Solution Manual For

Auditing An International Approach 8th Canadian Edition by Wally Smieliauskas, Amy Kwan, Kathleen Cogliano, Catherine Barrette

Chapter 1-21 With Appendix

CHAPTER 1
Introduction to Auditing

SOLUTIONS FOR REVIEW CHECKPOINTS

1-1. In this example of a three-party accountability structure, the owner is the 'third party', the hired manager is the 'first party' and the auditor is the 'second party'. The owner is looking out for his/her own longer-term economic interests, but has to rely on the actions and information provided by the hired manager, who may have shorter term concerns (like his/her own compensation and job prospects) and thus act self-interestedly.

The owner is accountable for financing the business and treating the manager fairly, particularly in terms of compensating his/her efforts and successes appropriately. The manager is accountable for giving reliable and fair reports of the business profit performance to the owner. Give the potential conflicts between the interests of the first and third parties, there is information risk - the risk that the financial statement information will not be a full and fair representation of the transactions and events that really occurred, and will not be reliable for economic decisions that the owner may base upon it. The auditor is accountable for objectively verifying the fairness and reliability of the information and providing an independent opinion on how well the information reflects the underlying realities of the entity's operations. The auditor's opinion can benefit both the first and third parties - the owner directly by lowering information risk, and the manager indirectly because if the owner has more basis to trust the manager not to act against the owner's interests the owner will be more willing to share the profits with the manager (this is referred to as lowering "agency costs," which are charged by the owner/principal and incurred by the manager/agent if the owner does not trust the manager). For the auditor's opinion to have value in giving the owner some comfort (i.e., "assurance") that the manager's information can be relied on, the auditor must have no personal interest in either side and be able remain objective.

1-2. The concept of reasonable assurance describes a mental attitude that the auditor gains from the conclusions drawn from audit examination findings. Based on the examination, if the auditor comes to believe the financial statements are reliable and fair to the interests of third party users, this belief forms the basis of the opinion the auditor will communicate to financial statement users in the Auditor's Report. An 'audit opinion' provides a **high level of assurance** to the user that the auditor believes that the information risk is low, and has evidence to support that belief.

1-3 Auditors add credibility to financial information provided by the accountable party such as management (i.e.

auditors make the financial or other information more likely to be true or representationally faithful). Other common ways of characterizing this property of audited numbers is that the numbers are more accurate, have higher assurance, or are more reliable. These relate to different dimension of truthfulness, as we discuss later in the text.

1-4 By obtaining more accurate or reliable information about the company, Aunt Zhang can obtain a more accurate valuation of the company. This more accurate valuation gives Aunt Zhang more confidence that she will get her money's worth in the investment. The preceding assumes Aunt Zhang is risk averse—a common assumption about economic behavior.

1-5 Auditing is the verification of numbers provided by others. To attest means to lend credibility or to vouch for the truth or accuracy of the statements that one party makes to another. The attest function is a term often applied to the activities of independent PAs when acting as auditors of financial statements.

Since financial statements are prepared by managers of an entity who have authority and responsibility for financial success or failure, an outsider may be skeptical that the statements are objective, free from bias, fully informative, and free from material error--intentional or inadvertent. The audit opinion of an independent-PA auditor helps resolve those doubts because the auditor's success depends upon his independent, objective, and competent assessment of the conformity of the financial statements with GAAP. The auditor's role is to lend credibility to the statements, hence the outsider will likely seek his independent audit opinion.

1-6	Client:	the company, board of directors, agency, or some other person or group who retains (hires) the auditor. Usually the party who pays the fee.
	Auditee:	the entity (e.g., business firm, hospital, city government) whose financial information is under audit.
	Auditors:	report <u>to</u> the client <u>on</u> the auditee's financial or control information.

Three party accountability consists of the auditor, the accountable party of the auditee such as management of the auditee, and the users. Users include the client as defined above. Traditionally management hired the auditor so that there was some confusion as to who was the true client. New corporate governance concepts in part attempt to clarify this three party accountability.

1-7 Auditors gather evidence related to the assertions management makes in financial statements and render a report. Accountants record, classify, and summarize (report) a company's assets, liabilities, capital, revenue, and expense in financial statements. Accountants produce the financial statements, auditors audit them.

1-8 The conditions of complexity, remoteness and consequences produce demands by outside users for financial reports. They cannot produce the reports for themselves because of these conditions. Company managers and accountant produce them.

1-9 Students can refer to the AAA and CAS 200 (CPA Canada) definitions in Chapter 1. Some instructors may want to extend the consideration of definitions to include the internal and governmental definitions.

In response to "what do auditors do," students can refer to Exhibit 1-2 and respond in terms of: (1) obtain and evaluate evidence about assertions management makes about economic actions and events, (2) ascertains the degree of correspondence between the assertions and GAAP, and (3) gives an audit report (opinion).

Students can also respond more generally in terms of "lending credibility" to financial statements presented by management (attestation).

1-10 The essence of the risk reduction theory is that audits of financial statements reduce the information risk (probability of materially misleading statements) to users to a socially acceptable level.

These various users cannot take it upon themselves to determine whether financial reports are reliable, therefore low in the information risk scale. They do not have the expertise, resources, or time to enter thousands of companies

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

SOLUTIONS FOR MULTIPLE CHOICE QUESTIONS

MC 1-1 LO1 When people speak of the assurance function, they are referring to the work of auditors in

a. lending credibility to a client's financial statements.
b. detecting fraud and embezzlement in a company.
***c*. lending credibility to an auditee's financial statements.**
d. performing a program results audit in a government agency.

MC 1-2 LO1 Company A hired Sampson & Delila, CPAs, to audit the financial statements of Company B and deliver the audit report to Megabank. Which is the client?

a. Megabank
b. Sampson & Delila
***c*. Company A**
d. Company B

MC 1-3 LO1 According to CPA Canada, the objective of an audit of financial statements is

***a*. an expression of opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with generally accepted accounting principles.**
b. an expression of opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the Financial Accounting Standards Board.

c. an expression of opinion on the fairness with which they present financial position, results of operations, and cash flows in conformity with accounting standards promulgated by the CPA Canada Accounting Standards Committee.

d. to obtain systematic and objective evidence about -financial assertions and report the results to interested users.

MC 1-4 LO4 Bankers who are processing loan applications from companies seeking large loans will probably ask for financial statements audited by an independent CPA because

a. financial statements are too complex for them to analyze themselves.

b. they are too far away from company headquarters to perform accounting and auditing themselves.

c. the consequences of making a bad loan are very undesirable.

***d*. they generally see a potential conflict of interest between company managers who want to get loans and their needs for reliable financial statements.**

MC 1-5 LO4 Operational audits of a company's efficiency and economy of managing projects and of the results of programs are conducted by whom?

a. Financial statement auditors

***b*. The company's internal auditors**

c. Tax auditors employed by the federal government

d. Fraud auditors

MC 1-6 LO3 Independent auditors of financial statements perform audits that reduce and control

a. the business risks faced by investors.

***b*. the information risk faced by investors.**

c. the complexity of financial statements.

d. quality reviews performed by other public accounting firms.

MC 1-7 LO4 The primary objective of compliance auditing is to

a. give an opinion on financial statements.

b. develop a basis for a report on internal control.

c. perform a study of effective and efficient use of resources.

***d*. determine whether auditee personnel are following laws, rules, regulations, and policies.**

SOLUTIONS FOR EXERCISES AND PROBLEMS

EP1-1 When the PA is hired by Hughes Corporation, he can no longer be considered independent with respect to the annual audit. The annual audit may then be unnecessary in a short-run view and unnecessary to the extent of services exclusive of the attest opinion. It is true that the in-house PA can perform all the procedural analyses that would be required of an independent audit; however, it is extremely unlikely that he could inspire the confidence of users of financial statements outside the company. He cannot modify the perception of potential conflict of interest that creates demand for the independent audit. As a matter of ethics rules, this PA would be prohibited from signing the standard unqualified attest opinion.