

Auditing & Assurance Services: A Systematic Approach, 11e (Messier)

Chapter 1 An Introduction to Assurance and Financial Statement Auditing

1) Auditing focuses on rules, techniques, and computations required to prepare and analyze financial information.

Answer: FALSE

Difficulty: 1 Easy

Topic: The Importance for Studying Auditing

Learning Objective: 01-01 Understand why studying auditing can be valuable to you whether or not you plan to become an auditor, and why it is different from studying accounting.

Bloom's: Remember

AACSB: Communication

AICPA: BB Legal; FN Decision Making

2) Decision makers demand reliable information that is provided by accountants.

Answer: TRUE

Difficulty: 1 Easy

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Understand

AACSB: Communication

AICPA: FN Decision Making; BB Industry

3) Information asymmetry seldom occurs.

Answer: FALSE

Difficulty: 2 Medium

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Apply

AACSB: Communication

AICPA: BB Industry; FN Reporting

4) Conflicts of interest often occur between absentee owners and managers.

Answer: TRUE

Difficulty: 2 Medium

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Apply

AACSB: Communication

AICPA: BB Industry; FN Reporting

5) Auditing services and attestation services are the same.

Answer: FALSE

Difficulty: 1 Easy

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.

Bloom's: Understand

AACSB: Communication

AICPA: BB Industry; FN Reporting

6) Auditing is a type of attest service.

Answer: TRUE

Difficulty: 1 Easy

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.; 01-04 Know the basic definition of a financial statement audit.

Bloom's: Understand

AACSB: Communication

AICPA: BB Industry; FN Reporting

7) Testing all transactions that occurred during the period is cost prohibitive.

Answer: TRUE

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-06 Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.

Bloom's: Apply

AACSB: Communication

AICPA: FN Decision Making; BB Critical Thinking

- 8) Why do auditors generally use a sampling approach to evidence gathering?
- A) Auditors are experts and do not need to look at much to know whether the financial statements are correct or not.
 - B) Auditors must balance the cost of the audit with the need for precision.
 - C) Auditors must limit their exposure to their auditee to maintain independence.
 - D) The auditor's relationship with the auditee is generally adversarial, so the auditor will not have access to all of the financial information of the company.

Answer: B

Difficulty: 1 Easy

Topic: The Audit Process

Learning Objective: 01-06 Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.

Bloom's: Understand

AACSB: Communication

AICPA: FN Decision Making; BB Industry

- 9) Which of the following statements best describes a relationship between sample size and other elements of auditing?
- A) If materiality increases, so will the sample size.
 - B) If the desired level of assurance increases, sample sizes can be smaller.
 - C) If materiality decreases, sample size will need to increase.
 - D) There is no relationship between sample size and materiality or the desired level of assurance.

Answer: C

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-06 Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.

Bloom's: Apply

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Risk Analysis

- 10) Which of the following statements about the study of auditing is NOT true?
- A) The study of auditing can be valuable to future accountants and business decision makers whether or not they plan to become auditors.
 - B) The study of auditing focuses on learning the analytical and logical skills necessary to evaluate the relevance and reliability of information.
 - C) The study of auditing focuses on learning the rules, techniques, and computations required to analyze financial statements.
 - D) The study of auditing begins with the understanding of a coherent logical framework and techniques useful for gathering and analyzing evidence about others' assertions.

Answer: C

Difficulty: 2 Medium

Topic: The Importance for Studying Auditing

Learning Objective: 01-01 Understand why studying auditing can be valuable to you whether or not you plan to become an auditor, and why it is different from studying accounting.

Bloom's: Analyze

AACSB: Communication

AICPA: FN Decision Making; BB Industry

- 11) The basic definition of auditing states it is a process to:
- A) detect fraud.
 - B) examine individual transactions so that the auditor may certify as to their validity.
 - C) objectively obtain and evaluate evidence regarding assertions.
 - D) assure the consistent application of correct accounting procedures.

Answer: C

Difficulty: 1 Easy

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.; 01-04 Know the basic definition of a financial statement audit.

Bloom's: Remember

AACSB: Communication

AICPA: FN Reporting; BB Critical Thinking

12) Assurance services may improve all of the following except:

- A) relevance.
- B) credibility.
- C) periodicity.
- D) reliability.

Answer: C

Difficulty: 1 Easy

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.

Bloom's: Remember

AACSB: Communication

AICPA: BB Industry; FN Reporting

13) Evidence is reliable if it:

- A) signals the true state of a management assertion.
- B) applies to the period being audited.
- C) relates to the audit assertion being tested.
- D) is sufficient to justify a conclusion.

Answer: A

Difficulty: 1 Easy

Topic: Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-05 Understand three fundamental concepts that underlie financial statement auditing.

Bloom's: Understand

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Measurement

14) Which of the following best describes the concept of audit risk?

- A) The risk of the auditor being sued because of association with an auditee.
- B) The risk that the auditor will provide a "clean" opinion on financial statements that are, in fact, materially misstated.
- C) The overall risk that a material misstatement exists in the financial statements.
- D) The risk that auditors use audit procedures that are inappropriate.

Answer: B

Difficulty: 2 Medium

Topic: Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-05 Understand three fundamental concepts that underlie financial statement auditing.

Bloom's: Understand

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Risk Analysis

15) An auditor who accepts an audit engagement and does not possess expertise with respect to the business entity's industry, should:

- A) engage financial experts familiar with the nature of the business entity.
- B) obtain a knowledge of matters that relate to the nature of the entity's business.
- C) refer a substantial portion of the audit to another CPA, who will act as the principal auditor.
- D) first inform management that an unqualified opinion cannot be issued.

Answer: B

Difficulty: 2 Medium

Topic: The Audit Process; Auditing Demands Logic, Reasoning, Resourcefulness

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.; 01-10 Understand why auditing demands logic, reasoning, and resourcefulness.

Bloom's: Apply

AACSB: Ethics

AICPA: FN Decision Making; BB Industry

16) For publicly-held companies, which of the following is integrated into the audit of financial statements?

- A) Budgetary information audit.
- B) The audit of internal controls.
- C) Audit of management forecasts.
- D) Audit of interim financial statements.

Answer: B

Difficulty: 1 Easy

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Remember

AACSB: Communication

AICPA: BB Legal; FN Reporting

- 17) During the first phase of an audit, a CPA most likely would:
- A) identify specific internal control activities that are likely to prevent fraud.
 - B) evaluate the reasonableness of the company's accounting estimates.
 - C) evaluate the integrity of management.
 - D) inquire of the company's attorney as to whether any unrecorded claims are probable or asserted.

Answer: C

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Apply

AACSB: Communication

AICPA: FN Decision Making; BB Resource Management

- 18) In the context of agency theory, information asymmetry refers to the idea that:
- A) information can vary in its reliability.
 - B) information can vary in its relevance.
 - C) management has more information about the entity's true financial position than do the absentee owners (i.e., stockholders).
 - D) management likely will not act in the best interests of the absentee owners.

Answer: C

Difficulty: 1 Easy

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Understand

AACSB: Communication

AICPA: BB Critical Thinking; FN Risk Analysis

- 19) Which of the following best describes why an independent auditor is asked to express an opinion on the fair presentation of financial statements?
- A) It is difficult to prepare financial statements that fairly present a company's financial position and changes in cash flows without the expertise of an independent auditor.
 - B) It is management's responsibility to seek available independent aid in the appraisal of the financial information shown in its financial statements.
 - C) The opinion of an independent party is needed because a company is not likely to be considered objective with respect to its own financial statements.
 - D) It is a customary courtesy that all stockholders of a company receive an independent report on management's stewardship in managing the affairs of the business.

Answer: C

Difficulty: 2 Medium

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Apply

AACSB: Reflective Thinking

AICPA: FN Reporting; BB Critical Thinking

- 20) Which of the following best describes the fundamental, underlying reason for why there is demand for an independent auditor to report on financial statements?
- A) A management fraud may exist and it is more likely to be detected by auditors if they are independent.
 - B) Different interests may exist between the company preparing the statements and the parties using the statements.
 - C) A misstatement of account balances may exist and it is the independent auditor's responsibility to ensure that financial statements are not misstated.
 - D) A poorly designed internal control system may be in place.

Answer: B

Difficulty: 2 Medium

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Analyze

AACSB: Reflective Thinking

AICPA: FN Reporting; BB Critical Thinking

- 21) Which of the following best describes why publicly-traded corporations follow the practice of having the external auditor appointed by the board of directors or elected by the stockholders?
- A) To promote an adversarial relationship between the auditor and the corporation's management.
 - B) To enhance auditor independence from the management of the corporation.
 - C) To encourage a policy of rotation of the independent auditors.
 - D) To give management more leverage over the auditor's decisions.

Answer: B

Difficulty: 2 Medium

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Analyze

AACSB: Ethics

AICPA: BB Legal; FN Risk Analysis

- 22) Auditing is defined as a "systematic process of objectively obtaining and evaluating evidence regarding assertions..." What is meant by "systematic process"?
- A) All audits involve obtaining the same evidence.
 - B) All audits involve evaluating evidence in the same manner.
 - C) There should be a well-planned approach for obtaining and evaluating evidence.
 - D) All assertions are equally important for all audits.

Answer: C

Difficulty: 2 Medium

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.; 01-04 Know the basic definition of a financial statement audit.

Bloom's: Understand

AACSB: Analytical Thinking

AICPA: FN Decision Making; BB Critical Thinking

- 23) Which of the following would best be described as an assurance service?
- A) Preparing a report representing a client's position during an IRS audit.
 - B) Working with a company to develop a more efficient method of processing financial transactions.
 - C) Offering an opinion concerning the accuracy of statements made on an entity's website relating to its online privacy policies.
 - D) Assisting a company in identifying potential sources of capital for potential acquisitions.

Answer: C

Difficulty: 2 Medium

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.

Bloom's: Understand

AACSB: Communication

AICPA: FN Decision Making; BB Industry

- 24) Which of the following statements is not true with respect to assurance, attest, and audit services?
- A) These services are applied only to financial statements and financial statement accounts.
 - B) These services all involve obtaining and evaluating evidence.
 - C) These services all involve determining the correspondence of some information to a set of criteria.
 - D) These services all involve issuing a report.

Answer: A

Difficulty: 2 Medium

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.

Bloom's: Apply

AACSB: Communication

AICPA: FN Decision Making; BB Industry

25) Auditors are most likely to use the most rigorous audit procedures to examine:

- A) routine transactions.
- B) management assertions that are deemed to be of low risk.
- C) only the rights and obligations assertion.
- D) management assertions that are deemed to be of high risk.

Answer: D

Difficulty: 2 Medium

Topic: Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-05 Understand three fundamental concepts that underlie financial statement auditing.

Bloom's: Apply

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Risk Analysis

26) When obtaining an understanding of the entity and its environment, the auditor should obtain an understanding of internal controls primarily to:

- A) identify areas of relatively high risk of misstatement and plan the audit accordingly.
- B) provide suggestions for improvement to the company.
- C) serve as a basis for setting audit risk and materiality.
- D) decide whether to perform an audit for the company.

Answer: A

Difficulty: 2 Medium

Topic: The Audit Process; Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-05 Understand three fundamental concepts that underlie financial statement auditing.; 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Understand

AACSB: Analytical Thinking

AICPA: BB Industry; FN Risk Analysis

- 27) Which one of the following statements best describes the concept of materiality?
- A) Materiality is determined by reference to specific quantitative guidelines established by the AICPA.
 - B) Materiality depends only on the dollar amount of an item relative to other items in the financial statements.
 - C) Materiality depends on the nature of an item but not on the dollar amount of the item.
 - D) Materiality is largely a matter of professional judgment.

Answer: D

Difficulty: 2 Medium

Topic: Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-05 Understand three fundamental concepts that underlie financial statement auditing.

Bloom's: Understand

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Measurement

- 28) Before accepting an engagement to audit a new entity, an auditor is required to:
- A) make inquiries of the predecessor auditor.
 - B) tell the company whether or not the auditor is willing to issue a "clean" opinion.
 - C) prepare a memorandum setting forth the staffing requirements and documenting the preliminary audit plan.
 - D) become a member of the entity's board of directors.

Answer: A

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Remember

AACSB: Communication

AICPA: FN Decision Making; BB Industry

29) An investor is reading the financial statements of the Stankey Corporation and observes that the statements are accompanied by an auditor's unqualified report. From this, the investor may conclude that:

- A) any disputes over significant accounting issues have been settled to the auditor's satisfaction.
- B) the auditor is satisfied that Stankey will be highly profitable in the future.
- C) the auditor is certain that Stankey's financial statements have been prepared accurately and that all account balances are precisely correct.
- D) the auditor has determined that Stankey's management is not qualified to lead the company.

Answer: A

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.; 01-08 Know what an audit report is and understand the nature of an unqualified report.

Bloom's: Understand

AACSB: Communication

AICPA: BB Industry; FN Reporting

30) Preliminary engagement activities include:

- A) evaluating internal controls.
- B) assessing audit risk at the account balance level.
- C) setting materiality.
- D) performing background checks on top management.

Answer: D

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Remember

AACSB: Analytical Thinking

AICPA: FN Decision Making; BB Resource Management

31) The auditor's report is generally addressed to the:

- A) chief operating officer.
- B) securities and exchange commission.
- C) stockholders of the company.
- D) chief financial officer.

Answer: C

Difficulty: 1 Easy

Topic: The Audit Process

Learning Objective: 01-08 Know what an audit report is and understand the nature of an unqualified report.

Bloom's: Remember

AACSB: Communication

AICPA: BB Industry; FN Reporting

32) An auditor would issue an adverse opinion if:

- A) the auditor encounters adverse attitudes toward the auditor on the part of company management.
- B) a qualified opinion cannot be given because the auditor is not qualified to do so.
- C) an immaterial misstatement is present.
- D) the statements taken as a whole do not fairly present the financial condition and results of operations of the company.

Answer: D

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-08 Know what an audit report is and understand the nature of an unqualified report.

Bloom's: Apply

AACSB: Communication

AICPA: BB Industry; FN Reporting

33) Which of the following is true with respect to the auditor's report?

- A) The report indicates that the company's financial statements were audited in accordance with generally accepted accounting standards.
- B) The report indicates that the company's financial statements were audited in accordance with applicable auditing standards.
- C) The report indicates that the company's financial statements were audited in accordance with the auditor's best judgment.
- D) The report indicates that the company's financial statements were audited in accordance with statements issued by the FASB.

Answer: B

Difficulty: 1 Easy

Topic: The Audit Process

Learning Objective: 01-08 Know what an audit report is and understand the nature of an unqualified report.

Bloom's: Remember

AACSB: Communication

AICPA: BB Industry; FN Reporting

34) Which of the following is not a concept that is included in the scope paragraph of the auditor's report?

- A) The conformance of the financial statements with generally accepted accounting principles.
- B) The audit was conducted in accordance with applicable auditing standards.
- C) The audit was planned and performed to obtain reasonable, rather than absolute, assurance.
- D) An audit involves examining items on a test (i.e., sampling) basis.

Answer: A

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-08 Know what an audit report is and understand the nature of an unqualified report.

Bloom's: Remember

AACSB: Communication

AICPA: BB Industry; FN Reporting

- 35) Which of the following is not a benefit of emerging audit technologies?
- A) Automate much of the more tedious work that auditors perform.
 - B) The potential to dramatically enhance the effectiveness and the value of the external audit.
 - C) Leave more time for auditors to better understand the businesses they are auditing the underlying risks related to financial reporting.
 - D) Remove the challenge of junior auditor work and make that work less interesting.

Answer: D

Difficulty: 1 Easy

Topic: Audit Technology

Learning Objective: 01-09 Understand that the way audits are done is changing in exciting ways due to the application of technology, and data analytics in particular.

Bloom's: Remember

AACSB: Communication

AICPA: BB Critical Thinking; FN Decision Making

36) Information Risk is defined as:

- A) the risk that information circulated by a company's management will be false or misleading.
- B) the risk that an assertion contains a misstatement, before considering internal controls.
- C) the risk that auditor is has followed appropriate auditing standards and issued a standard unqualified opinion, and the financial statements contain a material misstatement.
- D) the risk that the internal controls will not prevent or detect a misstatement in the financial statements.

Answer: A

Difficulty: 2 Medium

Topic: Audit Demand

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Remember

AACSB: Communication

AICPA: BB Critical Thinking; FN Decision Making

37) On a high level, the accounting processes of a business consist of internal controls, individual transactions, and account balances.

Required:

A. Describe the relationship between internal controls, individual transactions, and account balances.

B. Discuss how evidence regarding each of these three areas can help an auditor determine if the financial statements are fairly stated.

Answer:

A.

A company implements internal controls as a safeguard to ensure appropriate capturing and recording of individual transactions, which are then collected into ending account balances. Ending account balances are then used to prepare the financial statements. The auditor expresses an opinion on the financial statements, which are made up of ending account balances and disclosures.

B.

The auditor can obtain evidence from all three areas of the accounting process. For instance, an auditor can directly test the account balance (e.g., by examining a bank statement reconciliation). This evidence is usually the highest-quality but costliest evidence. Alternatively, the auditor can obtain indirect information by testing the individual transactions that make up an account balance. If transactions are handled properly, this provides indirect evidence that the ending balances are more likely to be fairly stated. The least direct method of obtaining evidence is to evaluate and test the company's internal controls, which are implemented to ensure that transactions are handled properly. If a company's system of internal control is effective, transactions are more likely to be handled properly, and thus the ending balances making up a set of financial statements are more likely to be fairly stated. Auditors usually collect evidence relating to all three areas: internal control, transactions, and ending balances.

Difficulty: 2 Medium

Topic: The Audit Process; Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-05 Understand three fundamental concepts that underlie financial statement auditing.; 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Apply

AACSB: Communication

AICPA: FN Decision Making; BB Critical Thinking

38) Sally Thompson's company, Sally's Shoes, is a successful shoe retail business with one store. Sally would like to expand to two locations, but the bank has asked for an independent audit before it will provide financing. Sally hires her brother-in-law, George Thompson, to perform the audit. George has experience in auditing non-profit organizations and he decides to perform the audit the same way as his other audits. After completing all the steps of the audit process, George issues an unqualified opinion indicating that he is certain that the company's financial statements contain no misstatements. Comment on any potential problems with George's audit of Sally's Shoes.

Answer:

Independence: Because George is Sally's brother-in-law, he is not considered independent. This presents a problem, both in the perceived value of the audit and in the actual objectivity of the audit. That is, George may be intentionally or unintentionally biased towards Sally's Shoes rather than its creditors. This would also violate professional standards.

Competence: George's competence in this audit is also questionable. While George has experience in auditing, he has no experience or knowledge of retail stores or even for-profit organizations. To successfully perform an audit, George would need to obtain an understanding of the industry. One audit should not be performed exactly the same as another—rather, audits should be tailored to the specific circumstances and risks.

Other: An unqualified audit opinion provides only reasonable assurance, not certainty or "absolute" assurance. It also provides assurance only with respect to the fairness of the financial statements "in all material respects;" it does not provide assurance with respect to all misstatements, only material ones.

Difficulty: 3 Hard

Topic: The Demand for Auditing and Assurance; The Audit Process

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.; 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Analyze

AACSB: Ethics

AICPA: BB Legal; FN Risk Analysis

39) Explain the relationship between audit, attest and assurance services.

Answer: All three services entail the evaluation of evidence to determine the correspondence of some information to a set of criteria and the issuance of a report to indicate the degree of correspondence.

Assurance services are independent professional services that improve the quality of information or its context, for decision makers. Note that assurance services cover both nonfinancial and financial information. Assurance services can capture information, improve its quality, and enhance its usefulness for decision makers. The extended reach of this definition allows professionals to report not only on the reliability and credibility of information but also on the relevance and timeliness of that information.

Attestation is a type of assurance. Attest services occur when a practitioner is engaged to issue or does issue a report on subject matter or an assertion about subject matter that is the responsibility of another party. The practitioner is able to add reliability and credibility to information beyond traditional financial information. Examples of attest services include financial forecasts and reports on internal control.

Auditing is a specialized form of an attest service. Auditing is a systematic process of (1) objectively maintaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and (2) communicating results to interested users. Examples of audit services include compliance auditing and audits of financial statements.

Difficulty: 2 Medium

Topic: Auditing, Attest, and Assurance Services Defined

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.

Bloom's: Understand

AACSB: Analytical Thinking

AICPA: FN Decision Making; BB Industry

40) Define "information asymmetry" and discuss it in the context of the financial markets. Include in your discussion how information asymmetry is reduced.

Answer: In the context of financial markets, information asymmetry is the concept that the company's management generally has more information about the true financial position and results of operations of the entity than the absentee owner does. While management of a public company works as an agent for the stockholders, a conflict of interest is apparent because both sides seek to maximize their self-interest. This leads to a risk that the manager will not always act in the best interest of the owner. Therefore, the owners attempt to protect themselves through monitoring. Audits provide reasonable assurance that the information presented by management is fairly stated. The owners are attempting to reduce information asymmetry by seeking out reliable company information.

Difficulty: 2 Medium

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Apply

AACSB: Communication

AICPA: BB Critical Thinking; FN Risk Analysis

41) The textbook presented the concept of auditing through an analogy that involved buying a house and hiring a house inspector. Name three desirable qualities of a house inspector or an auditor and discuss how those qualities apply to an auditor and why those qualities are important for an auditor to possess.

Answer: A house inspector should be competent, which means he should possess the required training, expertise, and experience to evaluate the property for sale. An auditor should also be competent. An auditor must know the acceptable methods to perform an audit and report an opinion. Furthermore, the auditor should have or obtain knowledge of the specific industry involved in the audit so she can appropriately adjust the timing, nature, and extent of auditing procedures.

A house inspector should be objective. He should have no reason to side with the seller; he is independent of the seller's influence. In the same way, an auditor should be independent of management's influence. Financial statement audits differ from house inspections in that auditing fees are paid for by the seller instead of the buyer. Because of this, an auditor needs to maintain independence in fact and appearance to decrease bias towards the company's management and garner public confidence for the findings.

A house inspector should be honest; he should conduct himself with integrity and share all findings with the buyer. If an auditor discovers a material misstatement, she is required to report the findings to management. If nothing is done to rectify the situation and the auditor feels the financial statements are not fairly presented, she cannot issue an unqualified report.

A house inspector should be skeptical. He will not simply take the seller's assertions at face value. He will conduct his own analysis and testing. An auditor, in comparison, should always exercise professional skepticism. An auditor gathers her own evidence to determine the validity of management's assertions.

A house inspector should be responsible and/or liable. He should stand behind his assessment with a guarantee and/or be subject to litigation if he fails to act with due care. An auditor should always act with due care. When a firm issues a report, the report is signed with the firm's name to signify the firm's responsibility for performing the audit.

Difficulty: 2 Medium

Topic: The Demand for Auditing and Assurance

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Apply

AACSB: Communication

AICPA: FN Decision Making; BB Marketing

42) Discuss an overview of the financial statement audit process using the terms "assertion," "evidence," and "report."

Answer: The auditor gathers evidence about the business transactions that have occurred (economic activity and events) and about management (the preparer of the statements). The auditor uses this evidence to compare the assertions contained in the financial statements to the criteria chosen by the user. The auditor's report communicates to the user the degree of correspondence between the assertions and the criteria.

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Understand

AACSB: Communication

AICPA: BB Industry; FN Reporting

43) You are a new employee at the accounting firm Murray & Murray, CPAs. Before you are assigned to your first audit, your supervisor tests your knowledge and asks you to explain the term "scope" in the context of a financial statement audit.

Required:

A. Provide a definition of scope.

B. Describe what influences an auditor's determination of scope.

Answer:

A.

The scope of an audit is the type and amount of audit work to be performed.

B.

The auditor's assessments of risk and materiality influence the scope of the audit. For instance, if an auditor sets a lower materiality amount or would like to substantially reduce audit risk, the scope of the audit would be increased. In establishing the scope of an audit, the auditor must make decisions about the nature, extent, and timing of evidence to be gathered in order to evaluate management's assertions.

Difficulty: 1 Easy

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Remember

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Measurement

44) Why must an auditor assess materiality?

Answer: An auditor must assess materiality because to find *all* misstatements would not be cost-efficient, or even feasible. To search for all misstatements, the auditor would need to examine every transaction. In addition, relatively minor misstatements may not matter to users. For this reason, when planning and performing an audit the auditor focuses on misstatements that would affect the users' decisions (i.e., material misstatements).

Difficulty: 2 Medium

Topic: The Audit Process; Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-06 Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.; 01-05 Understand three fundamental concepts that underlie financial statement auditing.

Bloom's: Apply

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Risk Analysis

45) You are a new staff auditor and you are auditing a company's inventory account. Briefly describe one way you might obtain direct evidence and one way you might obtain indirect evidence that the inventory account balance is fairly stated.

Answer: To obtain direct evidence, an auditor might physically examine and count the items included in the ending balance of the inventory account. To obtain indirect evidence, an auditor might examine invoices from suppliers relating to purchases of inventory or test whether the internal controls over the inventory process were working properly.

Difficulty: 3 Hard

Topic: Fundamental Concepts in Conducting a Financial Statement Audit

Learning Objective: 01-05 Understand three fundamental concepts that underlie financial statement auditing.

Bloom's: Apply

AACSB: Analytical Thinking

AICPA: FN Decision Making; BB Industry

46) Name and discuss the seven phases of the audit process.

Answer:

1. Client acceptance/continuance: To minimize the likelihood that an auditor will be associated with companies who lack integrity, prospective auditors are required to confer with the predecessor auditor and frequently conduct background checks on top management.
2. Preliminary engagement activities: Preliminary engagement activities include (1) determining the audit engagement team requirements; (2) ensuring the independence of the audit team and audit firm; and (3) establishing an understanding with management regarding the services to be performed and the other terms of the engagement.
3. Plan the audit: The audit team must make a preliminary assessment of materiality and relevant risks. With those determinations, the audit team can assess risk relating to the likelihood of material misstatements in the financial statements. Based on these assessments, the auditor then prepares a written audit plan that sets forth, in reasonable detail, the nature, extent, and timing of the audit work.
4. Consider and audit internal control: The auditor gains an understanding of internal control to determine its effectiveness at achieving reliability of financial reporting.
5. Audit business processes and related accounts: The auditor determines and performs individual audit procedures directed toward specific assertions in the accounts that are likely to be misstated.
6. Complete the audit: The auditor evaluates the sufficiency of the evidence gathered, assesses the possibility of contingent liabilities, and searches for any events subsequent to the balance sheet date that may impact the financial statements.
7. Evaluate results and issue audit report: The auditor reaches a conclusion as to whether or not the financial statements are fairly stated. If the uncorrected misstatements incorporated into the financial statements do not cause the statements to be materially misstated, the auditor issues an unqualified report.

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-07 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.

Bloom's: Remember

AACSB: Communication

AICPA: FN Decision Making; BB Resource Management

47) A standard, unqualified auditor's report for a public company contains three sections. Provide a brief (one or two sentences) description for each section.

Answer: The first section, *Opinion on the Financial Statements*, indicates the name of the company being audited, the financial statements covered by the report, and the auditor's opinion concerning the fairness of financial statements. The second section, *Basis for Opinion*, communicates to the users, in very general terms, what an audit entails and how the audit was conducted (in accordance with the PCAOB auditing standards). The third section, *Critical Audit Matters*, identifies matters arising from the audit that involve especially challenging, subjective, or complex auditor judgment, and how the auditor responded to those matters.

Difficulty: 1 Easy

Topic: The Audit Process

Learning Objective: 01-08 Know what an audit report is and understand the nature of an unqualified report.

Bloom's: Remember

AACSB: Communication

AICPA: BB Industry; FN Reporting

48) Explain the relationship between sample size, materiality, and desired level of assurance.

Answer: The size of a sample is influenced by the materiality and the desired level of assurance for the account or assertion being examined. There is an inverse relationship between sample size and materiality (i.e., if materiality increases then sample size decreases) and a direct relationship between sample size and the desired level of assurance (i.e., if the desired level of assurance increases then sample size increases).

Difficulty: 2 Medium

Topic: The Audit Process

Learning Objective: 01-06 Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.

Bloom's: Understand

AACSB: Analytical Thinking

AICPA: FN Decision Making; BB Industry

49) Other than a financial statement audit, what are two other assurance services? How do these assurance services differ from a financial statement audit?

Answer: Services like Consumer Reports, Carfax, and Angie's List are all examples of Assurance Services. Assurance services are defined as independent profession services that improve the quality of information, or its context for decision makers. Consumer Reports sells to consumers information about products and services based on Consumer Reports' scientific testing. Carfax generates reports on used vehicles' maintenance history and vehicle damage history for used car purchasers. Angie's List provides user reviews of home project service providers. The user reviews are verified by Angie's List. All of these assurance services differ from an Audit in that Auditing Standards require auditors to issue an audit report. The Assurance Services listed provide reports, but there is no government or regulatory body that requires them to do so. Also auditing is defined as a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events (i.e., financial statements) to ascertain the degree of correspondence between those assertions and established criteria (e.g., US GAAP) and communicating the results (i.e., audit report). These items are different than the more general definition of an assurance service.

Difficulty: 2 Medium

Topic: Assurance Services

Learning Objective: 01-03 Understand the relationships among auditing, attestation, and assurance services.

Bloom's: Remember

AACSB: Communication

AICPA: BB Critical Thinking; FN Research

50) The cost of capital can be generally defined as the rate of return expected by anyone who provides capital to a company (e.g., an investor or a bank). How can a financial statement audit reduce the cost of capital for a company?

Answer: An audit adds credibility to a company's financial statements. The audit reduces information risk, or the risk that information circulated by a company's management will be false or misleading. With reduced risk of poor information, anyone providing capital will have better information on which to base their capital decisions. This will lead to a lower cost to the company for obtaining capital.

Difficulty: 2 Medium

Topic: Audit Demand

Learning Objective: 01-02 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.

Bloom's: Analyze

AACSB: Analytical Thinking

AICPA: BB Critical Thinking; FN Risk Analysis