

Chapter 01 Introduction to Auditing

Multiple Choice Questions

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.

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-02 Introduction: The Concept of Auditing

Topic: 01-04 A Simple Illustration of the Importance of Auditing

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

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-02 Introduction: The Concept of Auditing

Topic: 01-04 A Simple Illustration of the Importance of Auditing

3. In an audit engagement, the three-party accountability relationship involves all but which of entities?

- A. society
- B. the users**
- C. the auditor
- D. the accountable party

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-02 Introduction: The Concept of Auditing

4. The idea of recognizing auditing as playing a bigger part of social control is known as _____.

- A. Professional responsibility
- B. An accountability relationship
- C. The effective auditor concept
- D. The audit society concept**

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-02 Introduction: The Concept of Auditing

5. The agency problem can be mitigated by _____.

- A. greater transparency
- B. a higher degree of independence
- C. design of contracts**
- D. internal auditing

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-05 Agency Theory and Accountability

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

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-07 Accounting

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**

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Easy

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-08 More on Auditing

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.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-08 More on Auditing

9. 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.

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-12 Audit Objective and the Auditor's Report

10. 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

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-05 Agency Theory and Accountability

11. 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

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-12 Audit Objective and the Auditor's Report

12. The risk that financial statements may be materially false and misleading is called _____.

- A. business risk
- B. information risk**
- C. client risk
- D. audit risk

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-03 Explain the role of auditing in information risk reduction.

Topic: 01-13 A Definition of Auditing Relating to "Risk Reduction"

13. 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

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-20 Kinds of Audits and Auditors

Topic: 01-21 International and Operational Auditing

14. Auditors on staff in the Office of the Auditor General of Canada (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 private investors
- D. guided by standards similar to GAAS

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-22 Public Sector (Governmental) Auditing

15. In addition to the audit of financial statements, comprehensive governmental auditing may also include audits of efficiency, effectiveness, and _____.

- A. stewardship
- B. accuracy
- C. economy
- D. adequacy

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-22 Public Sector (Governmental) Auditing

16. 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

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: Medium

Learning Objective: 01-05 (Appendix 1A) Explain how to become a professional accountant in Canada.

Topic: 01-21 Forensic Accounting and Fraud Auditing

17. the convergence of accounting and audit standards across multiple countries is known as _____.
- A.** international harmonization
 - B. Generally accepted auditing standards
 - C. independence
 - D. Public accountability

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-04 Provide an overview of international auditing and its impact on Canadian Auditing Standards.

Topic: 01-16 International Auditing

18. Really Big Co. is a publicly traded company that has consistently reported increasing profits each year. However, during this year's audit, it was discovered that the CEO and CFO conspired to falsify the financial statements. This discovery resulted in a large correction to both the current and prior year's net income. It is believed that management was motivated to falsify the statements to maximize bonus and stock option compensation. Such a situation reflects which problem of economic theory?

- A. Conflict of interest
- B. Agency Problem
- C. Three-party accountability**
- D. The "Dozy Watchdog"

Accessibility: Keyboard Navigation

Blooms: Apply

Difficulty: Hard

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-05 Agency Theory and Accountability

True / False Questions

19. 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

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Blooms: Understand

Difficulty: Medium

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-02 Introduction: The Concept of Auditing

Topic: 01-04 A Simple Illustration of the Importance of Auditing

20. The role of the auditor is to satisfy users' demand for reliable information.

TRUE

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-08 More on Auditing

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

FALSE

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-07 Accounting

22. All audits are both an assurance and attestation engagement.

TRUE

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-08 More on Auditing

Topic: 01-10 Definitions of Auditing

23. An attest engagement involves a public accountant affirming the validity of an assertion.

TRUE

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-10 Definitions of Auditing

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

FALSE

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-03 Explain the role of auditing in information risk reduction.

Topic: 01-13 A Definition of Auditing Relating to "Risk Reduction"

25. A material misstatement is one that would affect a user's decision making.

TRUE

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-03 Explain the role of auditing in information risk reduction.

Topic: 01-13 A Definition of Auditing Relating to "Risk Reduction"

26. Accounting risk is the part of information risk that is due to incorrectly predicting future events.

TRUE

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-03 Explain the role of auditing in information risk reduction.

Topic: 01-13 A Definition of Auditing Relating to "Risk Reduction"

27. Forensic accounting does not include fraud auditing.

FALSE

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-05 (Appendix 1A) Explain how to become a professional accountant in Canada.

Topic: 01-21 Forensic Accounting and Fraud Auditing

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

TRUE

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-20 Kinds of Audits and Auditors

Topic: 01-21 International and Operational Auditing

29. An engagement to advise management on how to better align its compensation plans with strategic objectives, would be considered an assurance engagement.

FALSE

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-32 Consulting or Management Advisory Services

30. Value-for-money (VFM) audits include testing of compliance with laws and regulations.

FALSE

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-22 Public Sector (Governmental) Auditing

31. A PA firm cannot provide business advisory services to a non-audit client.

TRUE

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Easy

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-30 Assurance Services

Short Answer Questions

32. 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.

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Blooms: Understand

Difficulty: Medium

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-02 Introduction: The Concept of Auditing

Topic: 01-04 A Simple Illustration of the Importance of Auditing

33. 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.

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Blooms: Understand

Difficulty: Easy

Learning Objective: 01-01 Explain the importance of auditing.

Topic: 01-05 Agency Theory and Accountability

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

There are three key conditions: **complexity** of information, **remoteness** or 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.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-07 Accounting

35. What is the difference between the American Accounting Association's (AAA) definition of auditing and the Chartered Professional Accountants of Canada (CPA Canada) 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 CPA Canada 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 address either how an audit is performed or how the results are communicated. The first of the eight auditing standards defined by the CPA Canada, 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.

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Blooms: Understand

Difficulty: Medium

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-10 Definitions of Auditing

Topic: 01-12 Audit Objective and the Auditor's Report

36. 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.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-10 Definitions of Auditing

37. What is a direct reporting engagement? Provide an example of such an engagement.

A type of assurance engagement in which the assertions are implied and not written down in some form. A report by the Auditor General of Canada on how well a particular federal agency operated would be an example of such an engagement.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-02 Distinguish auditing from accounting.

Topic: 01-10 Definitions of Auditing

38. What is information risk?

Information risk is the risk that a set of financial statements will be materially false or misleading. As a result, information risk includes failure to properly disclose business risk.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-03 Explain the role of auditing in information risk reduction.

Topic: 01-13 A Definition of Auditing Relating to "Risk Reduction"

39. 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.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-04 Provide an overview of international auditing and its impact on Canadian Auditing Standards.

Topic: 01-20 Kinds of Audits and Auditors

Topic: 01-21 International and Operational Auditing

40. What is International Harmonization and what is motivating the accounting profession towards it?

It is the international convergence of national accounting and auditing standards with IFRS and ISAs, including going concern, fraud, and the audit risk model. A major force behind the movement toward harmonization of standards is the increasing globalization of business.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Easy

Learning Objective: 01-04 Provide an overview of international auditing and its impact on Canadian Auditing Standards.

Topic: 01-16 International Auditing

41. Discuss the nature of value-for-money (VFM) 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.

Accessibility: Keyboard Navigation

Blooms: Remember

Difficulty: Medium

Learning Objective: 01-06 (Appendix 1B) Distinguish alternative theories of the role of auditing in a society.

Topic: 01-22 Public Sector (Governmental) Auditing

42. 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.

Accessibility: Keyboard Navigation

Blooms: Understand

Difficulty: Medium

Learning Objective: 01-04 Provide an overview of international auditing and its impact on Canadian Auditing Standards.

Topic: 01-29 Public Accounting Firms