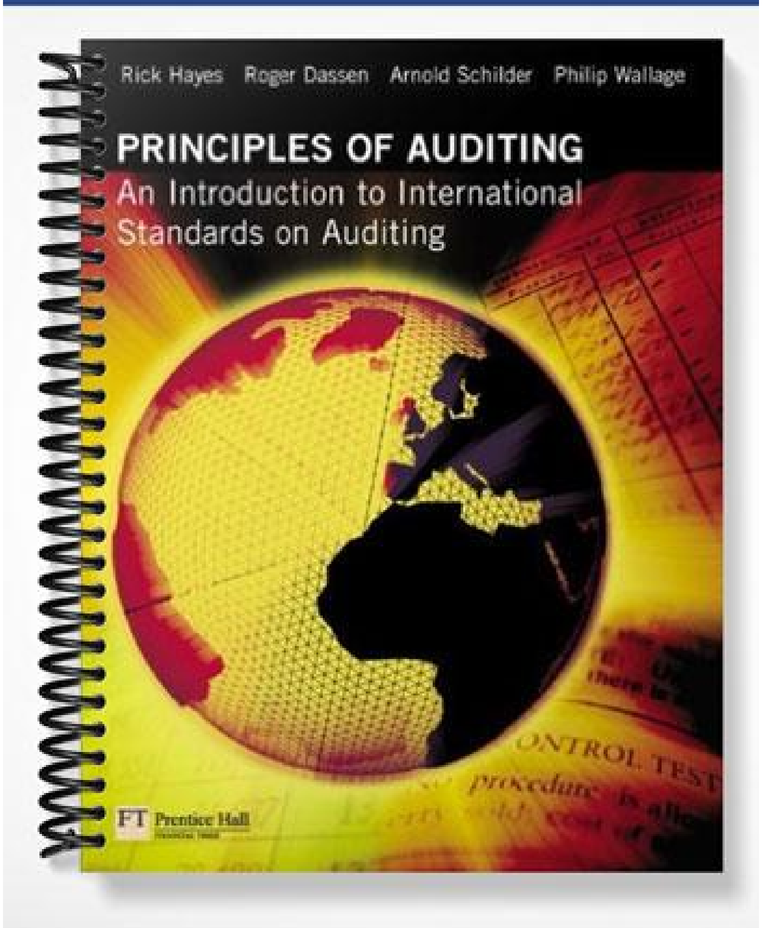
SOLUTIONS MANUAL



Solutions Manual

Principles of Auditing
An Introduction to International Standards on Auditing

Second edition

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QUESTIONS

1.2 Auditing through World History

1-1. Identify and briefly discuss factors that have created the demand for international auditing.

The practice of modern auditing dates back to the beginning of the modern corporation at the dawn of the Industrial Revolution. Companies then experienced a growth of technology, improvement in communications and transportation, and the exploitation of generally expanding worldwide markets. As a result, the demands of owner-managed enterprises for capital rapidly exceeded the combined resources of the owners' savings and the wealth-creating potential of the enterprises themselves. It became necessary for industry to tap the savings of the community as a whole. The result has been the growth of sophisticated securities markets and credit-granting institutions serving the financial needs of large national and increasingly international corporations.

The flow of investor funds to the corporations and the whole process of allocation of financial resources through the securities markets have become dependent to a very large extent upon reports made by management. One of the most important characteristics of these corporations is the fact that their ownership is almost totally divorced from their management. Management has control over the accounting systems of these enterprises. Management is not only responsible for the financial reports to investors; it also has the authority to determine the precise nature of the representations that go into those reports. To reduce the investor's potential lack of confidence about management's reports a demand for independent assurance has arisen, called "auditing."

1-2. What characteristics of the Industrial Revolution were essential for the enhanced development of the audit profession?

The Industrial Revolution created the demand for services of specialists in bookkeeping and auditing of internal and external financial reports. It started in Great Britain around 1780. This revolution led to the emergence of large industrial companies, with (1) complex bureaucratic structures and, gradually, (2) the need to look for external funds in order to finance further expansion: the separation between capital provision and management.

1.3 The Auditor, Corporations and Financial Information

1-3. Evaluate this quote: "Every international business, large or small, should have an annual audit by an independent auditor." Why should an auditor review the financial statements of a company each year?

Management can scarcely be expected to take an impartial view of this process. The financial reports measure the effectiveness of management's performance of its duties. Reports have an important influence on management's salaries, on the value of their shareholdings in the enterprise, and even on their continued employment with the company.

Income statements are compiled on a yearly basis. The income statement is very valuable to shareholders and other stakeholders. To increase the confidence of these stakeholders in the credibility of annually compiled financial statements, the statements must receive an independent and expert opinion on their fairness. An auditor provides the opinion on credibility.

1.4 International Accounting and Auditing Standards

1-4. How do International Financial Reporting Standards (IFRS) differ from International Standards on Auditing (ISA)?

Financial accounting standards are unique and separate from audit standards. By its nature, auditing requires that the real world evidence of financial transactions is compared to financial standards. The standards to which an international auditor compares financial statements are generally standards in the reporting country (e.g. FAS in the United States, or national standards in European Union (EU) Member States, which are based on EU Directives). In the future, companies and auditors in the EU and other countries will use International Financial Reporting Standards (IFRS), formerly called International Accounting Standards (IAS), which are set by the International Accounting Standards Board (IASB).

1-5. What are the ISA standards that are used by an auditor to guide him through the first phase of an audit?

The first phase of the audit is client acceptance. ISA 200 gives the objective and general principles of an audit of financial statements. ISA 210 describes the contents of an engagement letter. Although the standard does not require use of an engagement letter, the guidance is provided in a manner that presumes use of an engagement letter. ISA 310 requires a reasonable understanding of the client's business and industry. ISA 315 requires understanding the entity's environment and the risks. The auditor needs to have a level of knowledge of his or her client's business and industry that will enable him to identify the events, transactions, and practices that, in his judgment, may have a significant effect on the financial information. International standard ISA 510 discusses initial engagements.

1.5 An Audit Defined

1-6. What is the objective of an audit?

An audit is a process, a structured series of tasks, the purpose of which is to provide evidence to support the claim that the financial statements are fairly stated (give a true and fair view). To be fairly stated, the statements must conform to accepted accounting principles (whether these principles are set by government, private organizations or custom).

The audit process must be planned, staffed and carried out, and the evidence must be gathered, in a manner that is consistent with professional auditing standards.

1-7. What is the general definition of an audit? Briefly discuss the key component parts of the definition.

An audit is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users.

An audit is a **systematic** approach. The audit follows a structured, documented plan (audit plan). In the process of the audit, the auditors using a variety of generally accepted techniques analyze accounting records. The audit must be planned and structured in such a way that those carrying out the audit can fully examine and analyze all-important evidence.

An audit is conducted **objectively**. An audit is an independent, objective and expert examination and evaluation of evidence. Auditors are fair and do not allow prejudice or bias to override their *objectivity*. They maintain an impartial attitude.

The auditor **obtains** and **evaluates evidence**. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:

- Studying and evaluating accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the *nature*, *extent* and *timing* of other auditing procedures; and

- Carrying out such other tests, inquiries and other verification procedures of accounting transactions and account balances, as he considers appropriate in the particular circumstances.

The evidence obtained and evaluated by the auditor concerns **assertions** about economic actions and events. The basis of evidence-gathering objectives, what the evidence must prove, are the *assertions of management*. Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements. One assertion of management about economic actions is that all the assets reported on the balance sheet actually exist at the balance sheet date. The assets are real, not fictitious. This is the existence assertion. Furthermore, management asserts that the company owns all these assets. They do not belong to anyone else. This is the rights and obligations assertion.

The auditor **ascertains the degree of correspondence** between assertions and established criteria. The audit program tests most assertions by examining the physical evidence of documents, confirmation, inquiry and observation. The auditor examines the evidence for the assertion presentation and disclosure to determine if the accounts are described in accordance with the applicable financial reporting framework, such as IFRS, local standards or regulations and laws.

1-8. Name two types of risk in the audit process? Briefly discuss each.

Much of the planning in audits deals with obtaining information to help auditors assess the risks in the audit process. There are two types of risks in conducting an audit. One type of risk is the risk that the auditor or audit firm will suffer harm because of a client relationship, even though the audit report rendered for the client was correct. This is called business risk. The other type of risk is audit risk, the risk that an auditor may give an inappropriate audit opinion on financial statements that are materially misstated. For example, an auditor may give an unqualified opinion on financial statements without knowing that they are materially misstated.

1.6 Types of Audits

1-9. How many types of audits are there? Name each and briefly define them.

Audits are typically classified into three types: audits of financial statements, operational audits, and compliance audits. Audits of financial statements examine financial statements to determine if they give a true and fair view or fairly present the financial statements in conformity with specified criteria. An *operational audit* is a study of a specific unit of an organization for the purpose of measuring its performance. Operational audits review all or part of the organization’s operating procedures to evaluate effectiveness and efficiency of the operation. A *compliance audit* is a review of an organization’s procedures and financial records performed to determine whether the organization is following specific procedures, rules, or regulations set out by some higher authority.

1-10. What are the differences and similarities in audits of financial statements, compliance audits, and operational audits?

Audits of financial statements examine financial statements to determine if they give a true and fair view or fairly present the financial statements in conformity with specified criteria. A compliance audit measures the compliance of the client with some established criteria. The performance of a compliance audit is dependent upon the existence of verifiable data and of recognized criteria or standards, such as established laws and regulations, or an organization's policies and procedures. An operational audit is a study of a specific unit of an organization for the purpose of measuring its performance.

Operational audits review all or part of the organization's operating procedures to evaluate effectiveness and efficiency of the operation. Efficiency shows how well an organization uses its resources to achieve its goals. These reviews may not be limited to accounting. They may include the evaluation of organization structure, marketing, production methods, computer operations, or in whatever area the organization feels evaluation is needed. Recommendations are normally made to management for improving operations.

1.7 Types of Auditors

1-11. What are the three types of auditors? Briefly define them.

There are three basic types of auditors: independent auditors, government auditors and internal auditors. The independent auditor is an auditor who is not part of the entity being audited. Independent auditors are typically certified either by a professional organization or the government. The independent auditor specializes in auditing financial statements, performing review assignments or doing compilations of financial statements.

A wide variety of governmental agencies at national, regional, and local level use auditors to determine compliance with laws, statutes, policies, and procedures.

Many large companies and organizations maintain an internal auditing staff. Internal auditors are employed by individual companies to investigate and appraise the effectiveness of company operations for management. Much of their attention is often given to the appraisal of internal controls.

1.8 Setting Audit Objectives Based on Management Assertions

1-12. What are the financial statement assertions made by management according to ISA 500?

According to ISA 500, financial statement assertions are assertions by management, explicit or otherwise, that are embodied in the financial statements. They can be categorized as follows:

(1) Assertions about classes of transactions and events for the period under audit:

- *Occurrence.* Transaction and events that have been recorded have occurred and pertain to the entity. For example, management asserts that a recorded sales transaction was effective during the year under audit.
- *Completeness* – all transactions and events that should have been recorded have been recorded. For example, management asserts that all expense transactions are recorded, none were excluded.
- *Accuracy* – Amounts and other data relating to recorded transactions and events have been recorded appropriately. For example, management asserts that sales invoices were properly extended and the total amounts that were thus calculated were input into the system exactly.
- *Cutoff* – Transactions and events have been recorded in the correct accounting period. For example, management asserts that expenses for the period are recorded in that period and not in the next accounting period.
- *Classification* – Transactions and events have been recorded in the proper accounts. For example, management asserts that expenses are not recorded as assets.

(2) Assertions about account balances at the period end.

- *Existence* – Assets, liabilities and equity interests exist. For example, management asserts that inventory in the amount given exists, ready for sale, at the balance sheet date.
- *Rights and obligations* – An entity holds or controls the rights to assets, and liabilities are the obligations of the entity. For example, management asserts that the company has the legal rights to ownership of the equipment they use and that they have an obligation to pay the notes that finance the equipment.
- *Completeness* – all assets, liabilities and equity interests that should have been recorded have been recorded. For example, management asserts that all liabilities are recorded and included in the financial statements, that no liabilities were 'off the books'.
- *Valuation and allocation* – assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded. For example, management asserts that their accounts receivable are stated at face value, less an allowance for doubtful accounts.

(3) Assertions about presentation and disclosure.

- *Occurrence and rights and obligations* – Disclosed events, transactions, and other matters have occurred and pertain to the entity. For example, management asserts that events that did not occur have not been included in the disclosures.
- *Completeness* – all disclosures that should have been included in the financial statements have been included. For example, management asserts that all disclosures that are required by IFRS are made.
- *Classification and understandability* – financial information is appropriately presented and described, and disclosures are clearly expressed. For example, management asserts that all long-term liabilities listed on the balance sheet mature after one operating cycle or one year and that any special conditions pertaining to the liabilities are clearly disclosed.

- *Accuracy and valuation* – financial and other information is disclosed fairly and at appropriate amounts. For example, management asserts that account balances are not materially misstated.

1-13. What is the existence assertion? the rights and obligation assertion? the completeness assertion?

Existence is an assertion about account balances that assets, liabilities and equity interests exist. For example, management asserts that inventory in the amount given exists, ready for sale, at the balance sheet date. One assertion of management about economic actions is that all the assets reported on the balance sheet actually exist at the balance sheet date. The assets are real, not fictitious.

Rights and obligations is also an assertion about account balances, that an entity holds or controls the rights to assets, and liabilities are the obligations of the entity. For example, management asserts that the company has the legal rights to ownership of the equipment they use and that they have an obligation to pay the notes that finance the equipment.

Depending on whether the assertions are about classes of transactions, account balances or presentation and disclosure, the definition of completeness may differ. For classes of transactions, completeness means all transactions and events that should have been recorded have been recorded. For example, management asserts that all expense transactions are recorded, none were excluded. For account balances, completeness means all assets, liabilities and equity interests that should have been recorded have been recorded. For example, management asserts that all liabilities are recorded and included in the financial statements, that no liabilities were "off the books" For presentation and disclosure, completeness means all disclosures that should have been included in the financial statements have been included. For example, management asserts that all disclosures that are required by IFRS are made.

1.9 The Audit Process Model

1-14. How can one compare the empirical scientific cycle to the financial audit process?

One can liken the financial audit process to the empirical scientific cycle. The empirical scientific cycle is a systematic process of experimenting that starts with a research question, then a plan for an empirical test of the question is made, the test is done, feedback is analyzed, and the scientist makes a judgment. The scientist's opinion is that the experimental hypothesis is false or not false, or perhaps that the test is inconclusive. A financial audit is a systematic process that begins with a client's request for an audit of financial statements, followed by a plan of the audit, and after testing for evidence, the process culminates in a judgment or opinion. The auditors' judgment is whether the financial statements are unqualified as to their fairness, qualified, or disclaimed.

1-15. What are the four phases of an audit process model? Briefly describe each.

The phases of the audit are: (1) client acceptance, (2) planning the audit, (3) testing and evidence, and (4) evaluation and reporting. Illustration 1.5 shows the four-phase audit process and its major sub-components.

The process of (1) client acceptance involves evaluation of the client's background, selecting personnel for the audit and evaluating the need and requirements for using the work of other professionals.

The audit firm must (2) plan its work to enable it to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

(3) The audit should be performed with due professional care by persons who have adequate training, experience, and competence in auditing.

The auditor should (4) review and assess the conclusions drawn from audit evidence on which he will base his opinion of the financial information. This review and assessment involves forming an overall conclusion as to whether: a) the financial information has been prepared using acceptable accounting policies, consistently applied; b) the financial information complies with relevant regulations and statutory requirements; c) the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity; and d) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

1-16. Based on the Evaluation and Judgment phase (IV) of the audit process model the overall conclusions are formed on what judgments?

The auditor should review and assess the conclusions drawn from audit evidence on which he will base his opinion of the financial information. This review and assessment involves forming an overall conclusion as to whether: a) the financial information has been prepared using acceptable accounting policies, consistently applied; b) the financial information complies with relevant regulations and statutory requirements; c) the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity; and d) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

1.10 International Public Accountancy Firms

1-17. List the four basic positions within the organizational structure of an audit firm and describe the duties of each position.

<u>Staff Accountants (or Junior Assistants then Senior)</u>: Typically the first position of someone entering the public accounting profession is that of staff accountant (also called assistant or junior accountant). The staff accountant often performs the more detailed routine audit tasks. The assistants attend training programs that are either developed "in house" or sponsored by the professional organizations.

<u>Senior Accountants (or Supervisor)</u>: The senior ("in-charge") auditor or "supervisor" is in charge of audit fieldwork and typically has two or more years experience in public auditing. The senior is responsible for planning the audit and conducting the audit engagement at the client's place of business. The senior supervises

the work of the audit staff, reviews working papers and time budgets, and assists in drafting the audit report. The senior maintains a continuous record of staff hours in each phase of the audit examination, maintains professional standards of fieldwork, and is responsible for preventing excessive staff hours. This work is subject to review and approval by the manager and partner.

Managers: The manager supervises the audits conducted by the seniors. The manager helps the seniors plan their audit programs, reviews working papers periodically, and provides other guidance. The manager is responsible for determining the audit procedures applicable to specific audits and for maintaining uniform standards of fieldwork. Often managers have the responsibility of compiling and collecting the firm's billings to the audit client. The manager, who typically has at least five years of experience, needs a broad and current knowledge of tax laws, accounting standards, and government regulations. A manager is likely to specialize in accounting requirements of a specific industry.

Partners/Directors: Partners are the owners of the auditing firm. For some firms a change in legal structure means that those formerly known as partners are Directors. They are heavily involved in the planning of the audit, evaluation of the results, and determination of the audit opinion. They maintain contacts with clients, discuss the objectives and scope of the audit work, resolve controversies that may arise and may attend the client's stockholders' meetings to answer any questions regarding the financial statements or the auditors' report. They also review the manager's audit working papers, supervise staff, and sign the audit reports. Partners may specialize in a particular area such as tax laws or a specific industry. The partner is the person who must make the final decisions involving complex judgments.

1-18. Name the Big Four international audit firms and give a brief history of each.

The Big Four are: Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers.

Three founders established Deloitte: William Welch Deloitte, George Touche and Admiral Nobuzo Tohmatsu. Deloitte was founded in 1845 by W.W. Deloitte in a location opposite the Bankruptcy Court in Basinghall Street, London. In 1893 Deloitte opened offices in the United States. In 1990 Deloitte Touche Tohmatsu was created following a number of earlier mergers. In 2003 the names of Touche and Tohmatsu were dropped, leaving Deloitte as the firm's full name.

The founders of Ernst & Young were Arthur Young who had an interest in investments and banking which led to the foundation in 1906 of Arthur Young & Co in Chicago, US, and A.C. Ernst, who was a bookkeeper while still in high school, joined his brother and started Ernst & Ernst in 1903. In 1989, the firms they started combined to create Ernst & Young.

KPMG was formed in 1987 with the merger of Peat Marwick International (PMI) and Klynveld Main Goerdeler (KMG) and their individual member firms. Spanning three centuries, the organization's history can be traced through the names of its principal founding members – whose initials form the name "KPMG." William Barclay Peat founded the accounting firm William Barclay Peat & Co. in London in 1870. James Marwick founded the accounting firm Marwick, Mitchell & Co. with Roger Mitchell in New York City in 1897. Piet Klynveld founded the accounting firm

Klynveld Kraayenhof & Co in Amsterdam in 1917. Dr. Reinhardt Goerdeler is credited with laying much of the groundwork for the KMG merger.

In 1850 Samuel Lowell Price started an accounting business in London. In 1865 William H. Holyland and Edwin Waterhouse joined him in partnership, and by 1874 the company name changed to Price, Waterhouse & Co. The firm opened a New York City office in 1890. In 1854 William Cooper established his own practice in London, which seven years later became Cooper Brothers. The firm's history in the United States began in 1898. In 1957 there was a merger between Cooper Brothers & Co (UK), McDonald, Currie and Co (Canada), and Lybrand, Ross Bros, & Montgomery (US), forming Coopers & Lybrand. In 1990 Coopers & Lybrand merged with Deloitte Haskins & Sells. Finally, in 1998 Price Waterhouse and Coopers & Lybrand merged worldwide to become PricewaterhouseCoopers.

PROBLEMS AND EXERCISES

1.2 Auditing through World History

1-19. History of Auditing. In this chapter, the history of auditing has been briefly described, from an international perspective. Identify the major differences with the developments specific for your country and try to explain these based on differences in the economic system or development.

The answer to this question is specific to the country where instruction takes place. The students should identify the major differences between the developments specific to their country and to explain these in terms of differences in the economic system of their country and the general international accounting development.

1.3 The Auditor, Corporations and Financial Information

1-20. Expectations Gap The general public thinks that an auditor guarantees the accuracy of financial statements. Is this true? Why? What other things does the public believe about audited financial statements?

An auditor does not guarantee the accuracy of financial statements. The auditor guarantees that there is no "material" misstatement.

The public may believe audited financial statements are based on examination of 100% of the evidence, that the statements are free from fraud, that there is no questionable practice that is not disclosed. As this is not necessarily true, an expectation gap may exist between what the public expects and what auditors assure.

1.4 International Accounting and Auditing Standards

1-21. International Auditing Standards. The London, Tokyo and New York Stock Exchange, among others, require an annual audit of the financial statements of companies whose securities are listed on it. What are the possible reasons for this?

The London, Tokyo and New York Stock Exchange, among others, require an annual audit of the financial statements of companies whose securities are listed on them in order to:
1. To increase the confidence of investors.
2. Lend reliability and credibility to the financial statements and reports accompanying audited statements.
3. Provide a reliable and consistent basis for decision-making.
4. Provide a basis for comparison of companies in diverse industries.
5. Protect investor interests.
6. Track the spending of a department compared to the budget.
7. Check to see if internal controls on allocation of keys works.
8. Check data input and security controls on computer operations.

1-22. Describe the Public Interest Oversight Board. Discuss what you think their impact will be on worldwide auditing

The Public Interest Oversight Board (PIOB) will oversee IFAC standard setting activities in the areas of audit performance standards, independence, other ethical standards for auditors, audit quality control, and assurance standards. The PIOB will decide other areas that might fall within the scope of its oversight after consulting with the Monitoring Group (MG) and the IFAC Leadership Group (ILG) (see below). The composition of the PIOB will be selected by the MG. It will be made up of members of the organizations within the MG or their representatives.

Students can suggest a lot of impacts on worldwide auditing of the PIOB. One obvious one is that all firms will have to know PIOB standards if they are operating in countries where the PIOB holds sway. There are the political implications of who is on the board, what authority they will have, how they impact local markets, etc.

1.5 An Audit Defined

1-23. Objectives of an Audit. Tracy Keulen, the sole owner … audit is considered important.

REQUIRED

A. Describe the objectives of the independent audit.

A. An independent audit is an examination of the financial statements in accordance with certain auditing standards such as International Standards on Auditing. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework of other criteria. The auditor, after an objective evidence-gathering examination, expresses an opinion on the fair presentation of financial statements.

B. Identify five ways in which an independent audit may be beneficial to Keulen.

B. An independent audit can also be beneficial:

1. To serve as a basis for the extension of credit.
2. To supply credit rating agencies with required information.
3. To determine if accounting records and reporting meet accounting standards (such as International Financial Reporting Standards (IFRS)).
4. To serve as a basis for preparation of tax returns.
5. To establish amounts of losses from fire, theft, and burglary.
6. To establish a good basis for management decision making.
7. To determine amounts receivable or payable under
   a. agreements for bonuses based on profits.
   b. contracts for sharing expenses.
   c. cost-plus contracts.
8. To provide data for proposed changes in financial structure or to supply proper financial data in the event of a proposed sale or merger.
9. To assist the company in risk assessment.
10. To serve as a basis for changes in accounting or recording practices.
11. To serve as a basis for action in bankruptcy and insolvency cases.
12. To determine proper execution of trust agreements.
13. To determine the effectiveness of information and communication systems.
14. To furnish estates with information in order to obtain proper settlements and avoid costly litigation.
15. To provide a review of many aspects of the organization's activities and procedures.
16. To help companies improve their monitoring of risk, controls, and efficiency.
17. To establish and/or improve systems of internal control.
18. To provide important aid in case of tax audits and court actions.
19. To discourage employees from planning errors or irregularities, by making them aware of auditor presence.
20. To enhance the credibility of reports accompanying financial statements.
21. To provide industry-wide comparisons.
22. To provide a realistic look at inventories.
23. To review adequacy of insurance coverage.
24. To provide the professional knowledge of an external auditor, which is generally superior to the client's bookkeeping experience.

1-24. Based on ISA 200 what are the general principles governing an audit of financial statements? Discuss ethics, professional skepticism, audit scope, business risk and audit risk.

ISA 200 states that an auditor should comply with the *Code of Ethics for Professional Accountants* issued by IFAC (see Chapter 3). The ethical principles governing the auditor's professional responsibilities are: independence, integrity, objectivity, professional *competence* and due care, confidentiality, professional behavior and technical standards.

ISA 200 further states that the auditor should conduct an audit in accordance with International Standards on Auditing. The auditor would plan and perform the audit with an attitude of *professional skepticism* recognizing that circumstances may exist which cause the financial statements to be *materially misstated.*

The term *scope of an audit* refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit. ISA 200 states: "The procedures required to conduct an audit in accordance with ISAs should be determined by the auditor having regard to the requirements of ISAs, relevant professional bodies, legislation, regulation and, where appropriate, the terms of the audit engagement and reporting requirements."

Companies face a variety of *business risks*. Management is responsible for identifying such risks and responding to them. The auditor is concerned primarily with risks that may affect the financial statements.

The risk that causes the greatest concern by the auditor is the risk that the auditor gives a clean audit opinion when the financial statements are materially misstated (known as *audit risk*). The newest revision of ISA 200 states, "The auditor should plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit." The components of audit risk are *inherent risk*, *control risk*, and *detection risk.*

1.6 Types of Audits

1-25. Operational Audits. List four examples of specific operational audits that could be conducted by an internal audit in a manufacturing company. Describe how you would conduct each.

Four specific operation audits that could be conducted by an internal auditor at a manufacturing company include:

1. A review of the operational effectiveness of the receiving department.
2. A review of the operations of the computer system.
3. An audit of the operation of production methods.
4. A review of how manufacturing workers use material.
5. A review of the time it takes to receive payments on accounts receivable.
6. A review of the time between receiving an order and shipping the goods.
7. A determination of the time it takes to handle a customer complaint.
8. Review of the reliability of suppliers.

1-26. Auditing Tasks. Each of the following … (12) … used by a creditor. For each of the above, identify the most likely type of auditor (independent, government, or internal) and the most likely type of audit (financial, compliance, or operational).

The most likely type of auditor and the type of audit for each of the examples are:

EXAMPLE	TYPE OF AUDITOR	TYPE OF AUDIT
1	Independent auditor	Financial statements
2	Government auditor	Compliance
3	Internal auditor	Operational
4	Internal auditor	Operational
5	Government or independent or internal auditor	Compliance or financial statements
6	Internal auditor	Compliance or operational
7	Internal or independent or government	Compliance
8	Independent auditor	Financial statements
9	Government or independent auditor	Compliance
10	Independent auditor	Financial statements
11	Government auditor	Operational
12	Internal or independent auditor	Financial statements

1.7 Types of Auditors

1- 27. Independent External Auditor. Give reasons why … (f) … Lubbock, Texas

The following organizations should have annual audits by an independent external auditor because:
(a) The U.S. Federal Reserve Board. The financial statements should show a true and fair view for its users. An operational audit could show how efficient and effective the organization is, especially the control procedures. An audit might determine compliance with the laws, statutes, policies and procedures of the U.S. government. An audit of such a sensitive organization might help protect the U.S. public against large banking disasters.
(b) A retail company traded on the London Stock Exchange (LSE). A financial statement audit could be useful to provide consistent information to prospective investors. Present shareholders need a report that monitors the company because they have limited control. The investors may want to know if the company meets LSE's Code of Best Practice.
(c) Walt Disney Company. The U.S. Securities and Exchange Commission requires that all publicly traded companies (like Disney) be audited. Walt Disney has investors and runs operations all over the world. Stakeholders are concerned that the company complies with relevant regulations and statutory requirements and that there is adequate disclosure.
(d) Amnesty International is a not-for-profit organization, which raises funds internationally and must comply with certain regulations to retain a tax-free status. A financial audit might be important to people who contribute to the organization in order

to get an accurate picture of how their donations are spent. An audit of how effectively they meet their goals might be helpful to give credibility to the organization.
(e) A small grocery store in Ponta Grossa, Brazil. Although an audit is not required for a small store, the bank which makes loans to the grocery store or the partners of the enterprise may require audited financial statements. A small company can benefit from an operational audit, for instance, to see if they have proper controls and if the inventory is handled effectively. The audit might help the company with their income tax.
(f) A local Baptist church in Lubbock, Texas. A compliance audit to determine if the church is fulfilling the criteria of a non-profit organization might be helpful to tax authorities and members who make contributions. Traditionally churches have little in the way of controls, and an operational audit of controls would probably be helpful in decreasing loss of cash donations. If the church is of a major, organized religion (Baptist or Catholic, for example) a financial audit by the district administration might be required from time to time. A compliance audit might determine if they are using their donated money for the requirements of their congregation.

1.8 Setting Audit Objectives Based on Management Assertions

1-28. Management Assertions and Audit Objectives. The following are management

… (h) … payable discounts is taken.

A. Explain the differences among management assertions and specific audit objectives and their relationships to each other.

Management assertions are implied or expressed representations by management about the classes of transactions and related accounts in the financial statements. ISA 500 classifies three categories of assertions containing nine assertions which are stated in the problem. Specific audit objectives are determined by the auditor for each management assertion. These are done for each account balance to help the auditor determine the specific amount of evidence needed for that account to satisfy the audit objectives.

B. For each specific audit objective, identify the appropriate management assertion.

SPECIFIC AUDIT OBJECTIVE	MANAGEMENT ASSERTION
a. Existing accounts payable are included in the accounts payable balance on the balance sheet date.	4. Completeness
b. Accounts payable are recorded in the proper account.	5. Valuation and allocation
c. Acquisition transactions in the acquisition and payment cycle are recorded in the proper period.	7. Cutoff
d. Accounts payable representing the accounts payable balance on the balance sheet date agree with related subsidiary ledger amounts, and the total is correctly added and agrees with the general ledger.	5. Valuation and allocation 6. Accuracy
e. Accounts in the acquisition and payment cycle are properly disclosed according to IASs.	2. Occurrence 3. Rights and obligations
f. Accounts payable representing the accounts payable balance on the balance sheet date are valued at the correct amount.	5. Valuation and allocation
g. Accounts payable exist.	1. Existence
h. Any allowances for accounts payable discounts is taken.	5. Valuation and allocation

1.9 The Audit Process Model

1-29. Audit Process Model. What are the four Phases of an Audit? Discuss each.

Determine which is the most important of the four and explain why.

The four phases of the audit process model are: Phase I, Client Acceptance; Phase II, Planning; Phase III, Testing and Evidence; and Phase IV, Evaluation and Reporting.

Phase I, Client Acceptance: The client acceptance phase of the audit plan, Phase I, involves determining both acceptance of a client and acceptance by a client as well as deciding on acquiring a new client or continuation of relationship with an existing one and the type and amount of staff required. The procedures involved in this process are: (1) Evaluate the client's background and reasons for the audit. (2) Determine whether the auditor is able to meet the ethical requirements regarding the client. (3) Determine need for other professionals. (4) Communicate with predecessor auditor. (5) Prepare client proposal. (6) Select staff to perform the audit, and (7) Obtain an engagement letter.

Phase II, Planning: Determine the amount and type of evidence and review required to give the auditor assurance that there is no material misstatement of the financial statements. Procedures are: (1) Perform audit procedures to understand the entity and its environment, including the entity's internal control; (2) Assess the risks of material misstatements of the financial statements. (3) Determine materiality; and

(4) Prepare the planning memorandum and audit program, containing the auditor's response to the identified risks.

Phase III, Testing and Evidence: Test for evidence supporting internal controls and the fairness of the financial statements. Procedures are: (1) Tests of controls; (2) Substantive tests of transactions; (3) Analytical procedures; (4) Tests of details of balances. (5) Final evidence accumulation and search for unrecorded liabilities.

Phase IV, Evaluation and Reporting. The phase when the auditor completes the audit and issues an audit report based on the results of the audit. Procedures include (1) Evaluate governance evidence; (2) Perform procedures to identify subsequent events; (3) Review financial statements and other report material; (4) Perform wrap-up procedures; (5) Prepare Matters of Attention for Partners; (6) Report to the board of directors; and (7) Prepare Audit report.

The student may choose any of these as the most important. Most students believe Client Acceptance is the most important because it involves making the decision to accept a client or not. Choosing the right client can make tremendous differences in the success of the audit. Phase III, Testing and Evidence is important because it is these tests that support the fairness of the financial statements.

1-30. <u>Audit Process Model</u>. Based on the standard Audit Process Model, trace the procedures an auditor would use to audit a retail clothing business (continuing client) from the initial client contact to the audit opinion.

Based on the standard Audit Process Model, the procedures an auditor would use to audit a retail clothing business (continuing client) from the initial client contact to the audit opinion are.

1. Acquire knowledge of the client and the industry.
2. Review prior year's work papers.
3. Determine the need for experts or other auditors.
4. Pick audit staff and do a budget
5. Write an engagement letter spelling out the services to be performed.
6. Obtain more detailed company and industry information; perform procedures to obtain knowledge about internal controls. For a retail grocery store this would include examining transactions at the point of sale (cash register) and inventory.
7. Access risk and set materiality.
8. Plan the audit and design the audit program.
9. Perform tests of control and substantive tests (including analytical procedures).
10. Do closing procedures including management representation letters and legal letters.
11. Prepare Matters for the Attention of Partners
12. Prepare report for board of directors.
13. Based on the evidence, develop an audit opinion and a management letter to the client.

1.10 International Public Accountancy Firms

1-31. Auditor Responsibility. Four friends who are auditing student's … client's responsibility. Which student is correct and why?

Yalanda is correct. The CLIENT has the responsibility for the adequacy of disclosure in the financial statements and footnotes. The financial statements are the responsibility of management – the auditor's responsibility is to lend them credibility. The partner in charge of the audit is the most responsible for the correctness of the audit. If the proper procedures are not followed it is the partner in charge who must take the blame. Even though the staff auditor may draft the wording of the disclosure footnotes and suggest modifications in the financial statements, they are not responsible for the adequacy of disclosure.

CASES

1-32. Audit Objectives and Financial Statement Accounts. Look at the financial statements … defective products.

In the table is a list of typical accounts on a balance sheet and the financial statement assertions (existence, rights and obligations, occurrence, completeness, valuation and allocation, accuracy, cutoff, classification, and understandability) that might be associated with those accounts. Typically financial statement assertions are associated with balance sheet accounts, but if the student uses income statement accounts this is okay. The student should discuss why the accounts are associated with that assertion. It could be argued that all objectives should be included in all accounts.

ASSETS	ASSERTIONS
Short-term investments	all
Bank and cash	All
Inventories	All
Accounts receivable	All
less allowances for doubtful accounts	Valuation and allocation
Investments	All
Long-term loan receivables	All
Property, plant and equipment	All
Goodwill and other intangible assets	existence, rights and obligations, occurrence, valuation and allocation,
Other non-current assets	all

LIABILITIES	
Accounts payable	existence, rights and obligations, occurrence, completeness, valuation and allocation
accrued liabilities	All
Short-term borrowings	existence, rights and obligations, occurrence, completeness, valuation and allocation
Current portion of long-term debt	existence, rights and obligations, occurrence, completeness, valuation and allocation
Advance payments	existence, rights and obligations, occurrence, valuation and allocation
Provision for discontinued operations	Valuation and allocation, occurrence
Accrued Product Liability	Valuation and allocation, existence, completeness,
Long-term debt	existence, rights and obligations, occurrence, completeness, valuation and allocation
Other Long-term liabilities	existence, rights and obligations, occurrence, completeness, valuation and allocation
SHAREHOLDERS' EQUITY	
Share capital	existence, rights and obligations, occurrence, completeness, valuation and allocation
Other restricted equity	occurrence, valuation and allocation
Treasury shares	existence, completeness, valuation and allocation
Untaxed reserves	Valuation and allocation

1-33. International Standards on Auditing (ISA). Download the latest version of *Handbook Of International Auditing, Assurance, And Ethics Pronouncements* from the IFAC website www.IFAC.org. Pick one ISA and discuss how that standard would influence the work of an auditor.

Students may pick any of the standards and may have different things to say. This is meant as an open question to get the student familiar with the IFAC handbook. It is downloadable and free, so everyone should have a copy.

1-34. Qualifications of Auditors. From the library get a copy of the EC Eighth Company Law Directive that is about the qualifications and work of auditors. Based on the Eighth Directive, answer the following questions.

A. How many years of work experience must an auditor have before he or she can receive an auditing credential?

A. An auditor must have 3 years of work experience before he or she can receive an auditing credential.

B. How many years of education must an auditor have before certification?

B. An auditor must have a university or similar level degree before certification.

C. Name some of the requirements for the work of auditors.

C. Examples are competence, independence.

1-35. Due Professional Care. Discuss lawsuits resulting from negligence of "Due professional Care".

A. Consult the library, a data base like Lexis-Nexis or the Internet for lawsuits resulting from negligence of "Due Professional Care". Discuss at least two.

B. Describe briefly the court's final conclusion and results from the court decision.

A.& B This case is subjective. Students may search a database such as Lexis-Nexis, ABI Inform, etc. and may find a variety of cases. As an example, a search of Lexis – Nexis for lawsuits resulting from negligence of "Due Professional Care" in May 2004 yields 191 articles, some of which are below:

American Bankruptcy Institute Journal. 1995. "The CPA as Expert Witness – Does Liability Loom?", *American Bankruptcy Institute Journal* 1995.

Dennis Applegate. 2004. "Training New Auditors". *The Internal Auditor***.** Altamonte Springs: Apr. Vol. 61, Iss. 2; p. 66.

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Roger J. Buffington. 1997. " Note: A Proposed Standard Of Common Law Liability For The Public Accounting Profession". *Southern California Interdisciplinary Law Journal*, Summer. no 5, p. 485.

William J. Casazza. 1985. "Recent Development: Rosenblum, Inc. V. Adler: CPAS Liable At Common Law To Certain Reasonably Foreseeable Third Parties Who Detrimentally Rely On Negligently Audited Financial Statements". *Cornell Law Review*, January. vol. 70, p. 335.

Lewis P. Checchia. 1993. "Accountants' Liability To Third Parties Under Bily V. Arthur Young & Company: Does A Watchdog Need Protection?". *Villanova Law Review*, no. 38, p. 249.

Marie L. Coppolino. 1995. "Financial Services Regulation: A Mid-Decade Review: Note: Checkosky, Rule 2(E) And The Auditor: How Should The Securities And

Exchange Commission Define Its Standard Of Improper Professional Conduct?" *Fordham Law Review*, no. 63, p. 2227.

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Richard A. Glaser & Leslee M. Lewis. 1995. "Redefining the Professional: The Policies and Unregulated Development of Consultant Malpractice Liability". University of Detroit Mercy Law Review, Spring. no. 72, p. 563.

Willis W. Hagen II. 1988. "Forum: Accountants' Common Law Negligence Liability To Third Parties", *Columbia Business Law Review*. p. 181.

Jack E. Karns, Edwin A. Doty and Steven S. Long. 1995. "Accountant and Attorney Liability as 'Sellers' of Securities Under Section 12(2) of the Securities Act of 1933: Judicial Rejection of the Statutory, Collateral Participant Status Cause of Action". *Nebraska Law Review*. no. 74, p. 1.

Gary Lawson and Tamara Mattison. 1991 "A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation". *Ohio State Law Journal*. no. 52, p. 1309.

Jeffrey N. Leibell. 1991. "Note: Accountants' Liability In The Savings And Loan Crisis: An Argument In Favor Of Affirmative Defenses". *Columbia Business Law Review*. p. 71.

Reid Anthony Muoio. 1994."An Independent Auditor's Suit For Wrongful Discharge", *Albany Law Review*, vol 58, p. 413.

Denise M. Orlinski, 1994. "An Accountant's Liability To Third Parties: Bily V. Arthur Young & Co.". *DePaul Law Review*, Spring, vol 43, p. 859.

Richard W. Painter and Jennifer E. Duggan. 1996. "Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation". *Southern Methodist University Law Review*. September / October. no. 50, p. 225.

Richard S. Panttaja. 1994. "Accountants' Duty To Third Parties: A Search For A Fair Doctrine Of Liability", *Stetson Law Review*, Summer. no. 23, p. 927.

Robert A. Prentice. 1995. “Can The Contributory Negligence Defense Contribute To A Defusing Of The Accountants’ Liability Crisis?”. *Wisconsin International Law Journal*. Spring. no 13, p. 359.

Robert Anthony Reiley. 1997. “Symposium: Environmental Law And Business In The 21st Century: The New Paradigm: ISO 14000 and Its Place in Regulatory Reform*”. The Journal of Corporation Law*, Spring. no 22, p. 535.

Jodi B. Scherl. 1994. “Comment: Evolution Of Auditor Liability To Noncontractual Third Parties: Balancing The Equities And Weighing The Consequences”. *The American University Law Review*. Fall, number 44, p. 255.

Joel Seligman. 1993. “The Fifth Abraham L. Pomerantz Lecture: The New Corporate Law”, *Brooklyn Law Review*, Spring. vol 59, p. 1.

Joel Seligman. 1993.”Accounting And The New Corporate Law”. *Washington & Lee Law Review*. Summer. no. 50, p. 943.

Lorie Soares, 1988. “Note: The Big Eight, Management Consulting And Independence: Myth Or Reality?”, *Southern California Law Review*, no. 61, p. 1511.

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