

Chapter 1

Multiple Choice

- 1-1. C
- 1-2. A
- 1-3. A
- 1-4. C
- 1-5. B
- 1-6. A
- 1-7. C
- 1-8. D
- 1-9. C
- 1-10. D
- 1-11. A
- 1-12. B
- 1-13. D
- 1-14. C
- 1-15. A
- 1-16. D
- 1-17. B
- 1-18. C
- 1-19. B
- 1-20. A

Discussion Questions

1-21 [LO 2] Why do you have to be a good accountant in order to be a good auditor?

In order to be a good auditor, you must also be a good accountant. To be an effective auditor, one must thoroughly understand the accounts and processes to be audited. Auditors need a deep understanding of financial accounting to determine what information must be captured about an economic event and how it should be presented in the financial statements.

1-22 [LO 3] Auditors cannot change the financial statements. Explain the influence the auditor has on management's decisions regarding financial statement presentation. Also, explain your perception of the possible tension created by any power struggle inherent in the management-auditor relationship. How do you think auditors should respond when management wants the company's financial statements to be presented in a certain way but the auditor disagrees?

The auditor expresses an opinion on the financial statement presentation in the auditor's report. If there is a serious disagreement between management and the auditor with respect to whether the financial statements are a fair representation of the company's economic situation and activities, the auditor is required to render a qualified or adverse opinion in his report. Management usually needs a clean and unqualified opinion and failing to obtain one is disastrous. Because the auditor is hired and paid by management, the auditor – management

relationship is fraught with potential conflicts of interest. There is also enormous legal liability for the auditor. There are many risks involved in auditing.

Because financial reporting requires the exercise of much judgment, reasonable persons often disagree on issues of presentation. Successful auditors must persuade their clients to present the financial statements in the proper manner. The auditor's professional knowledge, experience, and demeanor are necessary to manage expectations, avoid problems, and defuse tensions before they become conflicts.

1-23 [LO 2] How do the capital markets and economy benefit as a result of all public-traded companies having an independent audit?

If the investing public perceives audited financial statements to be more reliable than nonaudited financial statements, then audits make a significant contribution by increasing investor confidence. Investors who have confidence in the information are more likely to participate in the world's capital markets. This participation allows our capital markets and our economy to grow. Independent audits are a necessary component of information transparency and reliability. After all, the integrity of financial reporting is the foundation upon which our public markets are built.

1-24 [LO 2] How do audits serve a "preventive" purpose?

If management knows their financial statements will be audited and that any significant errors or improprieties will be discovered, they should be motivated to make sure the financial statements are fairly stated before they release them.

1-25 [LO 3] Shareholders, management, and the Board of Directors/audit committee all benefit from an audit but are said to have different perspectives. If each group were solely responsible for the decision, would these three categories of constituents prefer to have the same set of economic events reported differently? For example, would one group benefit from more aggressive reporting, another from more conservative reporting, and so on? How might these different preferences impact reporting ?

By skewing the information to one side or the other, neutrality is lost and the value and transparency of the reports is diminished. Although each of the three categories of beneficiaries has different views about the usefulness and value of financial reports, there are significant interrelationships among the various constituents. Each group benefits from the common fact that the audit produces increased assurance regarding the fairness of the financial presentation. It is important for management to exercise discretion in choosing the best accounting methods and reporting techniques to serve the company as a whole, not favoring one constituency over the other.

1-26 [LO 3] Why does having audited financial statements bring down a company's cost of capital?

The decreased risk of incorrect financial information tends to decrease a company's cost of capital because the pool of informed investors willing to invest is increased when audited financial statements are available.

Problems

1-27 [LO 2] Michael is a new employee in the financial reporting department of Goldberg Corporation, a mid-size publicly held corporation with annual revenues of \$75 million. As Goldberg Corporation prepared for its annual audit, his manager came to him to complain about the auditors. Their audit fees were so high, yet every year they never found all of the mistakes made by the staff in Goldberg Corporation. One year, he explained, they even missed a \$5,000 fraud.

Required:

(a) How can Michael use the objectives of an audit to help his manager understand the value that the company receives from an audit?

The objective of an audit is to produce an opinion regarding the fairness of the financial statements. As a result of this opinion, Goldberg Corporation and its constituents receive a variety of benefits from the audit. The company has access to the public markets to raise capital. The Board of Directors receives value in discharging its fiduciary responsibilities to shareholders. Even if all the small mistakes are not found, management benefits from knowing that an objective party has looked at the company, its operations and reports and that the company's information is a valid basis for making decisions. If the company's operations can be more efficient or effective the audit process likely will result in recommendations for changes.

(b) What concept can Michael use to explain that missing a \$5,000 fraud in a company with revenues of \$75 million dollars does not indicate that the auditors performed an ineffective audit?

The main concept appropriate for explaining why the auditor missed a \$5,000 fraud is materiality. In all but the smallest companies \$5,000 is not material to the financial statements and the auditors likely set the materiality of transactions, etc., higher than that dollar amount. Consequently, the \$5,000 fraud is likely to be missed. In a company the size of Goldberg Corporation, \$5,000 is not material.

1-28 [LO 2] Javier is an experienced, second year staff at a mid-sized CPA firm who has only worked on audits of large, privately held companies. His firm recently won a proposal for the year-end audit of a small, publicly traded company. Javier's evaluations have indicated that he is a hard worker and value-added team player. The audit partner tells the human resources schedule to assign Javier to the audit team of the new public company engagement. Javier finds out that his first task is to work on the audit of the internal controls over financial reporting (ICFR). Javier is excited because he knows that the opportunity to gain experience on a public client is good. However, he has only performed financial statement audits and is apprehensive about his lack of experience.

Required:

How can Javier apply the components of the formal definition of auditing to the audit of ICFR?

Javier's experience in financial statement audits will help him learn and understand the audit of ICFR. ICFR audits are similar to financial statement audits in that:

- (i) the auditor is objective
- (ii) the auditor plans the audit to obtain and examine evidence supporting management's assertions
- (iii) the auditor determines whether management's assertions correspond with supporting evidence
- (iv) the auditor issues an audit conclusion

Javier should not be anxious concerning the ICFR audit as the procedures are similar to that of a financial statement audit. The offer to join the engagement team represents a great learning experience for Javier and an opportunity to advance his career.

1-29 [LO 2] Jessica is the lead hospitality industry audit partner at a prestigious international accounting firm. Jessica recently won an engagement of a large, publicly traded hotel chain. In planning the upcoming year's audit, she schedules one manager, three seniors, and six staff members, all of whom have experience in the hotel industry.

Required:

- (a) Does Jessica have sufficient staff to complete the audit in accordance with PCAOB standards? Explain.

A yes/no answer is not appropriate for this question. Since this is a new client, having staff (meaning staff, seniors and managers) that know the industry is good. This will help in making sure everyone is competent for the job. Having sufficient staff means that there are enough people with the right amount of expertise for the tasks assigned, that there are enough people to supervise and review the work of those under them, and that there is enough labor (work hours) available to get the job done by the deadlines.

- (b) Can Jessica schedule other experts on the audit?

Yes. It is very likely that Jessica may need help from other auditors with IT and valuation expertise. She can schedule other experts (both inside the firm and from the outside, if needed).

- (c) Will any other partners help Jessica work on the engagement?

Possibly. As discussed she may need auditors with other expertise, some of whom may be partners. A quality control review partner will definitely work on the engagement, but he or she has a specific task, and is not involved with "helping" the engagement management partner.

1-30 [LO 1, 2] R&R is a public corporation that, as of December 31, 2009, is subject to a year-end integrated audit by its independent auditing firm, Young & Young. An excerpt of Young & Young's audit opinion states:

In our opinion, the consolidated financial statements present fairly, in all material aspects, the financial position of R&R and its subsidiaries as of December 31, 2009, and the results of their operations and their cash flows for the fiscal year ended December 31, 2009, in conformity with U.S. GAAP. Also in our opinion, R&R maintained, in all material respects, effective internal control over financial reporting as of December 31, 2009, based on criteria established in Internal control – Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

Required:

- (a) What kind of opinion did Young & Young give R&R for its 2009 year-end financial statements?

An unqualified or clean opinion

- (b) Under which set of financial reporting standards does R&R report? Which set of auditing standards does Young & Young use in its audit of R&R?

R&R reports based on U.S. GAAP

The full report is not provided, but since R&R is a public company, and an ICFR audit opinion is given, it is safe to assume that the audit is performed based on PCAOB Audit Standards

- (c) Under which financial reporting standards might R&R report if it were a corporation based in Germany?

International Financial Reporting Standards (IFRS) or German GAAP

1-31 [LO 3] Over the course of Young & Young's audit of SQL Group, a publicly traded company, Young & Young concluded that SQL's financial statements presented fairly according to U.S. GAAP, but its internal controls over financial reporting were not effective as of the audit date. Management's initial evaluation was that the ICFR is effective. This is the first time anything like this has happened to management and they are not sure what to do. [LO 3]

Required:

- (a) Who is responsible for the ensuring that SQL's internal controls over financial reporting are effective?

SQL's management is ultimately responsible for ensuring that its ICFR are effective.

- (b) Can SQL's management do anything to alter Young & Young's opinion concerning the effectiveness of its internal controls over financial reporting? How should Young & Young respond to any such pressures?

SQL's management can choose to alter its ICFR based on Young & Young's recommendations which may cause Young & Young to change its opinion over the effectiveness of ICFR. The only problem that would cause pressure is if SQL tries to get Young & Young to change its opinion without any ICFR improvements. Young & Young should not respond to any pressure. The SOX has a section that specifically prohibits anyone from trying to influence an audit.

(c) Can Young & Young *require* management to change its report on ICFR effectiveness?

No. SQL can draft whatever report it wants to. All Young & Young can do is issue an opinion indicating that it disagrees with the management assessment stated in management's report.

1-32 [LO 5] Jason is a senior accounting major at State University who is entering his last semester. He needs one more accounting class to fulfill his requirements and notices an opening in the undergraduate auditing class. As Jason's father is the chairman of the board for a publicly traded company in the area, Jason's goal is to graduate and work in the corporation's financial reporting department. Jason does not think that an auditing class will provide future value for his career objectives.

Required:

(a) Is Jason's perspective correct concerning the value-added nature of an auditing class?

No. Jason is wrong. Corporate accountants – especially those who want to move up to top management – need and can benefit from knowledge of auditing.

(b) List the ways can Jason derive value from the class even if he does not plan to enter the audit profession?

Jason will understand what the auditors are doing when they come to the company he works for to perform an audit. He can help other employees work with the auditors. If he is in charge of a department he can manage the interaction of his employees and the auditors to make the audit time most effective and cause the least disruption to his department. Jason will be able to communicate with the auditors as a result of studying auditing.

1-33 [LO 4, 5] AH Family is a large privately owned and operated corporation in its 40th year of operation. When Patricia, the founder's daughter, recently became AH Family's CEO, she formulated an aggressive multinational expansion plan that will add locations in Europe and Asia. To accomplish this goal, Patricia and the Board of Directors realized its need to raise \$100 million in new capital. In order to raise such high levels of new capital, AH Family will have to go public. Currently, AH Family employs a local CPA firm to conduct yearly audits of the financial statements for its creditors.

Required:

- (a) Identify the types of audits AH Family will have to undergo if management chooses to take the company public.

While AH Family was not subject to any mandatory audits as a privately held corporation, it will now be subject to an Integrated Audit including an audit of the financial statements and an audit of Internal Controls over Financial Reporting (ICFR).

- (b) Identify the governing and standard setting bodies that will affect AH Family if it chooses to become a public company.

JH Family as a privately held corporation was subject to audits governed by the AICPA. If JH Family chooses to go public, it will be subject to integrated audits under the Public Company Accounting Oversight Board (PCAOB), which is ultimately regulated by the Securities and Exchange Commission (SEC).

- (c) Is it possible that new costs will result if the company goes public? Explain.

Potential new costs include but are not limited to:

- (i) The costs of an Internal Audit department/function required by the Sarbanes-Oxley Act of 2002
- (ii) The costs of an Integrated Audit which will add an audit of ICFR on top of the audit of the financial statements
- (iii) The costs of Reviews over 10Q quarterly reports required by the SEC
- (iv) The costs of hiring an audit firm with global capabilities to audit the new locations in Europe and Asia

1-34 [LO 4] Your professor has asked you to complete a research paper concerning the link between the auditing profession and financial reporting standard setters and regulators.

Required:

For each independent situation, determine which regulating or standard-setting body you should research:

- (a) The entity that sets accounting standards for the government sector.

GASB

- (b) The entity that decides what is required to become a licensed CPA and conduct work as a CPA.

State Board of Accountancy or State Department of Professional Regulation

- (c) The entity that sets standards for audits of publicly traded companies.

PCAOB

- (d) The entity that sets financial reporting standards in the U.S.

FASB (also another possibility is the SEC; in the international realm, an entity would use IASB for IFRS)

- (e) The entity that creates and administers the uniform CPA exam.

AICPA

- (f) The entity that has ultimate authority over public company reports as well as accounting and reporting standards.

SEC

1-35 [LO 2] Meagan is a graduate student in the accounting program at your school. While she has excelled in her auditing classes, managerial and cost accounting, and AIS classes, she has not performed as well in her required financial accounting classes but has still maintained a high overall GPA. Meagan wishes to pursue a career in auditing because she has done well in auditing classes, and she wishes to avoid a career in financial accounting because she has not done well in those classes.

Required:

- (a) Explain why Meagan's reasoning is flawed.

Meagan's reasoning is flawed because in order to be a good auditor, you must also be a good accountant. In order for Meagan to be an effective auditor, she must first understand the accounts and processes she will be auditing. Auditors are trusted advisors and should have a deeper understanding of financial accounting than their clients.

- (b) Will Meagan be able to excel in her career without a strong base in financial accounting? Explain.

Meagan will probably not be able to excel without a good understanding of financial accounting. In order to obtain her Certified Public Accountant (CPA) license, Meagan must demonstrate a deep understanding of financial accounting. Furthermore, Meagan will not be a truly effective auditor without first understanding the underlying content that she is auditing.

- (c) Will her strong performance in her managerial and cost accounting classes and AIS class help her in her auditing career?

Meagan's strong performance in her other classes will help her understand the aspects of her audit clients covered by those classes. But, she still needs a strong financial accounting background. Meagan could choose to retake or review classes she has previously taken as a refresher. She could conduct independent research to enhance her understanding. Finally, Meagan could enroll in one of many CPA study courses that will review many important financial accounting concepts.

1-36 [LO 2] Barton and Sons, Inc. is a small, privately-held corporation that operates two retail stores in western Kentucky. Jorge Barton and his two sons own all of the company's stock and manage the store operations. The family takes pride in the corporation's success in terms of growing sales and lack of borrowing. The company is currently considering expansion into other

regions of Kentucky and Indiana. Such expansion would likely require long-term borrowing and surrendering certain management responsibilities to non-family member employees. However, the family does not wish to sell stock in the company.

Required:

- (a) Discuss the factors that would make it beneficial for a company like Barton and Sons to have an external audit.

A bank or lending institution which may provide the company's debt financing is likely to require audited financial statements before lending significant amounts of money. In addition, lenders generally require audited financial statements during the time period the debt is outstanding. Also, as the company grows, the family will lose control of the day-to-day operations of its retail stores; an audit can provide an additional monitoring activity for the family in controlling the expanded operations of the company.

- (b) Discuss the factors that would make it beneficial for a company like Barton and Sons to implement an internal audit function.

As the company grows and the family loses control of the day-to-day operations of its retail stores, an internal audit function can provide additional monitoring activity for the family in controlling the expanded operations of the company. An internal audit function is generally regarded as an enhancement to the internal control environment of the company, which is especially important for a growing company like Barton and Sons.

1-37 [LO 3] You are a newly-hired associate auditor for Praxo & Hanks, CPAs, a professional services firm that provides financial audits, integrated audits, and tax work for a variety of private and public company clients in the mid-Atlantic region of the United States. Your first week with the firm was spent in a new associates training program for audit staff, which was led by two of the firm's audit managers. The first day of the training program focused on understanding the responsibilities of auditors and the nature and objectives of the services provided to audit clients.

Required:

- a. Distinguish between the assertions made by management in presenting financial statements and reporting on ICFR, and the statements made within an auditor's report.

Management makes assertions about economic events and actions that affect the company, claiming that those events and actions are properly communicated through the financial statements. Management also makes assertions about the effectiveness of internal controls underlying the company's financial reporting processes. On the other hand, the auditor's report is an independent assessment of management's assertions. Auditors must be able to evaluate management's assertions in order to prove or

disprove them. If the auditor is comfortable with the assertions set forth by management, a clean audit report will be issued.

(2) How do management's assertions relate to auditor's evidence?

The audit process focuses on objectively obtaining and evaluating evidence about management assertions. Auditors determine what information is necessary to properly account for an economic event or action, then they investigate the matter by evaluating relevant evidence to determine whether management's assertions are being met.

Auditors must collect evidence from such sources as company documents and records, observations and inquiries, etc. The evidence collected must relate specifically to management's assertions about the financial statement elements and internal controls.

Activity Assignments

1-38 Go to the SEC Web site (www.sec.gov). Under "About the SEC" select "Laws and Regulations" Select the Sarbanes-Oxley Act of 2002. Find the full text of the law. Review the following sections: 103, 201, 202, 203, 204, 206, 301, 302, 404, and 407. As you read, prepare a list of questions regarding items you do not understand and bring them to class for discussion.

Student answers will vary.

1-39 Select a publicly traded company of your choice. Find the most recent annual filing with the SEC (10K), or quarterly report filing (10Q) by going to either the SEC Web site or the company's Web site. Find management's report on ICFR (as required under Section 404 of the Sarbanes-Oxley Act.) Print out the management report. What are the primary points stated by management in the report?

Student answers will vary.

1-40 Go to the PCAOB Web site (www.pcaobus.org). Find Auditing Standard No. 5, "An Audit of Internal Control Over Financial Reporting that is Integrated with an Audit of Financial Statements." Go to Appendix B and read paragraphs B1–B9. Summarize the content of these paragraphs about integrating a financial statement and internal control audit.

The paragraphs are as follows:

B1. *Tests of Controls in an Audit of Internal Control.* The objective of the tests of controls in an audit of internal control over financial reporting is to obtain evidence about the effectiveness of controls to support the auditor's opinion on the company's internal control over financial reporting. The auditor's opinion relates to the effectiveness of the company's internal control over financial reporting as of a *point in time* and *taken as a whole* .

B2. To express an opinion on internal control over financial reporting as of a point in time, the auditor should obtain evidence that internal control over financial reporting has operated

effectively for a sufficient period of time, which may be less than the entire period (ordinarily one year) covered by the company's financial statements. To express an opinion on internal control over financial reporting taken as a whole, the auditor must obtain evidence about the effectiveness of selected controls over all relevant assertions. This requires that the auditor test the design and operating effectiveness of controls he or she ordinarily would not test if expressing an opinion only on the financial statements.

B3. When concluding on the effectiveness of internal control over financial reporting for purposes of expressing an opinion on internal control over financial reporting, the auditor should incorporate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the financial statements, as discussed in the following section.

B4. *Tests of Controls in an Audit of Financial Statements.* To express an opinion on the financial statements, the auditor ordinarily performs tests of controls and substantive procedures. The objective of the tests of controls the auditor performs for this purpose is to assess control risk. To assess control risk for specific financial statement assertions at less than the maximum, the auditor is required to obtain evidence that the relevant controls operated effectively during the *entire period* upon which the auditor plans to place reliance on those controls. However, the auditor is not required to assess control risk at less than the maximum for *all* relevant assertions and, for a variety of reasons, the auditor may choose not to do so.

B5. When concluding on the effectiveness of controls for the purpose of assessing control risk, the auditor also should evaluate the results of any additional tests of controls performed to achieve the objective related to expressing an opinion on the company's internal control over financial reporting, as discussed in paragraph B2. Consideration of these results may require the auditor to alter the nature, timing, and extent of substantive procedures and to plan and perform further tests of controls, particularly in response to identified control deficiencies.

B6. *Effect of Tests of Controls on Substantive Procedures.* If, during the audit of internal control over financial reporting, the auditor identifies a deficiency, he or she should determine the effect of the deficiency, if any, on the nature, timing, and extent of substantive procedures to be performed to reduce audit risk in the audit of the financial statements to an appropriately low level.

B7. Regardless of the assessed level of control risk or the assessed risk of material misstatement in connection with the audit of the financial statements, the auditor should perform substantive procedures for all relevant assertions. Performing procedures to express an opinion on internal control over financial reporting does not diminish this requirement.

B8. *Effect of Substantive Procedures on the Auditor's Conclusions About the Operating Effectiveness of Controls.* In an audit of internal control over financial reporting, the auditor should evaluate the effect of the findings of the substantive auditing procedures performed in the audit of financial statements on the effectiveness of internal control over financial reporting. This evaluation should include, at a minimum -

- The auditor's risk assessments in connection with the selection and application of substantive procedures, especially those related to fraud.
- Findings with respect to illegal acts and related party transactions.
- Indications of management bias in making accounting estimates and in selecting accounting principles.
- Misstatements detected by substantive procedures. The extent of such misstatements might alter the auditor's judgment about the effectiveness of controls.

B9. To obtain evidence about whether a selected control is effective, the control must be tested directly; the effectiveness of a control cannot be inferred from the absence of misstatements detected by substantive procedures. The absence of misstatements detected by substantive procedures, however, should inform the auditor's risk assessments in determining the testing necessary to conclude on the effectiveness of a control.

1-41 [LO 6] Go to the COSO Web site (www.COSO.org). Find the Internal Control Integrated Framework. What other publications are posted on the COSO Web site?

The COSO Web site provides articles, definitions, and other guidance, like *Effective Enterprise Risk Oversight: The Role of the Board of Directors and Strengthening Enterprise Risk Management for Strategic Advantage*.

1-42 Go to the PCAOB Web site (www.pcaobus.org). Explain the PCAOB mission and its rulemaking process.

PCAOB Mission: The PCAOB mission, as derived from the Sarbanes-Oxley Act of 2002, is to oversee the auditors of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, fair and independent audit reports.

The PCAOB rulemaking process is used in the registration, inspection, standard-setting and enforcement programs. Rules adopted by the PCAOB must be approved by the Securities and Exchange Commission before going into effect. The PCAOB's Rulemaking Docket shows the progress of each rule under consideration by the PCAOB. Each rule is assigned a docket number and all related materials, including PCAOB releases and comment letters, rule filings with the SEC, and other related documents can be found under that docket number. All dockets, whether open or closed for comment, are available on their Web site.

1-43 On the AICPA Web site (www.aicpa.org), find "Students and CPA Candidates." What is included under "The CPA Exam"?

Student answers will vary depending on their point of access to the exam material. The Web site lists information about pass rates, sample tests, tutorials, and content, which includes content specification outlines (CSOs) for the four sections of the computer-based Uniform CPA

Examination: Auditing & Attestation, Financial Accounting & Reporting, Regulation, and Business Environment & Concepts.

Appendix A

1-1 Go to the Web site of one of the Big Four public accounting firms (Deloitte, Ernst & Young, KPMG, PricewaterhouseCoopers). How do these firms market themselves on their Web sites? What types of services and industry expertise are highlighted?

Student summaries may vary in terms of details and perceptions.