Solution Manual For

Auditing & Assurance Services, 8th Edition By Timothy Louwers, Penelope Bagley, Allen Blay, Jerry Strawser, Jay Thibodeau and David Sinason

Chapter 1-12 With Module (A B C D E F G)

CHAPTER 01
Auditing and Assurance Services

LEARNING OBJECTIVES

	Review Checkpoints	Multiple Choice	Exercises, Problems, and Simulations
1. Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company.	1, 2, 3	29, 31, 38	65*
2. Define and contrast *financial statement auditing*, *attestation*, and *assurance services*.	4, 5, 6, 7, 8	23, 25, 28, 44, 50	60, 65*
3. Describe and define the assertions that management makes about the recognition, measurement, presentation, and disclosure of the financial statements and explain why auditors use them as a focal point of the audit.	9, 10, 11	36, 39, 40, 41, 45, 46, 47, 48, 49, 52, 53, 54, 55, 57, 58, 59	62, 63, 67
4. Define *professional skepticism* and explain its key characteristics.	12	24, 37	61
5. Describe the organization of public accounting firms and identify the various services that they offer.	13, 14	30, 42, 56	64*
6. Describe the audits and auditors in governmental, internal, and operational auditing.	15, 16, 17, 18	26, 27, 32, 34, 35	64*, 66

7. List and explain the requirements for becoming a certified public accountant (CPA) and other certifications available to an accounting professional.	19, 20, 21, 22	33, 43, 51	68, 69

(*) Item relates to multiple learning objectives

SOLUTIONS FOR REVIEW CHECKPOINTS

1.1 Business risk is the risk that an entity will fail to meet its business objectives. When assessing business risk, a professional must consider all possible threats to an entity's goals and objectives. Some illustrative examples include the risk that: 1) its existing customers will start buying products or services from its primary competitors; 2) its product lines will become obsolete; 3) its taxes will increase; 4) key government contracts will be lost; 5) key employees will leave the entity; and many other examples exist.

1.2 To help minimize business risk and take advantage of other opportunities presented in today's competitive business environment, decision makers such as chief executive officers (CEOs) demand timely, relevant, and reliable information. There are at least four environmental conditions that increase demand for reliable information. First, complexity which implies that events and transactions in today's global business environment can be complicated. Most investors do not have the level of expertise needed to properly account for complex transactions. Second is remoteness which implies that decision makers are often separated from current and potential business relationships due to distance and time. For example, investors may not be able to visit distant locations to check up on their investments. Third is time-sensitivity which implies that in today's economic environment, investors and other users of financial statements need to make decisions more rapidly than ever before. As a result, the ability to promptly obtain high-quality information is essential. Fourth is a consequence which implies that decisions may very well involve significant investments. As a result, the consequences can be severe if information cannot be obtained

1.3 Of all the different risks discussed in the chapter up to this point, information risk is the one that is most likely to create the demand for independent and objective assurance services is information risk or the probability that the information circulated by an entity will be false or misleading. Because the primary source of information for investors and creditors is the company itself, an incentive exists for that company's management to make their business or service appear to be better than it actually may be, to put their best foot forward. As a result, preparers and issuers of financial information (directors, managers, accountants, and other people employed in a business) might benefit by giving false, misleading, or overly optimistic information. This potential conflict of interest between information providers and users which provides the underlying basis for the demand for reliable information.

1.4 According to the American Accounting Association, "*Auditing* is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users." In effect, auditors add reliability to the information that is provided to interested users. Of course, this definition is focused on an external reporting context. Students may also discuss how governmental and internal auditors operate as well.

In response to "What do auditors do?" students can respond by stating that auditors (1) obtain and evaluate evidence about assertions made by management about economic actions and events, (2) ascertain the degree of correspondence between the assertions and the appropriate reporting framework, and (3) issue an audit report (opinion). Students can also respond more generally by stating that auditors essentially lend credibility to the financial statements presented by management.

1.5 An attestation engagement is "an engagement in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party"(SSAE 10, AT 101.01). 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 CPAs when acting as auditors of financial statements.

1.6 An *assurance services engagement* is any assignment that improves the quality of information, or its context, for decision makers. Because information (e.g., 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 information truly is objective, free from bias, fully informative, and free from material error, intentional or inadvertent. The services of an independent auditor helps resolve those doubts because the auditor's success depends upon his or her independent, objective, and competent assessment of the information (e.g., the conformity of the financial statements with the appropriate reporting framework). The independent auditor's role is to lend credibility to the information; hence, the outsider will likely seek his or her independent opinion about the financial statements.

1.7 An assurance service engagement is one that improves the quality of information, or its context, for decision makers. Thus, an attestation service engagement is <u>**one type**</u> of an assurance service. Another way of thinking about the issue is to remember that the financial statement audit engagement is <u>**one type**</u> of an attestation service. Please see exhibit 1.3 in the text which depicts the relationship among assurance, attestation, and auditing engagements.

1.8 The four major elements of the broad definition of assurance services are

<u>Independence</u>. CPAs want to preserve their reputation and competitive advantage by always preserving integrity and objectivity when performing assurance services.

<u>Professional services</u>. Virtually all work performed by CPAs is defined as "professional services" as long as it involves some element of judgment based on education and experience.

<u>Improving the quality of information or its context</u>. The emphasis is on "information," CPAs' traditional area of expertise. CPAs can enhance quality by assuring users about the reliability and relevance of information, and these two features are closely related to the familiar credibility-lending products of attestation and audit services. "Context" is relevance in a different light. For assurance services, *improving the context of information* refers to improving its usefulness when targeted to particular decision makers in the surroundings of particular decision problems.

<u>For decision makers</u>. As the "consumers" of assurance services, decision makers are the beneficiaries of the assurance services. Decision makers may or may not be the "client" that pays the fee and may or may not be one of the parties to an assertion or other information, but they personify the consumer focus of new and different professional work.

1.9 Financial accounting refers to the process of recording, classifying, summarizing and reporting about a company's assets, liabilities, capital, revenues, and expenses in the financial statements in accordance with the applicable financial reporting framework (e.g., GAAP). In so doing, the management team is making a number of assertions about the financial statements. The financial accounting process is the responsibility of the management team.

Financial statement auditing refers to the process whereby professional auditors gather evidence related to the assertions that management makes in the financial statements, evaluates the evidence and concludes on the fairness of the financial statements in a report.

They differ because accountants produce the financial statements in accordance with the applicable financial reporting framework. After this is complete, financial statement auditors then perform procedures to ascertain whether the financial statements have been prepared in accordance with the applicable financial reporting framework.

1.10 The three major classifications of ASB assertions with several assertions in each classification are:

<u>Transaction Assertions (i.e. Income Statement)</u>

Occurrence assertion: The objective is to establish with evidence that transactions giving rise to assets, liabilities, sales, and expenses actually occurred. Key questions include "Did the recorded sales transactions really occur?"

Completeness and cutoff assertion: The objective is to establish with evidence that all transactions of the period are in the financial statements and all transactions that properly belong in the preceding or following accounting periods are excluded. Completeness also refers to proper inclusion in financial statements of *all* assets, liabilities, revenue, expense, and related disclosures. Key questions related to completeness include "Are the financial statements (including footnotes) complete?" and "Were all the transactions recorded in the right period?"

Accuracy assertion: The objective is to establish with evidence that transactions have been recorded at the correct amount. Key questions include "Were the expenses recorded at the proper dollar amount?"

Classification assertion: The objective is to establish with evidence that transactions were posted to the correct accounts. Key questions include "Was this expense recorded in the appropriate account?"

<u>Balance Assertions (i.e., Balance Sheet)</u>

Existence assertion: The objective is to establish with evidence that the balance represents assets, liabilities, sales, and expenses that are real and in existence at the balance sheet date. Key questions include "Does this number truly represent assets that existed at the balance sheet date?"

Rights and obligations assertion: The objectives related to rights and obligations are to establish with evidence that assets are *owned* (or rights such as capitalized leases are shown) and liabilities are *owed.* Key questions related to this assertion include "Does the company really own the assets? And "Are related legal responsibilities identified?"