

Solution Manual Manual

Principles of Auditing & Other Assurance Services 21st Edition by Ray Whittington
(Author), Kurt Pany

Chapter 1-21

CHAPTER 1

The Role of the Public Accountant in the American Economy

Review Questions

- 1-1 The “ crisis of credibility” largely arose from the number of companies that restated their previously issued financial statements as a result of accounting irregularities and fraud. Especially responsible were the very visible Enron and WorldCom fraud cases. Both companies filed for bankruptcy and constituted the largest companies in American history to do so. The extent of the accounting irregularities and fraud being investigated and disclosed brought into question the effectiveness of financial statement audits. In addition, the criminal conviction of Arthur Andersen, LLP, one of the then Big 5 accounting firms, on charges of destroying documents related to the Enron case brought into question the ethical standards of the profession.

- 1-2 Assurance services are professional services that enhance the quality of information, or its context, for decision-making. The two types are: (a) those that increase the reliability of information and (b) those that involve putting information in a form or context that facilitates decision-making.
- 1-3 A financial statement audit is, by far, the most common type of attest engagement. The overall assertion, made by management, most frequently is that the financial statements follow generally accepted accounting principles.
- 1-4 A large corporation with securities listed on a stock exchange is required by the rules of the stock exchange and by the rules of the Securities and Exchange Commission to provide an audit report with the annual financial statements furnished to its stockholders. It also is required to engage the auditors to provide an opinion on its internal control. Apart from legal requirements, however, a large listed corporation recognizes that it must maintain investor confidence in the reliability of its financial statements and internal control over financial reporting if it is to continue to be able to secure capital from the public. The report by a firm of certified public accountants adds credibility to the financial statements prepared by the corporation. When a small family-owned enterprise elects to have an audit, the purpose usually is to use the auditors' report to support an application for a bank loan.
- 1-5 A report by an independent public accountant concerning the fairness of a company's financial statements is commonly required in the following situations:
- (1) Application for a bank loan.
 - (2) Establishing credit for purchase of merchandise, equipment, or other assets.
 - (3) Reporting operating results, financial position, and cash flows to absentee owners (stockholders or partners).
 - (4) Issuance of securities by a corporation.
 - (5) Annual financial statements by a corporation with securities listed on a stock exchange or traded over the counter.
 - (6) Sale of an ongoing business.
 - (7) Termination of a partnership.

- 1-6 To add credibility to financial statements is to increase the likelihood that they have been prepared following the appropriate criteria, usually generally accepted accounting principles. As such, an increase in credibility results in financial statements that can be believed and relied upon by third parties.
- 1-7 Business risk is the risk that the investment will be impaired because a company invested in is unable to meet its financial obligations due to economic conditions or poor management decisions. Information risk is the risk that the information used to assess business risk is not accurate. Auditors can directly reduce information risk, but have only limited effect on business risk.
- 1-8 At the beginning of the century, the principal objective of auditing was the prevention and detection of fraud. Audit work centered on the balance sheet, because the income statement was regarded as highly confidential and not for public disclosure. Today, the principal objective of auditing is to form an opinion on the fairness of financial statements and their conformity with generally accepted accounting principles. But the professional standards also require that an audit be designed to provide reasonable assurance of detecting material misstatements, due to errors or fraud. Particular emphasis is placed on the income statement which is of great importance to investors. Auditing today also has the objectives of meeting the requirements of the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board for public companies.
- 1-9 An operational audit attempts to measure the effectiveness and efficiency of a specific unit of an organization. It involves more subjective judgments than a compliance audit or an audit of financial statements because the criteria of effectiveness and efficiency of departmental performance are not as clearly established as are many laws and regulations or generally accepted accounting principles.

The report prepared after completion of an operational audit is usually directed to management of the organization in which the audit work was done.

- 1-10 A compliance audit is an audit to determine whether financial reports or other assertions are in compliance with established criteria. The necessary ingredients are verifiable data and the existence of standards established by an authoritative body. An operational audit, on the other hand, is a review of a department or other unit of a business or governmental organization to measure the effectiveness and efficiency of operations. Internal auditors often perform operational audits as do auditors employed by the Government Accountability Office (GAO) of the federal government.
- 1-11 Internal auditors must be independent of the department heads and other line executives whose work they review. However, internal auditors are not independent in the same sense as a public accounting firm. The public accounting firm serves many clients and the revenue obtained from any one client is only a small part of the revenue of the firm. Internal auditors, on the other hand, are employees of one company, and are subject to the restraints inherent in the employer-employee relationship. Internal auditors can achieve a great deal of independence by reporting to the audit committee of the board of directors, but they cannot achieve the same degree of independence as is possessed by the external public accounting firm.
- 1-12 The internal auditors are employees of Spacecraft, Inc., and may be influenced by corporate management. The public accounting firm is independent of the company and is in a better position to take positions opposed to those of company management. The work of the internal audit staff emphasizes measurement of the efficiency and effectiveness of various operating units of the company and compliance with all types of controls, whereas the public accounting firm is primarily concerned with determining the fairness of Spacecraft's financial statements.
- 1-13 The Government Accountability Office (GAO) is a staff of professional auditors which reports to Congress. Its function is to determine that programs carried out by federal agencies conform to the financial authorization of the Congress. It is also concerned with the cost-