

## CHAPTER 1

### Introduction to Auditing

#### SOLUTIONS FOR REVIEW CHECKPOINTS

- 1-1. In this example of a three-party accountability structure, the owner is the 'third party', the hired manager is the 'first party' and the auditor is the 'second party'. The owner is looking out for his/her own longer-term economic interests, but has to rely on the actions and information provided by the hired manager, who may have shorter term concerns (like his/her own compensation and job prospects) and thus act self-interestedly.
- The owner is accountable for financing the business and treating the manager fairly, particularly in terms of compensating his/her efforts and successes appropriately. The manager is accountable for giving reliable and fair reports of the business profit performance to the owner. Given the potential conflicts between the interests of the first and third parties, there is information risk - the risk that the financial statement information will not be a full and fair representation of the transactions and events that really occurred, and will not be reliable for economic decisions that the owner may base upon it. The auditor is accountable for objectively verifying the fairness and reliability of the information and providing an independent opinion on how well the information reflects the underlying realities of the entity's operations. The auditor's opinion can benefit both the first and third parties - the owner directly by lowering information risk, and the manager indirectly because if the owner has more basis to trust the manager not to act against the owner's interests the owner will be more willing to share the profits with the manager (this is referred to as lowering "agency costs," which are charged by the owner/principal and incurred by the manager/agent if the owner does not trust the manager). For the auditor's opinion to have value in giving the owner some comfort (i.e., "assurance") that the manager's information can be relied on, the auditor must have no personal interest in either side and be able to remain objective.
- 1-2. The concept of reasonable assurance describes a mental attitude that the auditor gains from the conclusions drawn from audit examination findings. Based on the examination, if the auditor comes to believe the financial statements are reliable and fair to the interests of third party users, this belief forms the basis of the opinion the auditor will communicate to financial statement users in the Auditor's Report. An 'audit opinion' provides a **high level of assurance** to the user that the auditor believes that the information risk is low, and has evidence to support that belief.
- 1-3 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 or representationally faithful). 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 dimensions of truthfulness, as we discuss later in the text.
- 1-4 By obtaining more accurate or reliable information about the company, Aunt Zhang can obtain a more accurate valuation of the company. This more accurate valuation gives Aunt Zhang more confidence that she will get her money's worth in the investment. The preceding assumes Aunt Zhang is risk averse—a common assumption about economic behavior.
- 1-5 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.

- 1-6      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.

- 1-7      Auditors gather evidence related to the assertions management makes in financial statements and render a report. Accountants 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.
- 1-8      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.
- 1-9      Students can refer to the AAA and CAS 200 (CPA Canada) 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).

- 1-10     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.

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

- 1-11     IAASB stands for International Auditing and Assurance Standards Board. Its ISAs are the basis for Canada's CASs used throughout this text. The IFAC site is at [www.ifac.org](http://www.ifac.org) and click on "standards and guidance."

## SOLUTIONS FOR MULTIPLE CHOICE QUESTIONS

- MC 1-1 LO1**      When people speak of the assurance function, they are referring to the work of auditors in
- lending credibility to a client's financial statements.
  - detecting fraud and embezzlement in a company.
  - lending credibility to an auditee's financial statements.**
  - performing a program results audit in a government agency.

- MC 1-2 LO1** Company A hired Sampson & Delila, CPAs, to audit the financial statements of Company B and deliver the audit report to Megabank. Which is the client?
- Megabank
  - Sampson & Delila
  - Company A**
  - Company B
- MC 1-3 LO1** According to CPA Canada, the objective of an audit of financial statements is
- an expression of opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.**
  - an expression of opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the Financial Accounting Standards Board.
  - an expression of opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the CPA Canada Accounting Standards Committee.
  - to obtain systematic and objective evidence about financial assertions and report the results to interested users.
- MC 1-4 LO4** Bankers who are processing loan applications from companies seeking large loans will probably ask for financial statements audited by an independent CPA because
- financial statements are too complex for them to analyze themselves.
  - they are too far away from company headquarters to perform accounting and auditing themselves.
  - the consequences of making a bad loan are very undesirable.
  - they generally see a potential conflict of interest between company managers who want to get loans and their needs for reliable financial statements.**
- MC 1-5 LO4** Operational audits of a company's efficiency and economy of managing projects and of the results of programs are conducted by whom?
- Financial statement auditors
  - The company's internal auditors**
  - Tax auditors employed by the federal government
  - Fraud auditors
- MC 1-6 LO3** Independent auditors of financial statements perform audits that reduce and control
- the business risks faced by investors.
  - the information risk faced by investors.**
  - the complexity of financial statements.
  - quality reviews performed by other public accounting firms.
- MC 1-7 LO4** The primary objective of compliance auditing is to
- give an opinion on financial statements.
  - develop a basis for a report on internal control.
  - perform a study of effective and efficient use of resources.
  - determine whether auditee personnel are following laws, rules, regulations, and policies.**

## 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 PA 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 effective 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
- risk of litigation needs offsetting lower information risk (for example, litigation due to share price decline or failure to meet a bond covenant).
  - strength of internal controls (e.g., controls over financial instruments, controls over cash).
  - financial health of client (industry factors, economic factors).
  - 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").
  - 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 used to consist of some very specific rules (bright line rules) that the auditor effectively tested compliance with (to determine finance or operational lease accounting). 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 Ontario Auditor General. 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's 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 non-PA 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.

Kind of Auditor	Type of Audit			
	Financial Statement	Compliance	Economy, Efficiency	Program Results
Independent PA	2, 10			
Internal Auditor		6, 8	4, 8	
Governmental (auditors)			3, 9	X,
CRA Auditor	X	5	X	X
Bank Examiner	X	7	X	X

  

1.	1. Sports complex forecast	Financial statement	Independent PAs
2.	Advertising agency financial statements	Financial statement	Independent PAs
3.	Drug enforcement vehicle seizures	Compliance or Economy and Efficiency or Program Results	Governmental (AGC)
4.	Municipal services	Economy and Efficiency	Internal auditors
5.	Tax shelters	Compliance	CRA auditors
6.	Test pilot reporting	Compliance	Internal auditors
7.	Bank solvency	Compliance	Bank examiners
8.	Materials inspection by manufacturer	Compliance or Economy and Efficiency Economy and Efficiency	Internal auditors

#### 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 ( $1/6 \times 1/6 \times 1/6$ ), 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 ( $.80 \times .90 \times .95 \times .90 \times .90$ ). 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 below, 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.

As part of your regular year-end audit of a publicly-held client, you must make an estimate of the probability of success of its proposed new product line. The client has experienced financial difficulty during the last few years and--in your judgment--a successful introduction of the new product line is necessary for the client to remain a going concern.

Any one of the following occurrences will prevent successful introduction of the new product line: (1) unsuccessful labor negotiations between the construction firms contracted to build the necessary addition to the present plant and the building trades unions; (2) unsuccessful defense of patent rights; (3) failure to obtain product approval by the FDA; (4) failure to successfully negotiate a long-term raw materials contract with a foreign supplier; and (5) failure to successfully conclude distribution contract talks with a large national retail distributor.

In view of the circumstances, you contact experts who have provided your audit firm with reliable estimates in the past. The labor relations expert estimates that there is a 20 percent chance that labor negotiations will not be successfully resolved before the strike deadline. Legal counsel advises that there is a 10 percent chance that the patent rights defense will not be successful. The expert on FDA product approvals estimates the probability of failing to obtain approval at five percent. The experts in the two remaining areas estimate the probabilities of failing to resolve (a) the raw materials contract and (b) the distribution contract talks to be 10 percent in each case. Assume these estimates are reliable.

Required:

What is your assessment of the probability that the product introduction will fail? (Hint: You can assume the five steps are independent of each other.)

**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 Information Risk Questions.

Examples of misstatements that create audit risk: the balance sheet does not balance, cash is understated, inventory is overstated, and unrecorded payables. Note that these misstatements relate to what is actually reported. Audit risk is thus relative to the client proposed reported number, not necessarily with what the auditor thinks SHOULD be reported. Presumably the audit risk relative to what the auditor thinks is appropriate to report is low. Thus it may be preferable to think of audit risk as a type of evidence risk, and the decision as to what to report as involving a separate type of risk which we call the accounting risk. This is the distinction reflected in audit opinion modifications such as disclaimer of opinion (insufficient evidence as indicated by high audit risk) versus adverse opinion (auditor has sufficient evidence but auditor disagrees with the reporting based on the evidence). Under this classification the more obvious types of accounting risk are misreporting due to factual misstatements about cash balance or amount of inventory, and any projections based on such facts such as in statistical sampling of a population. More complex examples of misstatements that create accounting risk are based on judgmental misstatements: a company that will fail in the next 3 months records all assets and liabilities assuming that the going concern assumption is true, impaired goodwill is not written down, the allowance for doubtful accounts has not been adjusted for changed economic circumstances, and the fair value assets have not been updated for changes in future cash flows. Note that factual and projected misstatements relate directly to the evidence the auditor collects and why it may be intuitive to think of these as audit misstatements. However, it may be better to think of these as accounting misstatements because they relate to the accuracy of financial reporting. The more complex accounting misstatements relating more directly to future events make it quite clear that the issues become more of an appropriateness of financial reporting that can be analyzed separately. This is discussed in more detail in chapter 19.

EP1-10 The audit society.

An example from the Auditor General of Ontario is given in the text. There was extensive coverage in Globe and Mail, Toronto Star, and local TV news coverage.

EP1-11 The audit society

A recent controversy is the Canadian government's proposed acquisition of a fleet of 65 single engine F35 fighter jets for \$46 billion. See [http://www.thestar.com/news/canada/2012/04/03/auditor\\_general\\_slams\\_canadas\\_plan\\_to\\_buy\\_f35\\_jets.html](http://www.thestar.com/news/canada/2012/04/03/auditor_general_slams_canadas_plan_to_buy_f35_jets.html)

EP1-12 The audit society

The Auditor General of Ontario's report can be found at the following link:

<https://www.thestar.com/news/queenspark/2017/12/06/highlights-from-the-ontario-auditor-generals-2017-annual-report.html>

It is noteworthy that political scientists are questioning the political role of public sector auditors as can be seen at the following link provided by reporter Jeff Buckstein: . <http://www.canadian->

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