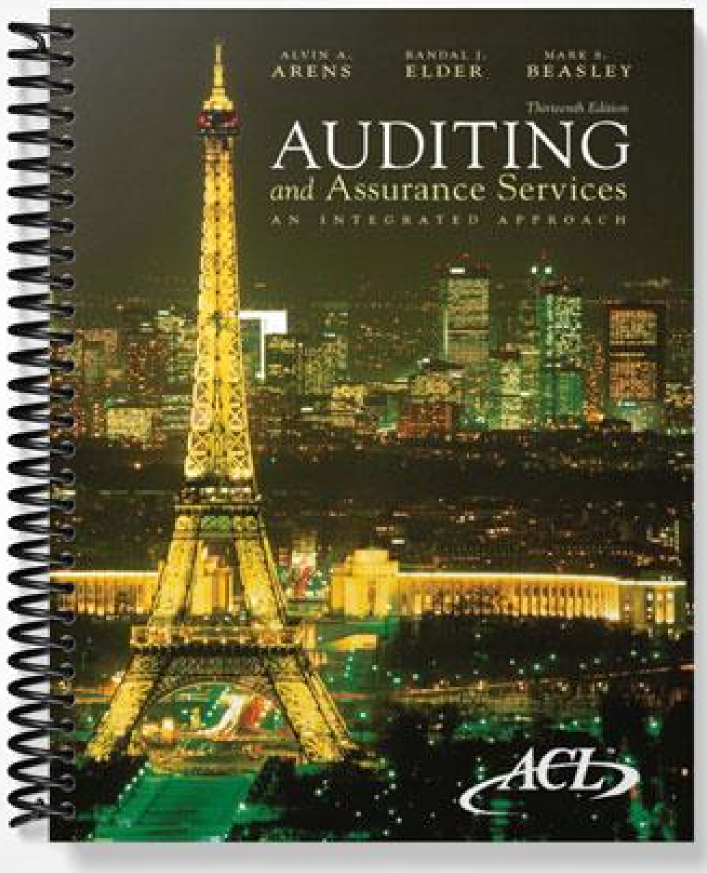
SOLUTIONS MANUAL



Chapter 1

The Demand for Audit and Other Assurance Services

■ Review Questions

1-1 The relationship among audit services, attestation services, and assurance services is reflected in Figure 1-3 on page 13 of the text. An assurance service is an independent professional service to improve the quality of information for decision makers. An attestation service is a form of assurance service in which the CPA firm issues a report about the reliability of an assertion that is the responsibility of another party. Audit services are a form of attestation service in which the auditor expresses a written conclusion about the degree of correspondence between information and established criteria.

The most common form of audit service is an audit of historical financial statements, in which the auditor expresses a conclusion as to whether the financial statements are presented in conformity with generally accepted accounting principles. An example of an attestation service is a report on the effectiveness of an entity's internal control over financial reporting. There are many possible forms of assurance services, including services related to business performance measurement, health care performance, and information system reliability.

1-2 An independent audit is a means of satisfying the need for reliable information on the part of decision makers. Factors of a complex society which contribute to this need are:

1. Remoteness of information
    a. Owners (stockholders) divorced from management
    b. Directors not involved in day-to-day operations or decisions
    c. Dispersion of the business among numerous geographic locations and complex corporate structures
2. Biases and motives of provider
    a. Information will be biased in favor of the provider when his or her goals are inconsistent with the decision maker's goals.
3. Voluminous data
    a. Possibly millions of transactions processed daily via sophisticated computerized systems
    b. Multiple product lines
    c. Multiple transaction locations
4. Complex exchange transactions
    a. New and changing business relationships lead to innovative accounting and reporting problems
    b. Potential impact of transactions not quantifiable, leading to increased disclosures

1-3 1. *Risk-free interest rate* This is approximately the rate the bank could earn by investing in U.S. treasury notes for the same length of time as the business loan.

2. *Business risk for the customer* This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions such as a recession, poor management decisions, or unexpected competition in the industry.

3. *Information risk* This risk reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements.

Auditing has no effect on either the risk-free interest rate or business risk. However, auditing can significantly reduce information risk.

1-4 The four primary causes of information risk are remoteness of information, biases and motives of the provider, voluminous data, and the existence of complex exchange transactions.

The three main ways to reduce information risk are:

1. User verifies the information.
2. User shares the information risk with management.
3. Audited financial statements are provided.

The advantages and disadvantages of each are as follows:

	ADVANTAGES	**DISADVANTAGES**
USER VERIFIES INFORMATION	1. User obtains information desired. 2. User can be more confident of the qualifications and activities of the person getting the information.	1. High cost of obtaining information. 2. Inconvenience to the person providing the information because large number of users would be on premises.
USER SHARES INFORMATION RISK WITH MANAGEMENT	1. No audit costs incurred.	1. User may not be able to collect on losses.
AUDITED FINANCIAL STATEMENTS ARE PROVIDED	1. Multiple users obtain the information. 2. Information risk can usually be reduced sufficiently to satisfy users at reasonable cost. 3. Minimal inconvenience to management by having only one auditor.	1. May not meet needs of certain users. 2. Cost may be higher than the benefits in some situations, such as for a small company.

1-5 To do an audit, there must be information in a *verifiable form* and some standards (*criteria*) by which the auditor can evaluate the information. Examples of established criteria include generally accepted accounting principles and the Internal Revenue Code. Determining the degree of correspondence between information and established criteria is determining whether a given set of information is in accordance with the established criteria. The information for Jones Company's tax return is the federal tax returns filed by the company. The established criteria are found in the Internal Revenue Code and all interpretations. For the audit of Jones Company's financial statements the information is the financial statements being audited and the established criteria are generally accepted accounting principles.

1-6 The primary evidence the internal revenue agent will use in the audit of the Jones Company's tax return include all available documentation and other information available in Jones' office or from other sources. For example, when the internal revenue agent audits taxable income, a major source of information will be bank statements, the cash receipts journal and deposit slips. The internal revenue agent is likely to emphasize unrecorded receipts and revenues. For expenses, major sources of evidence are likely to be cancelled checks, vendors' invoices and other supporting documentation.

1-7 This apparent paradox arises from the distinction between the function of auditing and the function of accounting. The accounting function is the recording, classifying and summarizing of economic events to provide relevant information to decision makers. The rules of accounting are the criteria used by the auditor for evaluating the presentation of economic events for financial statements and he or she must therefore have an understanding of generally accepted accounting principles (GAAP), as well as auditing standards. The accountant need not, and frequently does not, understand what auditors do, unless he or she is involved in doing audits, or has been trained as an auditor.

1-8

	OPERATIONAL AUDITS	COMPLIANCE AUDITS	AUDITS OF FINANCIAL STATEMENTS
PURPOSE	To evaluate whether operating procedures are efficient and effective	To determine whether the client is following specific procedures set by higher authority	To determine whether the overall financial statements are presented in accordance with specified criteria (usually GAAP)
USERS OF AUDIT REPORT	Management of organization	Authority setting down procedures, internal or external	Different groups for different purposes — many outside entities
NATURE	Highly nonstandard; often subjective	Not standardized, but specific and usually objective	Highly standardized
PERFORMED BY: **CPAs**	Frequently	Occasionally	Almost universally
GAO AUDITORS	Frequently	Frequently	Occasionally
IRS AUDITORS	Never	Universally	Never
INTERNAL AUDITORS	Frequently	Frequently	Frequently

1-9 Five examples of specific operational audits that could be conducted by an internal auditor in a manufacturing company are:

1. Examine employee time cards and personnel records to determine if sufficient information is available to maximize the effective use of personnel.
2. Review the processing of sales invoices to determine if it could be done more efficiently.
3. Review the acquisitions of goods, including costs, to determine if they are being purchased at the lowest possible cost considering the quality needed.

1-9 (continued)

4. Review and evaluate the efficiency of the manufacturing process.
5. Review the processing of cash receipts to determine if they are deposited as quickly as possible.

1-10 When auditing historical financial statements, an auditor must have a thorough understanding of the client and its environment. This knowledge should include the client's regulatory and operating environment, business strategies and processes, and measurement indicators. This strategic understanding is also useful in other assurance or consulting engagements. For example, an auditor who is performing an assurance service on information technology would need to understand the client's business strategies and processes related to information technology, including such things as purchases and sales via the Internet. Similarly, a practitioner performing a consulting engagement to evaluate the efficiency and effectiveness of a client's manufacturing process would likely start with an analysis of various measurement indicators, including ratio analysis and benchmarking against key competitors.

1-11 The major differences in the scope of audit responsibilities are:

1. CPAs perform audits in accordance with auditing standards of published financial statements prepared in accordance with generally accepted accounting principles.
2. GAO auditors perform compliance or operational audits in order to assure the Congress of the expenditure of public funds in accordance with its directives and the law.
3. IRS agents perform compliance audits to enforce the federal tax laws as defined by Congress, interpreted by the courts, and regulated by the IRS.
4. Internal auditors perform compliance or operational audits in order to assure management or the board of directors that controls and policies are properly and consistently developed, applied and evaluated.

1-12 The four parts of the Uniform CPA Examination are: Auditing and Attestation, Financial Accounting and Reporting, Regulation, and Business Environment and Concepts.

1-13 It is important for CPAs to be knowledgeable about e-commerce technologies because more of their clients are rapidly expanding their use of e-commerce. Examples of commonly used e-commerce technologies include purchases and sales of goods through the Internet, automatic inventory reordering via direct connection to inventory suppliers, and online banking. CPAs who perform audits or provide other assurance services about information generated with these technologies need a basic knowledge and understanding of information technology and e-commerce in order to identify and respond to risks in the financial and other information generated by these technologies.

■ Multiple Choice Questions From CPA Examinations

1-14	a.	(3)	b.	(2)	c.	(2)	d.	(3)
1-15	a.	(2)	b.	(3)	c.	(4)	d.	(3)

■ Discussion Questions And Problems

1-16 a. The relationship among audit services, attestation services and assurance services is reflected in Figure 1-3 on page 13 of the text. Audit services are a form of attestation service, and attestation services are a form of assurance service. In a diagram, audit services are located within the attestation service area, and attestation services are located within the assurance service area.

b.

1. (1) Audit of historical financial statements
2. (2) An attestation service other than an audit service; or
   (3) An assurance service that is not an attestation service (*WebTrust* developed from the AICPA Special Committee on Assurance Services, but the service meets the criteria for an attestation service.)
3. (2) An attestation service other than an audit service
4. (2) An attestation service other than an audit service
5. (2) An attestation service other than an audit service
6. (2) An attestation service that is not an audit service (Review services are a form of attestation, but are performed according to Statements on Standards for Accounting and Review Services.)
7. (2) An attestation service other than an audit service
8. (2) An attestation service other than an audit service
9. (3) An assurance service that is not an attestation service

1-17 a. The interest rate for the loan that requires a review report is lower than the loan that did not require a review because of lower information risk. A review report provides moderate assurance to financial statement users, which lowers information risk. An audit report provides further assurance and lower information risk. As a result of reduced information risk, the interest rate is lowest for the loan with the audit report.

b. Given these circumstances, Vial-tek should select the loan from City First Bank that requires an annual audit. In this situation, the additional cost of the audit is less than the reduction in interest due to lower information risk. The following is the calculation of total costs for each loan:

1-17 (continued)

LENDER	CPA SERVICE	COST OF CPA SERVICES	ANNUAL INTEREST	ANNUAL LOAN COST
Existing loan	None	0	$ 332,500	$ 332,500
First National Bank	Review	$ 20,000	$ 297,500	$ 317,500
City First Bank	Audit	$ 45,000	$ 262,500	$ 307,500

c. Vial-tek should select the loan from First National Bank due to the higher cost of the audit and the reduced interest rate for the loan from First National Bank. The following is the calculation of total costs for each loan:

LENDER	CPA SERVICE	COST OF CPA SERVICES	ANNUAL INTEREST	ANNUAL LOAN COST
Existing loan	None	0	$ 332,500	$ 332,500
First National Bank	Review	$ 20,000	$ 280,000	$ 300,000
City First Bank	Audit	$ 50,000	$ 262,500	$ 312,500

d. Vial-tek may desire to have an audit because of the many other positive benefits that an audit provides. The audit will provide Vial-tek's management with assurance about annual financial information used for decision-making purposes. The audit may detect errors or fraud, and provide management with information about the effectiveness of controls. In addition, the audit may result in recommendations to management that will improve efficiency or effectiveness.

e. The auditor must have a thorough understanding of the client and its environment, including the client's e-commerce technologies, industry, regulatory and operating environment, suppliers, customers, creditors, and business strategies and processes. This thorough analysis helps the auditor identify risks associated with the client's strategies that may affect whether the financial statements are fairly stated. This strategic knowledge of the client's business often helps the auditor identify ways to help the client improve business operations, thereby providing added value to the audit function.

1-18 a. The services provided by Consumers Union are very similar to assurance services provided by CPA firms. The services provided by Consumers Union and assurance services provided by CPA firms are designed to improve the quality of information for decision makers. CPAs are valued for their independence, and the reports provided by Consumers Union are valued because Consumers Union is independent of the products tested.

1-18 (continued)

b. The concepts of information risk for the buyer of an automobile and for the user of financial statements are essentially the same. They are both concerned with the problem of unreliable information being provided. In the case of the auditor, the user is concerned about unreliable information being provided in the financial statements. The buyer of an automobile is likely to be concerned about the manufacturer or dealer providing unreliable information.

c. The four causes of information risk are essentially the same for a buyer of an automobile and a user of financial statements:
   (1) *Remoteness of information* It is difficult for a user to obtain much information about either an automobile manufacturer or the automobile itself without incurring considerable cost. The automobile buyer does have the advantage of possibly knowing other users who are satisfied or dissatisfied with a similar automobile.
   (2) *Biases and motives of provider* There is a conflict between the automobile buyer and the manufacturer. The buyer wants to buy a high quality product at minimum cost whereas the seller wants to maximize the selling price and quantity sold.
   (3) *Voluminous data* There is a large amount of available information about automobiles that users might like to have in order to evaluate an automobile. Either that information is not available or too costly to obtain.
   (4) *Complex exchange transactions* The acquisition of an automobile is expensive and certainly a complex decision because of all the components that go into making a good automobile and choosing between a large number of alternatives.

d. The three ways users of financial statements and buyers of automobiles reduce information risk are also similar:
   (1) *User verifies information him or herself* That can be obtained by driving different automobiles, examining the specifications of the automobiles, talking to other users and doing research in various magazines.
   (2) *User shares information risk with management* The manufacturer of a product has a responsibility to meet its warranties and to provide a reasonable product. The buyer of an automobile can return the automobile for correction of defects. In some cases a refund may be obtained.
   (3) *Examine the information prepared by Consumer Reports* This is similar to an audit in the sense that independent information is provided by an independent party. The information provided by *Consumer Reports* is comparable to that provided by a CPA firm that audited financial statements.

1-19 a. The following parts of the definition of auditing are related to the narrative:

(1) Virms is being asked to issue a report about qualitative and quantitative information for trucks. The trucks are therefore the *information* with which the auditor is concerned.

(2) There are four *established criteria* which must be evaluated and reported by Virms: existence of the trucks on the night of June 30, 2009, ownership of each truck by Regional Delivery Service, physical condition of each truck and fair market value of each truck.

(3) Susan Virms will *accumulate* and *evaluate* four types of *evidence*:

(a) Count the trucks to determine their existence.

(b) Use registrations documents held by Oatley for comparison to the serial number on each truck to determine ownership.

(c) Examine the trucks to determine each truck's physical condition.

(d) Examine the blue book to determine the fair market value of each truck.

(4) Susan Virms, CPA, appears qualified, as a *competent, independent person*. She is a CPA, and she spends most of her time auditing used automobile and truck dealerships and has extensive specialized knowledge about used trucks that is consistent with the nature of the engagement.

(5) The *report results* are to include:

(a) which of the 35 trucks are parked in Regional's parking lot the night of June 30.

(b) whether all of the trucks are owned by Regional Delivery Service.

(c) the condition of each truck, using established guidelines.

(d) fair market value of each truck using the current blue book for trucks.

b. The only parts of the audit that will be difficult for Virms are:

(1) Evaluating the condition, using the guidelines of poor, good, and excellent. It is highly subjective to do so. If she uses a different criterion than the "blue book," the fair market value will not be meaningful. Her experience will be essential in using this guideline.

(2) Determining the fair market value, unless it is clearly defined in the blue book for each condition.

1-20 a. The major advantages and disadvantages of a career as an IRS agent, CPA, GAO auditor, or an internal auditor are:

EMPLOYMENT	ADVANTAGES	DISADVANTAGES
INTERNAL REVENUE AGENT	1. Extensive training in individual, corporate, gift, trust and other taxes is available with concentration in area chosen. 2. Hands-on experience with sophisticated selection techniques.	1. Experience limited to taxes. 2. No experience with operational or financial statement auditing. 3. Training is not extensive with any business enterprise.
CPA	1. Extensive training in audit of financial statements, compliance auditing and operational auditing. 2. Opportunity for experience in auditing, tax consulting, and management consulting practices. 3. Experience in a diversity of enterprises and industries with the opportunity to specialize in a specific industry.	1. Exposure to taxes and to the business enterprise may not be as in-depth as the internal revenue agent or the internal auditor. 2. Likely to be less exposed to operational auditing than is likely for internal auditors.
GAO AUDITOR	1. Increasing opportunity for experience in operational auditing. 2. Exposure to highly sophisticated statistical sampling and computer auditing techniques.	1. Little exposure to diversity of enterprises and industries. 2. Bureaucracy of federal government.
INTERNAL AUDITOR	1. Extensive exposure to all segments of the enterprise with which employed. 2. Constant exposure to one industry presenting opportunity for expertise in that industry. 3. Likely to have exposure to compliance, financial and operational auditing.	1. Little exposure to taxation and the audit thereof. 2. Experience is limited to one enterprise, usually within one or a limited number of industries.

(b) Other auditing careers that are available are:

- Auditors within many of the branches of the federal government (e.g., Atomic Energy Commission)
- Auditors for many state and local government units (e.g., state insurance or bank auditors)

1-21 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.	IRS	Compliance
2.	GAO	Operational
3.	Internal auditor or CPA	Operational
4.	CPA or Internal auditor	Financial statements
5.	GAO	Operational
6.	CPA	Financial statements
7.	GAO	Financial statements
8.	IRS	Compliance
9.	CPA	Financial statements
10.	Internal auditor or CPA	Compliance
11.	Internal auditor or CPA	Financial statements
12.	GAO	Compliance

1-22 a. The conglomerate should either engage the management advisory services division of a CPA firm or its own internal auditors to conduct the operational audit.

b. The auditors will encounter problems in establishing criteria for evaluating the actual quantitative events and in setting the scope to include all operations in which significant inefficiencies might exist. In writing the report, the auditors must choose proper wording to state that no financial audit was performed, that the procedures were limited in scope and that the results reported do not necessarily include all the inefficiencies that might exist.

■ Internet Problem Solution: Sarbanes—Oxley Act Internal Control Reporting Requirements

1-1 The Sarbanes-Oxley Act (SOX), also known as the Public Company Accounting Reform and Investor Protection Act, was signed into law on July 30, 2002. Considered by many to be the most sweeping corporate reform legislation since the 1933 and 1934 securities legislation, SOX ushered in a variety of new requirements including reporting on internal control over financial reporting. The newly created Public Company Accounting Oversight Board (PCAOB) was charged with establishing standards applicable to audits of internal control over financial reporting. Visit the PCAOB's website (below) to review the full text of SOX to answer the following questions:

[http://www.pcaobus.org/About_the_PCAOB/Sarbanes_Oxley_Act_of_2002.pdf]

1. According to Section 404 of SOX a public company's annual report must include an internal control report. What are the two required elements of management's report on internal control?

Internet Problem 1-1 (continued)

Answer: According to Section 404 the two required elements of management's report on internal control are:

a. a statement that management is responsible for establishing and maintaining an adequate internal control structure and procedures for financial reporting.

b. an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting.

2. What obligation does a public company's auditor have with respect to internal control over financial reporting according to Section 404?

   Answer: With respect to the internal control assessment prepared by management, the company's auditing firm that prepares or issues the audit report for the company shall attest to, and report on, the assessment made by the management of the issuer. Section 404 indicates that the attestation should not be a separate engagement, which means that it is to be integrated with the audit of the financial statements.

(**Note**: Internet problems address current issues using Internet sources. Because Internet sites are subject to change, Internet problems and solutions may change. Current information on Internet problems is available at www.pearsonhighered.com/arens).