoring and Adjustment in Probabilistic Inference in Auditing." Journal of Accounting Research, Spring, 1981, pp. 1

The case is set up to illustrate a person's tendency to anchor an estimate on some known information and adjust from that point in the course of performing analysis. This particular case set-up is intended to illustrate conjunctive and disjunctive events. Ashton's "answer key" explains in this manner:

Ashton's Answer Key (abridged)

This exercise focuses on probability estimates for two types of complex events called "conjunctive" and "disjunctive." The occurrence of a conjunctive event depends on the joint occurrence of all of a number of sub-events, each with a given probability of occurrence.

An example is getting three 3's in a row when rolling a die. This is a conjunctive event with probability of 1/6 raised to the third power (1/6 x 1/6 x 1/6), or about 0.005.

An example of a disjunctive event is getting at least one of a number of sub-events, such as one 3 in three rolls of the die. The probability of this disjunctive event is about 0.42

If you are asked to estimate the probabilities of the conjunctive and disjunctive events of rolling the die, a natural starting place (anchor) would be to know that the probability of getting one three in one roll is 1/6, or 0.167. Then to estimate the harder conjunctive event (three 3's in a row), a downward adjustment would be required. Conversely, for the disjunctive event (one 3 in three rolls), an upward adjustment would be needed. However, since adjustments from an anchor are usually insufficient, the estimated probability of the conjunctive event will likely be too large, and that of the disjunctive event too small.

Form A of the problem (the one in the textbook chapter) is a conjunctive statement of the problem, and it asks for an estimate of the probability of successful product introduction. With the five sub-events considered independent of each other, the best answer is 0.554 (.80 x .90 x .95 x .90 x .90). Students may anchor on the probabilities of the elementary sub-events and fail to adjust sufficiently downward, and their probability estimates will be higher than 0.554.

Form B of the problem (reproduced on the next page, not in the textbook) is a disjunctive statement of the same problem, and the best answer is still 0. 554. Form B, however, is stated in terms of failure in the chain of events. (Student responses must be subtracted from 1.000 to make them comparable to Form A.) If students anchor on the probabilities of the elementary disjunctive sub-events in Form B, their probability estimates (subtracted from 1.000) will probably be too low.

NOTE TO INSTRUCTORS: You may want to reproduce Form B and give both the textbook problem (conjunctive) and the Form B alternative (disjunctive) to different groups of students to illustrate the anchoring and adjustment behavioral phenomenon.

You may also want to give students a response scale to make your classroom discussion easier. Ask them to circle one:

.00 .10 .20 .30 .40 .50 .60 .70 .80 .90 1.00

EP1-9 Management certification means that, in the words of SOX, "The CEO and CFO of each issuer shall prepare a statement to accompany the audit report to certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operations and financial condition of the issuer." A violation of this section must be knowing and intentional to give rise to liability." Before SOX, management's responsibility was implicit, now it is made publicly explicit in writing. The primary effect on auditors is to reduce their legal liabilities by making it clearer that management takes on primary responsibility for financial reporting. Auditors are still needed because as the chapter discusses users may not trust management so any statements management makes does not really address this problem. Management however is now held more accountable. For example, management may no longer claim they didn't understand technical aspects of accounting and deferred to the auditor's judgment.

EP1-10 Protecting investors is the most likely response. In public sector, protecting the tax payer would be another possible response. In both cases, however, we are talking about capital providers as the 3rd parties and capital users as the 2nd party in a 3 party accountability relationship.

There are other issues, however, such as how sophisticated are the 3rd parties. For example, do they understand the limitations of GAAP? How much about GAAP should we expect them to understand? For example, can we assume that they know about the accounting risks associated with GAAP? This question is very open ended.

EP1-11 1st party=CRA auditor, 2nd party=taxpayer, 3rd party= Canadian government

EP1-12 Most non-auditors feel that an auditor's prime responsibility is to detect fraud (part of the expectation's gap). This was the major focus of audits before the 20th century. The switch to fairness of presentation seemed to take place with increased use of estimates in accounting in the 20th century, especially after passage of the SEC Acts. The past decade has brought a renewed interest in fraud detection, especially in the post-Enron environment.

CHAPTER 2

Auditors' Professional Roles and Responsibilities

SOLUTIONS FOR REVIEW CHECKPOINTS

2-1 Self-regulation refers to the powers a professional group has in regulating its affairs without intervention by the government or government established external regulator. These affairs include setting of standards, codes of conduct, education requirements, certification, and disciplining of members.

Since the failure of Enron in 2001, there has been increased involvement by outside agencies in the monitoring of the audit function. Auditing is increasingly viewed as a key pillar in capital markets, along with regulators and good governance practices. As a result external regulation of the profession has been increasing. In Canada, this has taken the form of increased monitoring of auditors of public companies via CPAB. CPAB however does not have the power to create audit and ethics standards as does the PCAOB in the U.S. Nevertheless, both CPAB and PCAOB are increasingly assertive monitoring the quality of audit practice and sanctioning auditors who do not meet their expectations. A major focus of inspections by CPAB and PCAOB is the quality of the audit. Quality generally refers to degree of conformity with standards and nature of procedures performed and their documentation. "Procedures" relate to acts to be performed. "Standards" deal with measures of the quality of performance of those acts and the objectives to be attained by the use of procedures. The standards are less subject to change. The standards provide the criteria for rejecting, accepting, or modifying a procedure in a given circumstance. An example of the relative stability of standards and procedures is found in the change from non-EDP to EDP systems. New procedures were required to audit EDP systems, but auditing standards remained unchanged and were the criteria for determining the adequacy of the new procedures.

The word "procedure" is used in SAS 46 (AU 390)--"Consideration of Omitted Procedures After the Report Date"--to refer to (1) an act to be performed and (2) sufficient competent evidence. SAS 46 speaks of omitted procedures and the relative seriousness of their omission. The importance of any "omitted procedure," however, is the evidence the auditors failed to obtain. Merely omitting technical procedures is only a superficial analysis of an audit problem; the substance is the evidence not obtained.

The standard for due audit care is the care which would be exercised by the <u>prudent auditor</u>. The prudent auditor is one who exercises reasonable judgment, who is not expected to be omniscient, who is presumed to have knowledge special to his profession, who is expected to be aware of his own ignorance, who is expected to possess the skills of his profession whether he is a beginner or a veteran.

2-2 The Canadian board (CPAB) is more self-regulatory in that the profession has more influence through having a higher percentage of board membership, themonitoring process is less public and more designed to help firms improve their practices. The CICA continues to set audit standards. The PCAOB, on theother hand, not only sets standards but also has a more confrontational and public approach in its monitoring process.

The most important difference is that PCAOB actually sets auditing and professional ethics standards for public company audits in the U.S. In Canada, audit standards are set by the CICA while professional ethics standards are set by the provincial institutes/societies of CGAs, CMAs, and CAs. PCAOB reports are much more detailed disclosing the results of each inspection by firm, whereas CPAB reports are more generic providing an overall evaluation of the state of public company audits in Canada. Students generally find the PCAOB reports more interesting because they learn about problems identified for the firms they have accepted positions in. The CPAB report issued on April 3, 2012 on 2011 inspections was disappointed with the state of audits in Canada, particularly the implementation of audits in higher risk areas. "The Big 4 firms, which audit 94% of reporting issuers by market capitalization, had a GAAS deficiency rate of 20-26% on files inspected by CPAB." Other audit firms had a 47% GAAS deficiency rate. CPAB found these results consistent with other regulators. This is not just a Canadian problem.

2-3 CA's, CGA's, and CMA's

2-4 Examples of other representations are on the effectiveness of internal controls, vote counts at the Academy Awards, forecasts of financial information, efficiency of public sector activities. Vote counts (Academy Awards)
Amount of prizes claimed to have been given in sweepstakes advertisements
Investment performance statistics
Characteristics claimed for computer software programs
Also see the list of value for money audit engagements in chapter 1.

2-5 The three major areas of public accounting services:
Accounting and auditing
Taxation
Management advisory services (consulting)

2-6 The SEC site is more comprehensive but covers only the Canadian companies cross listed on U.S. exchanges.

2-7 "Procedures" relate to acts to be performed. "Standards" deal with measures of the quality of performance of those acts and the objectives to be attained by the use of procedures. The standards are less subject to change. The standards provide the criteria for rejecting, accepting, or modifying a procedure in a given circumstance. An example of the relative stability of standards and procedures is found in the change from non-EDP to EDP systems. New procedures were required to audit EDP systems, but auditing standards remained unchanged and were the criteria for determining the adequacy of the new procedures.

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2-8 The standard for due audit care is the care which would be exercised by the prudent auditor. The prudent auditor is one who exercises reasonable judgment, who is not expected to be omniscient, who is presumed to have knowledge special to his profession, who is expected to be aware of his own ignorance, who is expected to possess the skills of his profession whether he is a beginner or a veteran.

2-9 Three elements of planning and supervision considered essential in audit practice are:

1.A written audit program.
2- An understanding of the client's (auditee's) business.
PA firm procedures to allow an audit team member to document disagreements with accounting or auditing conclusions and disassociate himself or herself from the matter.
3. Ensuring that staff have appropriate training and competence to perform the audit.

2-10 The timing of the auditor's appointment matters because the auditor needs time to plan the audit properly and perform the work without undue pressure from too-short deadlines.

2-11 An auditor obtains an understanding of a client's internal control system as a part of the control risk assessment process primarily in order to plan the nature, timing and extent of subsequent substantive audit procedures. Understanding of internal control allows an auditor to gain a measure of comfort as to how much to rely on the information generated by the auditee's accounting system. A secondary purpose (not covered in Chapter 2) is to obtain information about reportable conditions (control deficiencies) to report to the client.

2-12 CAS 500.5(c)defines audit evidence as "Information used by the auditor in arriving at conclusions on which the