CHAPTER 1 SOLUTIONS MANUAL
AN INTRODUCTION TO ASSURANCE AND FINANCIAL STATEMENT AUDITING

Answers to Review Questions

1-1 The study of auditing is more conceptual in nature compared to other accounting courses. Rather than focusing on learning the rules, techniques, and computations required to prepare financial statements, auditing emphasizes learning a framework of analytical and logical skills to evaluate the relevance and reliability of the systems and processes responsible for financial information, as well as the information itself. To be successful, students must learn the framework and then learn to use logic and common sense in applying auditing concepts to various circumstances and situations.

Understanding auditing can improve the decision-making ability of consultants, business managers, and accountants by providing a framework for evaluating the usefulness and reliability of information—an important task in many different contexts.

1-2 There is a demand for auditing in a free-market economy because in the agency relationship there is a natural conflict of interest between an absentee owner and a manager and due to the information asymmetry that exists between the owner and manager. As a result, the agent agrees to be monitored as part of his/her employment contract. Auditing appears to be a cost-effective form of monitoring.

The empirical evidence suggests auditing was demanded prior to government regulation such as statutory audit requirements. Additionally, many private companies and other entities not subject to government auditing regulations also purchase various forms of auditing and assurance services.

1-3 There is a natural *conflict of interest* in the agency relationship between an owner and manager because of differences in the two parties' goals. For example, the manager may spend funds on excessive personal benefits or favour entity growth at the expense of stockholders values. If both parties seek to maximize their own self-interest, it is likely that the manager will not act in the best interest of the owner and may manipulate the information provided to the owner accordingly.

1-4 Independence is a bedrock principle for auditors. If an auditor is not independent of the client, users may lose confidence in the auditor's ability to report objectively and truthfully on the financial statements, and the auditor's work loses its value. From an agency perspective, if the principal (owner) knows that the auditor is not independent, the owner will not trust the auditor's work. Thus, the agent will not hire the auditor because the auditor's report will not be effective in reducing information risk from the perspective of the owner.

1-5 **Auditing** (broadly defined) is a systematic process of (1) objectively obtaining 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 the results to interested users.

An assurance engagement is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

1-6 The phrase *systematic process* implies that there should be a well-planned, logical approach for conducting an audit that involves *objectively obtaining and evaluating evidence*.

1-7 **Audit risk** is defined as the risk that 'the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated' (ISA 200).
Materiality: 'Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.'(ISA 320).

The audit report states that the auditor obtains '*reasonable assurance*' whether the financial statements are free from '*material*' misstatement. The term 'reasonable assurance' informs the reader that there is some level of risk that the audit did not detect all material misstatements. In addition, the auditor's opinion commonly uses the wording that the financial statements present fairly, '*in all material respects*.' These phrases communicate to third parties that the audit opinion is limited to material information.

1-8 On most audits, it is not feasible or cost-effective to audit all transactions. For example, in a small business, the auditor might be able to examine all transactions that occurred during the period. However, it is unlikely that the owner of the business could afford to pay for such an extensive audit. For a large organization, the sheer volume of transactions prevents the auditor from examining every transaction. Thus, there is a trade-off between the exactness or precision of the audit and its cost.

1-9 The major phases of the audit are:

- Client acceptance/continuance
- Preliminary engagement activities
- Plan the audit
- Consider internal control
- Audit business processes and related accounts
- Complete the audit
- Evaluate results and issue audit report

1-10 Based on the auditor's understanding of the entity and its environment (including knowledge about the nature of the entity and its industry, the entity's performance measurement, and the quality of the entity's internal control), the **planning phase** of an audit involves making preliminary assessment of the client's business risks and determine materiality to then assess the risks of material misstatements in the financial statements. The outcome of the auditor's planning process is a written plan that sets forth the overall audit strategy and the nature, extent and timing of the audit work.

1-11 The elements of the audit report with an unmodified opinion are: (1) the title; (2) the addressee; (3) the introductory paragraph; (4) the management's responsibility paragraph; (5) the auditor's responsibility paragraph; (6) the auditor's opinion paragraph; (7) the auditor's signature; (8) the date of the auditor's report; and (9) the auditor's address, as illustrated in this chapter.

1-12 Auditors frequently face situations where no standard audit procedure exists, such as the example from the text of verifying the inventory of reindeer. Such circumstances require that the auditor possess creativity and innovation when planning and administering audit procedures where little or no precedent exists. Every client is different, and applying auditing concepts in different situations requires logic and common sense, and frequently creativity and innovation.

Solutions to Problems

1-13 The memo should cite the following facts:

- There is a historical relationship between accounting and auditing.
- The parties to the agency relationship (contract) do not possess the same amount of information (information asymmetry) and have a natural conflict of interest. For example, when an owner and manager are negotiating an employment contract, the owner may assume that the manager likely will use organizational funds for personal uses. Auditing plays an important role in such relationships. The owner and manager will consummate an employment contract only if the manager agrees to be monitored. Auditing can be used to monitor the contract agreed to by the two parties. (P.S. As a lawyer, Lee should be well versed on contract law.)
- Auditing is also used to monitor other types of contracts for which no laws or regulations require an audit, for example, contracts between management and debt holders.
- There is historical evidence of forms of auditing in the early Greek states and in Europe during the industrial revolution.
- Additional evidence for the demand for auditing is also provided by the fact that many private companies and other entities not subject to a statutory audit requirement contract for audits.

1-14 There are two major factors that may make an audit necessary for Greenbloom Garden Centres. First, the company may require long-term financing for its expansion into other cities. Entities such as banks or insurance companies are likely to be the sources of the company's debt financing. These entities may require audited financial statements before lending significant funds and require audited financial statements during the time period the debt is outstanding. There is information asymmetry between the lender of funds and the owner of the business, and this asymmetry results in information risk to the lender. Even if the business could get funding without an audit, an audit report with an unmodified opinion by a reputable auditor might very well reduce the lender's information risk and make the terms of the loan more favourable to the owner. Second, as the company grows, the family will lose control over the day-to-day operations of the stores. An audit can provide an additional monitoring activity for the family in controlling the expanded operations of the company.

1-15

a Evidence that assists the auditor in evaluating financial statement assertions consists of the underlying accounting data and any additional information available to the auditor, whether originating from the client or externally.

b Management makes assertions about elements of the financial statements. For example, an entity's financial statements may contain a line item that accounts receivable amount to €1,750,000. In this instance, management is asserting, among other things, that the receivables exist, the entity owns the receivables, and the receivables are properly valued. Audit evidence helps the auditor determine whether management's assertions are being met. If the auditor is comfortable that he or she can provide reasonable assurance that all assertions are met for all accounts, he or she can issue an audit report with an unmodified opinion. In short, the assertions are a conceptual tool to help the auditor ensure that she or he all relevant aspects.

c In searching for and evaluating evidence, the auditor should be concerned with the relevance and reliability of evidence. If the auditor mistakenly relies on evidence that does not relate to the assertion being tested, an incorrect conclusion may be reached about the management assertion. Reliability refers to the ability of evidence to signal the true state of the assertion, i.e. whether it is actually being met or not.

1-16

a The major phases of the audit and their descriptions are:

1. <u>Client acceptance/continuance</u>. The auditor decides to accept a new client or to retain an existing client.
2. <u>Preliminary engagement activities</u>. This phase involves (1) determining the audit engagement team requirements, (2) ensuring the independence of the audit team and audit firm, and (3) establishing an understanding with the client regarding the services to be performed and the other terms of the engagement.
3. <u>Plan the audit</u>. During this phase of the audit, the auditor uses the knowledge of the entity to plan the audit (i.e. to set forth the overall audit strategy and the nature, extent and timing of the audit work). The purpose of this phase is to plan an effective and efficient audit.
4. <u>Consider internal control</u>. The auditor understands and evaluates the entity's internal controls in order to assess the risk that they will be prevented, or detect and correct a material misstatement.

5. Audit business processes and related accounts. The auditor conducts substantive tests, including analytical procedures and the details of the account balances, searching for material misstatements.
6. Complete the audit. The auditor searches for contingencies and subsequent events, and performs a final review of the evidence gathered.
7. Evaluate results and issue the audit report. Based on the collection and evaluation of evidence, the auditor issues a report on whether the financial statements are fairly presented.

b While audit procedures may be designed to test a specific assertion, they often simultaneously provide evidence on another account or assertion. An example would be when an auditor obtains evidence about an entity's transactions affecting the inventory account and whether shipments of inventory to customers were included in the proper period. Such evidence may also be relevant to the entity's assertions regarding whether accounts receivable balances were correct at the end of the period.

c Auditors develop an understanding of an entity's internal control in order to establish the scope of the audit. However, during the course of this work, the auditor may become aware of deficiencies in internal control. The auditor is required to communicate significant deficiencies to those charged with governance (e.g. the board of directors) and management. The auditor may also make suggestions on how to correct the deficiencies. The auditor's work on internal control may also have a preventive effect on the entity's employees. If the employees know that their work will be examined, they are less likely to commit errors or fraud.

1-17 Auditor's Responsibility paragraph: 'Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free from material misstatement.' The use of the term 'reasonable assurance' indicates that there is no guarantee that the financial statements are correct, only 'reasonable assurance.' Also the statement that the financials are 'free of material misstatement' indicates that the financials may have some error that is not material.

'An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made …' The explanation that management uses estimates indicates that some of the figures in the financial statements are not exact.

'We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.' This statement indicates that the audit is not 'proof' that the financial statements are exact, only that there is reasonable evidence about their accuracy.

Auditor's opinion paragraph: '…the consolidated financial statements present fairly, in all material respects, …' This sentence indicates that the financial statements are a 'fair', not exact, representation. Also, the idea of materiality is revisited here, indicating that there may still be immaterial errors in the financial statements.

Solution to Discussion Case

1-18 Independent audits are a critical component of corporate governance and can enhance the effectiveness of the examination and supervision process. Such audits can improve the reliability of financial reports and help identify internal control deficiencies. Thus, such audits can benefit bank examiners in enhancing the safety and soundness of financial institutions.

Solutions to Internet Assignments

1-19 A search of the home page of many companies will include links to their latest financial information. Examining the auditor's report and financial statements will allow the student to have a better idea as to how the chapter's information is applied in real companies.

1-20 There are numerous Internet sites that contain accounting and auditing information. Following are some suggested pages:

- The International Federation of Accountants (www.ifac.org/) home page provides among other things detailed information on the organization, its boards and committees, and its pronouncements, including IAASB's International Standards on Auditing (ISAs) and the Code of Ethics for Professional Accountants (IESBA). The IFAC home page also includes links to its member organizations.
- The International Accounting Standards Board (IASB) home page (www.ifrs.org/Pages/default.aspx) contains information on the organization, its standards, and its publications.
- The International Organization of Securities Commissions (IOSCO) home page (www.iosco.org/) contains information about IOSCO, its publications, and links to its member bodies and other relevant organizations.
- The International Organization of Supreme Audit Institutions (INTOSAI) home page (www.intosai.org/) contains information about INTOSAI, its committees, standards, and links to its member bodies.
- The Institute of Internal Auditors home page (www.theiia.org/) contains detailed information on internal auditing.
- The Association of Certified Fraud Examiners home page (www.acfe.com/) contains extensive information on the Association's certification as Certified Fraud Examiners (CFE).
- The European Commission, Internal Market, Auditing home page (ec.europa.eu/internal_market/auditing/index_en.htm) contains information on auditing in the European Union.
- Fédération des Experts Comptables Européens (FEE) home page (www.fee.be/) contains information about FEE, its publication, and numerous European and international links.

- The European Accounting Association (EAA) home page (www.eaa-online.org/) contains information on accounting scholars and research activities in Europe.
- The American Institute of Certified Public Accountant (AICPA) home page (www.aicpa.org/) contains extensive information on the organization's activities.
- The American Accounting Association home page (aaahq.org/) contains information on accounting scholar and research activities in the USA and numerous links, including to professional organizations, accounting journals, and education sites.
- The U.S. Securities and Exchange Commission's (SEC) Edgar Web site (www.sec.gov/) contains all filings by public companies with the SEC. It also contains information on other activities by the SEC.
- The Public Company Accounting Oversight Board's (PCAOB) home page (www.pcaobus.org/) offers detailed information about the PCAOB and its standards.
- The major public accounting firms and many smaller firms also maintain Web sites.