

Chapter 01 - Introduction to Auditing

Chapter 01
Introduction to Auditing

True / False Questions

1. The role of the auditor is to satisfy users' demand for reliable information.

TRUE

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.1

Page Reference: 3

2. The concept of three-party accountability means that the auditor is expected to act in the interests of the party paying the audit fee.

FALSE

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.2

Page Reference: 4

3. The three underlying conditions affecting users' demand for accounting information are complexity, reliability, and completeness.

FALSE

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.2

Page Reference: 5

4. The assurance function involves the lending of credibility to financial information.

TRUE

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.2

Page Reference: 6

5. Business risk is the risk that the financial statements do not reflect the economic substance of business activities.

FALSE

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.3

Page Reference: 11

6. A material misstatement is one that would affect a user's decision making.

TRUE

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.3

Page Reference: 11

7. The failure of Enron and WorldCom in the U.S. raised questions about the audit profession and as a result auditing is likely to become less important in society.

FALSE

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.4

Page Reference: 13

8. One of the main impacts on auditors of the Sarbanes-Oxley Act is to decrease the responsibilities of the audit committee in an organization.

TRUE

Blooms Taxonomy: Knowledge recall

Difficulty: 2

Learning Objective: 1.4

Page Reference: 13

9. Internal auditing is an independent activity designed to add value and improve an organization's operations.

TRUE

Blooms Taxonomy: Knowledge recall

Difficulty: 2

Learning Objective: 1.5

Page Reference: 14

10. Value-for-money audits include testing of compliance with laws and regulations.

FALSE

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.5

Page Reference: 16

11. A prospectus is the information, including financial information, about a firm that accompanies any new issuance of shares in a regulated securities market.

TRUE

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.6

Page Reference: 22

12. The CICA's policy is to adopt ISAs as is, unless there is already a Canadian standard dealing with the same topic.

FALSE

Blooms Taxonomy: Comprehension

Difficulty: 1

Learning Objective: 1.7

Page Reference: 16

Multiple Choice Questions

13. Which of the following best describes the main reason that independent auditors report on a company's financial statements?

A. Management fraud may exist within the company and it is likely that the independent auditors will detect it.

B. Users of financial need confidence in the numbers they base their decisions on.

C. Misstated account balances may be corrected as the result of the independent audit work.

D. The accounting system from which the financial statements are derived may have a poorly designed system of internal control.

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.1

Page Reference: 3

14. Reducing information risk means the same as:

A. Serving the public interest.

B. Monitoring economic activities.

C. Improving the credibility of information.

D. Ensuring generally accepted accounting principles are used to measure profit.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.1

Page Reference: 5

15. The underlying conditions that create demand by users for reliable financial information include the fact that

- A. More reliable information will allow investors to calculate the rate of return on their investment.
- B. Users are separated from accounting records by distance and time.**
- C. Governments rely on such information to create tax policies.
- D. There is a need for the expression of an opinion as to the fairness of financial statements.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.2

Page Reference: 5

16. The auditee is the person or company:

- A. who will use the audited information.
- B. who performs an audit.
- C. who pays the audit fee.
- D. whose information is being audited.**

Blooms Taxonomy: Comprehension

Difficulty: 1

Learning Objective: 1.2

Page Reference: 6

17. Professional judgment is a widely used concept in accounting and auditing. How is it defined in the audit standards?

- A. There is no definition of professional judgment in the auditing standards.**
- B. Professional judgment includes consideration of key principles and concepts of disciplines underlying the professional standards, such as economics, psychology, law, finance, statistics and philosophy.
- C. Professional judgement means reaching a complex decision by incorporating auditing standards, accounting standards, and rules of professional ethics in a coherent manner.
- D. Professional judgement involves specialized concepts and language integrating several disciplines in order to provide appropriate justification for audit decisions.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.2

Page Reference: 6

18. The primary role and responsibility of independent external auditors is to
- A. Prepare a company's annual financial statements and notes.
 - B.** Perform an audit and provide an opinion on the financial statements of a company.
 - C. Provide business consulting advice to audit clients.
 - D. Obtain an understanding of a client's internal control system and prepare a report for management about control weaknesses.

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.2

Page Reference: 8

19. The risk that financial statements may be materially false and misleading is called
- A. Business risk.
 - B.** Information risk.
 - C. Client risk.
 - D. Risk assessment.

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.3

Page Reference: 9

20. Self regulation as applied to the auditing profession means:
- A. The profession advises the government on the laws which should be applied to the profession.
 - B. The profession is solely responsible for disciplining any member found to be engaged in wrong doing.
 - C.** The profession establishes the rules that govern audit practice and monitors compliance with these rules.
 - D. The profession exists to protect the best interests of its members and not the best interests of the public.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.4

Page Reference: 13

21. SOX's has had consequences for many areas of corporate activities, including the following impact on the work of the auditor:

- A. The auditor is now required to report all fraudulent activities it uncovers directly to the Securities and Exchange Commission.
- B.** The auditor is specifically required to evaluate the internal controls used by management to prepare financial information.
- C. The auditor is must monitor how well management is carrying out its financial reporting responsibilities.
- D. The auditor must prepare a report verifying the information in the financial statements.

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.4

Page Reference: 13

22. In operational auditing, the auditor studies business operations and makes recommendations about all of the following except

- A. Economic and efficient use of resources.
- B. Effective achievement of business objectives.
- C.** The fairness of the financial statements.
- D. Compliance with company policies.

Blooms Taxonomy: Knowledge recall

Difficulty: 2

Learning Objective: 1.5

Page Reference: 14

23. Auditors on staff in the Office of the Auditor General (OAG) are considered to be external auditors with respect to the government agencies they audit because the OAG is

- A.** Organizationally independent.
- B. The accounting and auditing agency of the Canadian Senate.
- C. Funded by the federal government.
- D. Guided by standards similar to GAAS.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.5

Page Reference: 15

24. In addition to the audit of financial statements, governmental auditing may also include audits of efficiency, effectiveness and

- A. Fraud.
- B. Accuracy.
- C. Economy.
- D. Adequacy.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.5

Page Reference: 16

25. An example of a forensic accounting assignment might be:

- A. To ensure compliance with specific legislation.
- B. To provide an opinion about the effectiveness of a government program.
- C. To provide assurance about the fairness of prospective financial information included in an initial public offering document.
- D. To estimate the value of inventory lost in a warehouse fire.

Blooms Taxonomy: Application

Difficulty: 2

Learning Objective: 1.5

Page Reference: 17

26. On which of the following reasons do many people blame for the profession's problems in the post-Enron world?

- A. Inadequate training of professional accountants.
- B. The lack of focus on fraud investigation by external auditors.
- C. A lack of independence between audit services and non-audit services provided to the same client.
- D. New stock trading technology causing major swings in the capital markets.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.6

Page Reference: 19

27. Why is it important to Canadian auditors to understand the rules of the Security and Exchange Commission?

- A. Many Canadian companies are finding it cheaper to raise money on U.S. stock exchanges.
- B. Canadian investors think these rules apply to Canadian companies.
- C. The Free Trade Act requires Canadian companies to follow U.S. rules.
- D. There is no similar body in Canada regulating the stock markets.

Blooms Taxonomy: Knowledge recall

Difficulty: 2

Learning Objective: 1.6

Page Reference: 23

28. What is one of the factors mentioned that is driving the international harmonization of auditing standards?

- A. Increased ownership of Canadian companies by companies outside North America.
- B. Increased overseas investment by Canadians.
- C. Improved living standards throughout the world.
- D. Technological change permitting world wide trading in financial securities.

Blooms Taxonomy: Knowledge recall

Difficulty: 2

Learning Objective: 1.7

Page Reference: 24

Question Type: EMPTY

Essay Questions

29. Why is three-party accountability an important distinguishing feature of auditing?

In three-party accountability, accountability is represented as a three point relationship among the auditor of the financial information, the management preparing the financial information, and the users of the financial information. This triangle reflects an accountability relationship because management is accountable to the users. However, the users cannot rely on the financial statements as they do not completely trust management. They demand that the financial statements be verified by a competent, independent auditor. Thus, the auditor is also accountable to the user.

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.1

Page Reference: 4

30. Discuss the underlying conditions affecting users' demand for accounting information.

There are three key conditions: complexity of information, distance between users from management, and the consequences of bad decisions. First, a company's transactions are increasingly numerous and complicated. Users of financial information are not trained to collect and compile it themselves. They need the services of professional accountants. Second, users of financial information are increasingly separated from a company's accounting records by distance and time as a result of global financial markets. Users need full-time professional accountants to do the work they cannot do for themselves. Finally, financial decisions are important to the state of investors' and other users' wealth, including investors in companies that provide loans or trade credit to another company. Decisions can involve large dollar amount, the loss of which may cause a cascade of bankruptcies. Good information, obtained through the financial reports prepared by accountants, is an absolute necessity to reduce the risk of loss.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.2

Page Reference: 5

31. What is the difference between the American Accounting Association's (AAA) definition of auditing and the Canadian Institute of Chartered Accountants (CICA) objectives of financial statement auditing?

The AAA definition is broad and general - it encompasses external, internal, and governmental auditing. The CICA has not defined auditing per se but has outlined a set of objectives specific to the external audit of financial statements. The CICA objectives do not focus on broad assertions about economic events but state that the main objective of an audit is the expression of an opinion on the financial statements. The objectives further assert that the audit of financial statements must be performed in accordance with GAAS (generally accepted auditing standards). The AAA definition does not refer to auditor qualifications and does not specifically address either how an audit is performed or how the results are communicated. The first of the eight auditing standards defined by the CICA, the general standard, outlines the qualifications the auditor must have; the next three, the examination standards, outline how the auditor must perform the audit; and the last four, the reporting standards, outline how the auditor should communicate the results.

Blooms Taxonomy: Comprehension

Difficulty: 2

Learning Objective: 1.3

Page Reference: 7

32. What is information risk?

The risk that a set of financial statements will be materially false or misleading.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.3

Page Reference: 11

33. Describe the Sarbanes-Oxley Act.

The Sarbanes-Oxley Act was drafted after the fall of Enron in 2001 and was enacted into law on July 30, 2002. The act created a five member Public Company Accounting Oversight Board (PCAOB) with the authority to tighten quality control of the audit practices and report on the results of inspections of audit firm practices. The legislation is to be implemented by the board in conjunction with the SEC in the US.

Blooms Taxonomy: Knowledge recall
Difficulty: 1
Learning Objective: 1.4
Page Reference: 12

34. What are three key features of the Sarbanes-Oxley Act?

Three key features are (any three):

1. Increased oversight of auditors, including audit standard setting by PCAOB
2. Increased penalties for corporate wrong-doers
3. More timely and extensive financial disclosures.
4. More timely and extensive disclosure on the way the firm is governed
5. New options of recourse for aggrieved shareholders.

Blooms Taxonomy: Knowledge recall
Difficulty: 1
Learning Objective: 1.4
Page Reference: 12

35. What is the Canadian Public Accountability Board?

The CICA created the Canadian Public Accountability Board to act as an overseer of the audit firms who are involved in the audit of public companies. This board was organized to be a self-regulating part of the CICA. The government in Canada has not gotten as involved as the government in the US.

Blooms Taxonomy: Knowledge recall
Difficulty: 1
Learning Objective: 1.4
Page Reference: 12

36. What is operational auditing and who performs it?

Operational auditing is the study of an entity, or a specific unit within an entity, in order to evaluate its performance. The operational auditor reports on whether the entity uses its resources economically and efficiently and whether it achieves its business objectives effectively. Internal auditors normally perform operational audits. However, independent accounting firms as part of their management advisory services also may conduct operational audits.

Blooms Taxonomy: Knowledge recall

Difficulty: 1

Learning Objective: 1.5

Page Reference: 14

37. Discuss the nature of value-for-money audits and give three examples of its application.

Value-for-money audits involve studies of the management of government organizations, programs, activities, and functions. Its goal is to improve the government's accountability to taxpayers for the effective use of tax dollars. Examples of findings include:

1. Health care: Stronger efforts needed to control undesirable practices by unregulated health care providers
2. Education: Need to improve availability of programs for exceptional children.
3. Young offenders: Suggested improved documentation before releasing young offenders.

Blooms Taxonomy: Knowledge recall

Difficulty: 2

Learning Objective: 1.5

Page Reference: 16

Chapter 01 - Introduction to Auditing

38. Discuss the conflict between the need for an audit firm to perform quality services and its desire to make a profit in the context of the investor's need for reliable information.

An audit firm needs to be able to pay its staff in line with their abilities. Otherwise, more qualified staff will seek opportunities elsewhere. If they leave, only less qualified people will remain which will reduce the quality of audit possible. With less qualified people, the audit firm may be unable to express the correct opinion on the fairness of the financial statements. This would tend to increase investor's information risk.

One way to have more money to pay staff appropriately is to reduce the amount of time spent on each assignment. More assignments each with less time spent would permit more profit on each assignment. However, reducing the amount of time spent on each audit engagement would also increase the risk that a material error was missed in the audit. This increases the information risk to investors which decreases the value of the audit to them and increases the likelihood that they will sue the auditors to recover any investment losses.

A constant demand by investors for reduction in information risk means that except in the short term, an auditor cannot reduce the quality of its services. By the same token, there is an equilibrium level of profit for audit firms, and compensation for its staff and partners which investors are willing to provide in exchange for their desired reduction in information risk.

Blooms Taxonomy: Comprehension

Difficulty: 3

Learning Objective: 1.6

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