

CHAPTER 1

AN INTRODUCTION TO ASSURANCE AND FINANCIAL STATEMENT AUDITING

Answers to Review Questions

- 1-1** The study of auditing is more conceptual in nature as 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. This framework enables auditors 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 business contexts.
- 1-2** There is a demand for auditing in a free-market economy because the agency relationship between an absentee owner and a manager produces a natural conflict of interest due to the information asymmetry that exists between these two parties. 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 that auditing was demanded prior to government regulation. In 1926, before it was required by law, independent auditors audited 82 percent of the companies on the New York Stock Exchange. Additionally, many private companies and municipalities not subject to government regulations, such as the Securities Act of 1933 and Securities Exchange Act of 1934, also purchase various forms of auditing and assurance services. Many private companies seek out financial statement audits in order to secure financing for their operations. Companies preparing to go public also benefit from having an audit.
- 1-3** The agency relationship between an owner and manager produces a natural *conflict of interest* because of differences in the two parties' goals and because of the *information asymmetry* that exists between them. That is, the manager likely has different goals than the owner, and generally has more information about the "true" financial position and results of operations of the entity than the absentee owner does. If both parties seek to maximize their own self-interest, the manager may 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. Auditor independence is also a regulatory requirement.

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.

Attest services occur when a practitioner issues a report on subject matter, or an assertion about subject matter, that is the responsibility of another party.

Assurance services are independent professional services that improve the quality of information, or its context, for decision makers.

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*. It requires organizing a plan for gathering evidence and documenting steps taken during the audit to evaluate the relevance and validity of the evidence.

1-7 Audit risk is defined as the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated (AS 1101). **Materiality** is defined as "the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement" (FASB Statement of Financial Accounting Concepts No. 8, Chapter 3: Qualitative Characteristics of Useful Accounting Information, which is pending revision at the time of the writing of this book per the Board's November 2017 decision to revert to a definition of materiality similar to the one found in superseded Concept No. 2).

The concept of materiality is reflected in the wording of the auditor's standard audit report through the phrase "the financial statements present fairly *in all material respects*." This is the manner in which the auditor communicates the notion of materiality to the users of the auditor's report. The auditor's standard report states that the audit provides only *reasonable assurance* that the financial statements do not contain material misstatements. The term "reasonable assurance" implies that there is some risk that a material misstatement could be present in the financial statements and the auditor will fail to detect it.

1-8 The major phases of the audit are:

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

1-9 Plan the audit: During this phase of the audit, the auditor uses knowledge about the client and any controls in place to plan the audit and perform preliminary analytical procedures. The outcome of the planning process is a written audit plan that sets forth the nature, extent, and timing of the audit procedures to be performed. The purpose of this phase is to plan an effective and efficient audit.

- 1-10** The auditor's standard unqualified report for a public company client includes the following sections: (1) opinion on the financial statements, (2) basis for opinion, and (3) critical audit matters, as illustrated in this chapter.
- 1-11** The emergence of advanced audit technologies will help remove many of the tedious tasks that are usually performed by junior auditors. Thus, auditors of all positions and experience will be required to spend additional time reasoning through fundamental business, accounting, and auditing concepts. An auditors' knowledge in these areas will enable them to provide greater benefit to clients by asking the right questions and identifying new, more effective ways to collect, analyze, and interpret results. In using audit data analytics, for example, auditors must understand the client and its industry, as well as the fundamentals of accounting and auditing, in order to ask the right questions in querying the data and in interpreting the results obtained.
- 1-12** Auditors frequently face situations where no standard audit procedure exists, such as the example from the text of verifying the inventory of cattle. Such circumstances require that the auditor exercise creativity and innovation when planning and administering audit procedures where little or no guidance or precedent exists. Every client is different, and applying auditing concepts in different situations requires logic and common sense, and frequently creativity and innovation.

Answers to Multiple-Choice Questions

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|-------------|---|-------------|---|
| 1-13 | b | 1-19 | a |
| 1-14 | b | 1-20 | d |
| 1-15 | c | 1-21 | d |
| 1-16 | c | 1-22 | d |
| 1-17 | c | 1-23 | b |
| 1-18 | c | | |

Solutions to Problems

- 1-24** There are two major factors that may make an audit necessary for Greenbloom Garden Centers. First, the company may require long-term financing for its expansion into other cities in Florida. Entities such as banks or insurance companies are likely to be the sources of the company's debt financing. These entities normally require audited financial statements before lending significant funds and generally 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, a clean audit report by a reputable auditor might very well reduce the lender's information risk and make the terms of the loan more favorable 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.

- 1-25**
- 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 components 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 a clean audit report. In short, the assertions are a conceptual tool to help the auditor ensure that she or he has "covered all the bases."
 - 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.
- 1-26**
- a. The major phases of the audit and their descriptions are:
 - 1. **Client acceptance/continuance.** The auditor decides to accept a new client or to retain an existing client.
 - 2. **Preliminary engagement activities.** 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. **Plan the audit.** During this phase of the audit, the auditor uses the knowledge of the client to plan the audit and perform preliminary analytical procedures. The purpose of this phase is to plan an effective and efficient audit.
 - 4. **Consider and audit internal control.** The auditor understands and evaluates the client's internal controls in order to assess the risk that they will not prevent or detect a material misstatement. In the case of a public company, the auditor will conduct an audit of internal control over financial reporting.
 - 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 contingent liabilities 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. As the book explains, if the auditor designs procedures to test whether the entity's internal control over financial transactions is effective, the auditor can obtain additional indirect information regarding whether the account balances are fairly stated: if controls are effective, then the transactions will probably be captured and summarized properly, which means in turn that the account balances are likely to be free of material

misstatement. While it is indirect, evidence about internal control is often a relatively cost-effective form of audit evidence about the fairness of account balances.

- 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 weaknesses in the entity's accounting systems. The auditor is required to communicate this information to management. The auditor may also make suggestions on how to correct the weaknesses. The auditor's work on internal control may also have a preventive effect on the behavior of the entity's employees. If the employees know that their work will be audited, they are less likely to commit errors or fraud. Because of the Sarbanes-Oxley Act, internal control is a topic that is front-and-center in the accounting profession.

1-27 A search of the homepage of most public companies will include links to their latest financial information or 10-K filings. The SEC's homepage will also include this information along with any other recent filings. Examining the independent 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.

1-28 **Opinion paragraph:** "...the 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 the audit does not provide assurance that there are no *immaterial* errors in the financial statements.

Basis for Opinion paragraph: "[These] standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of 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 audit does not provide assurance that the financials are free of error that is not material.

"Such procedures include examining, on a test basis, evidence..." The explanation that the auditor uses a test basis indicates that some of the figures were not fully examined, but rather only a sample of information was taken to gather evidence.

"We believe that our audits provide a reasonable basis for our opinion." This statement indicates that the audit is not "proof" that the financial statements are exact, only that there is reasonable evidence about their fairness in accordance with GAAP.

Critical Audit Matter paragraph: "...involved especially challenging, subjective, or complex audit judgments." This sentence prefaces the entire purpose of the paragraph which is to ensure the public is aware that some financial statement amounts and disclosures require extensive judgment by management and auditors, suggesting that the financial statements inherently are not precisely accurate.

Solution to Discussion Case

1-29 The memo should cite the following facts:

- There is a historical relationship between accounting and auditing.
- When parties to the agency relationship (contract) do not possess the same amount of information (information asymmetry) there is a natural conflict of interest between the parties. 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. (As an attorney, Dashawn should be well versed in 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 the United Kingdom during the industrial revolution. More relevant evidence is the fact that 82 percent of the NYSE companies were audited prior to the securities acts.
- Additional evidence for the demand for auditing is also provided by the fact that many private companies and municipalities not subject to the securities acts contract for audits.

Solution to Internet Assignment

1-30 There are numerous Internet sites that contain accounting information. Following are some suggested sites:

- The AICPA's home page (www.aicpa.org) contains extensive information on the organization's activities. For example, it contains the entire report of the Special Committee on Assurance Services.
- The American Accounting Association's home page (www.aaahq.org) has numerous links, including professional organizations, accounting journals, and education sites.
- The Association of Certified Fraud Examiners' home page (www.acfe.com) has extensive information on the Association's certification (CFE) program.
- The Institute of Internal Auditors' home page (www.theiia.org) contains detailed information on internal auditing.
- The International Federation of Accountants' website (www.ifac.org) provides detailed information on international accounting and auditing standards.
- The Government Accountability Office's website (formerly the General Accounting Office, (www.gao.gov) provides detailed information on the GAO's activities and allows users to obtain copies of GAO reports.
- The SEC's Edgar website (www.sec.gov) contains all filings by public companies with the SEC. It also contains information on other activities by the SEC.
- The PCAOB's website (www.pcaobus.org) offers detailed information about the PCAOB and the standards it has proposed and established.
- The major public accounting firms and many smaller firms also maintain websites.