c1

Student: ____

1. Which of the following best describes the main reason that independent auditors report on a company's financial statements?
A. Management fraud may exist within the company and it is likely that the independent auditors will detect it.
B. Users of financial statements need confidence in the numbers they base their decisions on.
C. Misstated account balances may be corrected as the result of the independent audit work.
D. The accounting system from which the financial statements are derived may have a poorly designed system of internal control.

2. Reducing information risk means the same as ________.
A. serving the public interest
B. monitoring economic activities
C. improving the credibility of information
D. ensuring generally accepted accounting principles are used to measure profit

3. The underlying conditions that create demand by users for reliable financial information include the fact that ________.
A. more reliable information will allow investors to calculate the rate of return on their investment
B. users are separated from accounting records by distance and time
C. governments rely on such information to create tax policies
D. there is a need for the expression of an opinion as to the fairness of financial statements

4. The auditee is the person or company ________.
A. who will use the audited information
B. who performs an audit
C. who pays the audit fee
D. whose information is being audited

5. Professional judgment is a widely used concept in accounting and auditing. How is it defined in the audit standards?
A. There is no definition of professional judgment in the auditing standards.
B. Professional judgment includes consideration of key principles and concepts of disciplines underlying the professional standards, such as economics, psychology, law, finance, statistics and philosophy.
C. Professional judgment means reaching a complex decision by incorporating auditing standards, accounting standards, and rules of professional ethics in a coherent manner.
D. Professional judgment involves specialized concepts and language integrating several disciplines in order to provide appropriate justification for audit decisions.

6. What is the primary role and responsibility of independent external auditors?
A. to prepare a company's annual financial statements and notes.
B. to perform an audit and provide an opinion on the financial statements of a company.
C. to provide business consulting advice to audit clients.
D. to obtain an understanding of a client's internal control system and prepare a report for management about control weaknesses.

7. The risk that financial statements may be materially false and misleading is called ________.
A. business risk
B. information risk
C. client risk
D. risk assessment

8. Three-party accountability is a special case of which economic theory problem?
A. independence
B. agency
C. business risk
D. forensics

9. The agency problem can be mitigated by ________.
A. greater transparency
B. a higher degree of independence
C. design of contracts
D. internal auditing

10. In operational auditing, the auditor studies business operations and makes recommendations about all of the following EXCEPT ________.
A. economic and efficient use of resources
B. effective achievement of business objectives
C. the fairness of the financial statements
D. compliance with company policies

11. Auditors on staff in the Office of the Auditor General (OAG) are considered to be external auditors with respect to the government agencies they audit because the OAG is ________.
A. organizationally independent
B. the accounting and auditing agency of the Canadian Senate
C. funded by the federal government
D. guided by standards similar to GAAS

12. In addition to the audit of financial statements, governmental auditing may also include audits of efficiency, effectiveness, and ________.
A. fraud
B. accuracy
C. economy
D. adequacy

13. An example of a forensic accounting assignment might be ________.
A. to ensure compliance with specific legislation
B. to provide an opinion about the effectiveness of a government program
C. to provide assurance about the fairness of prospective financial information included in an initial public offering document
D. to estimate the value of inventory lost in a warehouse fire

14. International harmonization is also known as ________.
A. convergence
B. harmony
C. independence
D. critical thinking

15. Since financial decision makers usually obtain accounting information from companies wanting loans or selling stock, this creates a potential ________.
A. agency problem
B. conflict of interest
C. harmonization problem
D. expectations gap

16. The difference between what the public expects of auditors and what auditors can actually deliver is known as ________.
A. forensics
B. an expectations gap
C. a business risk
D. an information risk

17. The role of the auditor is to satisfy users' demand for reliable information.
True False

18. The concept of three-party accountability means that the auditor is expected to act in the interests of the party paying the audit fee.
True False

19. The three underlying conditions affecting users' demand for accounting information are complexity, reliability, and completeness.
True False

20. The assurance function involves the lending of credibility to financial information.
True False

21. Business risk is the risk that the financial statements do not reflect the economic substance of business activities.
True False

22. A material misstatement is one that would affect a user's decision making.
True False

23. Forensic accounting does not include fraud auditing.
True False

24. An attest engagement involves a public accountant affirming the validity of an assertion.
True False

25. Internal auditing is an independent activity designed to add value and improve an organization's operations.
True False

26. Value-for-money audits include testing of compliance with laws and regulations.
True False

27. Accounting risk is the part of information risk that is due to incorrectly predicting future events.
True False

28. There are no restrictions on the type of business advisory services a PA firm can provide to a nonaudit client.
True False

29. Why is three-party accountability an important distinguishing feature of auditing?

30. Discuss the underlying conditions affecting users' demand for accounting information.

31. What is the difference between the American Accounting Association's (AAA) definition of auditing and the Canadian Institute of Chartered Accountants' (CICA) objectives of financial statement auditing?

32. What is information risk?

33. What is an attest engagement?

34. When does an agency problem occur?

35. What is a direct reporting engagement?

36. What is operational auditing and who performs it?

37. Discuss the nature of value-for-money audits and give three examples of its application.

38. Discuss the conflict between the need for an audit firm to perform quality services and its desire to make a profit in the context of the investor's need for reliable information.

c1 Key

1. *(p. 3)* Which of the following best describes the main reason that independent auditors report on a company's financial statements?
A. Management fraud may exist within the company and it is likely that the independent auditors will detect it.
B. Users of financial statements need confidence in the numbers they base their decisions on.
C. Misstated account balances may be corrected as the result of the independent audit work.
D. The accounting system from which the financial statements are derived may have a poorly designed system of internal control.

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-01 Explain the importance of auditing.
Smieliauskas - Chapter 01 #1

2. *(p. 5)* Reducing information risk means the same as ________.
A. serving the public interest
B. monitoring economic activities
C. improving the credibility of information
D. ensuring generally accepted accounting principles are used to measure profit

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-01 Explain the importance of auditing.
Smieliauskas - Chapter 01 #2

3. *(p. 6)* The underlying conditions that create demand by users for reliable financial information include the fact that ________.
A. more reliable information will allow investors to calculate the rate of return on their investment
B. users are separated from accounting records by distance and time
C. governments rely on such information to create tax policies
D. there is a need for the expression of an opinion as to the fairness of financial statements

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #3

4. *(p. 7)* The auditee is the person or company ________.
A. who will use the audited information
B. who performs an audit
C. who pays the audit fee
D. whose information is being audited

Blooms Taxonomy: Comprehension
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #4

5. *(p. 8)* Professional judgment is a widely used concept in accounting and auditing. How is it defined in the audit standards?
A. There is no definition of professional judgment in the auditing standards.
B. Professional judgment includes consideration of key principles and concepts of disciplines underlying the professional standards, such as economics, psychology, law, finance, statistics and philosophy.
C. Professional judgment means reaching a complex decision by incorporating auditing standards, accounting standards, and rules of professional ethics in a coherent manner.
D. Professional judgment involves specialized concepts and language integrating several disciplines in order to provide appropriate justification for audit decisions.

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #5

6. *(p. 10)* What is the primary role and responsibility of independent external auditors?
A. to prepare a company's annual financial statements and notes.
B. to perform an audit and provide an opinion on the financial statements of a company.
C. to provide business consulting advice to audit clients.
D. to obtain an understanding of a client's internal control system and prepare a report for management about control weaknesses.

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #6

7. *(p. 12)* The risk that financial statements may be materially false and misleading is called ________.
A. business risk
B. information risk
C. client risk
D. risk assessment

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-03 Explain the role of auditing in information risk reduction.
Smieliauskas - Chapter 01 #7

8. *(p. 5)* Three-party accountability is a special case of which economic theory problem?
A. independence
B. agency
C. business risk
D. forensics

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-01 Explain the importance of auditing.
Smieliauskas - Chapter 01 #8

9. *(p. 5)* The agency problem can be mitigated by ________.
A. greater transparency
B. a higher degree of independence
C. design of contracts
D. internal auditing

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-01 Explain the importance of auditing.
Smieliauskas - Chapter 01 #9

10. *(p. 15)* In operational auditing, the auditor studies business operations and makes recommendations about all of the following EXCEPT ________.
A. economic and efficient use of resources
B. effective achievement of business objectives
C. the fairness of the financial statements
D. compliance with company policies

Blooms Taxonomy: Knowledge recall
Difficulty: Medium
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #10

11. *(p. 15)* Auditors on staff in the Office of the Auditor General (OAG) are considered to be external auditors with respect to the government agencies they audit because the OAG is ________.
A. organizationally independent
B. the accounting and auditing agency of the Canadian Senate
C. funded by the federal government
D. guided by standards similar to GAAS

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #11

12. *(p. 16)* In addition to the audit of financial statements, governmental auditing may also include audits of efficiency, effectiveness, and ________.
A. fraud
B. accuracy
C. economy
D. adequacy

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #12

13. *(p. 18)* An example of a forensic accounting assignment might be ________.
A. to ensure compliance with specific legislation
B. to provide an opinion about the effectiveness of a government program
C. to provide assurance about the fairness of prospective financial information included in an initial public offering document
D. to estimate the value of inventory lost in a warehouse fire

Blooms Taxonomy: Application
Difficulty: Medium
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #13

14. *(p. 22)* International harmonization is also known as ________.
A. convergence
B. harmony
C. independence
D. critical thinking

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-05 Provide an overview of international auditing and its impact on Canadian auditing standards.
Smieliauskas - Chapter 01 #14

15. *(p. 7)* Since financial decision makers usually obtain accounting information from companies wanting loans or selling stock, this creates a potential ________.

A. agency problem
B. conflict of interest
C. harmonization problem
D. expectations gap

Blooms Taxonomy: Knowledge recall
Difficulty: Medium
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #15

16. *(p. 10)* The difference between what the public expects of auditors and what auditors can actually deliver is known as ________.

A. forensics
B. an expectations gap
C. a business risk
D. an information risk

Blooms Taxonomy: Knowledge recall
Difficulty: Medium
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #16

17. *(p. 7)* The role of the auditor is to satisfy users' demand for reliable information.
TRUE

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #17

18. *(p. 4)* The concept of three-party accountability means that the auditor is expected to act in the interests of the party paying the audit fee.
FALSE

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-01 Explain the importance of auditing.
Smieliauskas - Chapter 01 #18

19. *(p. 6)* The three underlying conditions affecting users' demand for accounting information are complexity, reliability, and completeness.
FALSE

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #19

20. *(p. 8)* The assurance function involves the lending of credibility to financial information.
TRUE

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #20

21. *(p. 11)* Business risk is the risk that the financial statements do not reflect the economic substance of business activities.
FALSE

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-03 Explain the role of auditing in information risk reduction.
Smieliauskas - Chapter 01 #21

22. *(p. 12)* A material misstatement is one that would affect a user's decision making.
TRUE

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-03 Explain the role of auditing in information risk reduction.
Smieliauskas - Chapter 01 #22

23. *(p. 18)* Forensic accounting does not include fraud auditing.
FALSE

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #23

24. *(p. 9)* An attest engagement involves a public accountant affirming the validity of an assertion.
TRUE

Blooms Taxonomy: Knowledge recall
Difficulty: Medium
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #24

25. *(p. 14)* Internal auditing is an independent activity designed to add value and improve an organization's operations.
TRUE

Blooms Taxonomy: Knowledge recall
Difficulty: Medium
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #25

26. *(p. 16)* Value-for-money audits include testing of compliance with laws and regulations.
FALSE

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #26

27. *(p. 12)* Accounting risk is the part of information risk that is due to incorrectly predicting future events.
TRUE

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-03 Explain the role of auditing in information risk reduction.
Smieliauskas - Chapter 01 #27

28. *(p. 22)* There are no restrictions on the type of business advisory services a PA firm can provide to a nonaudit client.
TRUE

Blooms Taxonomy: Comprehension
Difficulty: Easy
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #28

29. *(p. 4)* Why is three-party accountability an important distinguishing feature of auditing?

In three-party accountability, accountability is represented as a three-point relationship among the auditor of the financial information, the management preparing the financial information, and the users of the financial information. This triangle reflects an accountability relationship because management is accountable to the users. However, the users cannot rely on the financial statements because they do not completely trust management. They demand that the financial statements be verified by a competent, independent auditor. Thus, the auditor is also accountable to the user.

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-01 Explain the importance of auditing.
Smieliauskas - Chapter 01 #29

30. *(p. 6)* Discuss the underlying conditions affecting users' demand for accounting information.

There are three key conditions: complexity of information, distance between users from management, and the consequences of bad decisions. First, a company's transactions are increasingly numerous and complicated. Users of financial information are not trained to collect and compile it themselves. They need the services of professional accountants. Second, users of financial information are increasingly separated from a company's accounting records by distance and time as a result of global financial markets. Users need full-time professional accountants to do the work they cannot do for themselves. Finally, financial decisions are important to the state of investors' and other users' wealth, including investors in companies that provide loans or trade credit to other companies. Decisions can involve large dollar amounts, the loss of which may cause a cascade of bankruptcies. Good information, obtained through the financial reports prepared by accountants, is an absolute necessity to reduce the risk of loss.

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #30

31. *(p. 8,10)* What is the difference between the American Accounting Association's (AAA) definition of auditing and the Canadian Institute of Chartered Accountants' (CICA) objectives of financial statement auditing?

The AAA definition is broad and general—it encompasses external, internal, and governmental auditing. The CICA has not defined auditing per se but has outlined a set of objectives specific to the external audit of financial statements. The CICA objectives do not focus on broad assertions about economic events but state that the main objective of an audit is the expression of an opinion on the financial statements. The objectives further assert that the audit of financial statements must be performed in accordance with GAAS (generally accepted auditing standards). The AAA definition does not refer to auditor qualifications and does not specifically addresses either how an audit is performed or how the results are communicated. The first of the eight auditing standards defined by the CICA, the general standard, outlines the qualifications the auditor must have; the next three, the examination standards, outline how the auditor must perform the audit; and the last four, the reporting standards, outline how the auditor should communicate the results.

Blooms Taxonomy: Comprehension
Difficulty: Medium
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #31

32. *(p. 12)* What is information risk?

The risk that a set of financial statements will be materially false or misleading.

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-03 Explain the role of auditing in information risk reduction.
Smieliauskas - Chapter 01 #32

33. *(p. 9)* What is an attest engagement?

When a public accountant is hired to perform procedures and issue a report resulting from those procedures that affirms the validity of an assertion, this is known as an attest engagement.

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #33

34. *(p. 5)* When does an agency problem occur?

An agency problem occurs when three conditions are present in an agency relationship: (a) the agent has objectives that are different from those of the principal, (b) the agent has more information than the principal does, and (c) the contract between the two is incomplete in that not every possible contingency can be anticipated.

Blooms Taxonomy: Comprehension
Difficulty: Easy
Learning Objective: 01-01 Explain the importance of auditing.
Smieliauskas - Chapter 01 #34

35. *(p. 9)* What is a direct reporting engagement?

A type of assurance engagement in which the assertions are implied and not written down in some form.

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-02 Distinguish auditing from accounting.
Smieliauskas - Chapter 01 #35

36. *(p. 15)* What is operational auditing and who performs it?

Operational auditing is the study of an entity, or a specific unit within an entity, in order to evaluate its performance. The operational auditor reports on whether the entity uses its resources economically and efficiently and whether it achieves its business objectives effectively. Internal auditors normally perform operational audits. However, independent accounting firms as part of their management advisory services also may conduct operational audits.

Blooms Taxonomy: Knowledge recall
Difficulty: Easy
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #36

37. *(p. 16)* Discuss the nature of value-for-money audits and give three examples of its application.

Value-for-money audits involve studies of the management of government organizations, programs, activities, and functions. Their goal is to improve the government's accountability to taxpayers for the effective use of tax dollars. Examples of findings include:

1. Health care: Stronger efforts needed to control undesirable practices by unregulated health-care providers
2. Education: Need to improve availability of programs for exceptional children.
3. Young offenders: Suggested improved documentation before releasing young offenders.

Blooms Taxonomy: Knowledge recall
Difficulty: Medium
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #37

38. *(p. 19)* Discuss the conflict between the need for an audit firm to perform quality services and its desire to make a profit in the context of the investor's need for reliable information.

An audit firm needs to be able to pay its staff in line with their abilities. Otherwise, more qualified staff will seek opportunities elsewhere. If they leave, only less qualified people will remain, thus reducing the quality of audit possible. With less qualified people, the audit firm may be unable to express the correct opinion on the fairness of the financial statements. This would tend to increase investors' information risk. One way to have more money to pay staff appropriately is to reduce the amount of time spent on each assignment. More assignments each with less time spent would permit more profit on each assignment. However, reducing the amount of time spent on each audit engagement would also increase the risk that a material error would be missed in the audit. This increases the information risk to investors, which decreases the value of the audit to them and increases the likelihood that they will sue the auditors to recover any investment losses.
A constant demand by investors for reduction in information risk means that except in the short term, an auditor cannot reduce the quality of its services. By the same token, there is an equilibrium level of profit for audit firms, and compensation for its staff and partners that investors are willing to provide in exchange for their desired reduction in information risk.

Blooms Taxonomy: Comprehension
Difficulty: Hard
Learning Objective: 01-04 Describe the other major types of audits and auditors.
Smieliauskas - Chapter 01 #38

c1 Summary

Category	*# of Questions*
Blooms Taxonomy: Application	1
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Blooms Taxonomy: Knowledge recall	23
Difficulty: Easy	20
Difficulty: Hard	1
Difficulty: Medium	17
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