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to accompany

Audit and assurance

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by

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Chapter 1: An overview of auditing

Multiple-choice questions

1. The three major professional accounting bodies in Australia are:

- a. CAANZ, CPA and ASIC.
- b. CPA Australia, IPA and AARF.
- c. ATO, AUASB and ASIC.
- *d. CAANZ, CPA Australia and IPA.

The correct option is d.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

2. Which of these is not an objective of the ASIC?

- a. To maintain, facilitate and improve the performance of companies.
- *b. To establish new institutional arrangements for standard setting.
- c. To receive, process and store information given to the Commission under the laws.
- d. All of the above are objectives of the ASIC.

The correct option is b.

Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

3. Which of the following is true regarding auditors and fraud?

- a. Auditors are required to detect all fraud during an audit.
- b. Auditors should actively investigate the possibility of fraud if suspicious circumstances exist.
- c. In the Kingston Cotton Mill case, it was said that the audit role was not primarily to detect fraud.
- *d. b and c are true.

The correct option is d.

Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

4. Which of these was not an Australian corporate collapse?

- a. Harris Scarfe.
- b. HIH Insurance Ltd.
- c. One.Tel.
- *d. All were Australian corporate collapses.

The correct option is d.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

5. ABC firm are the auditors of XYZ Company. The partner responsible for the audit has recently spent a week working with XYZ as a paid consultant on their internal control systems. The ethical principle that has been breached is:

- a. auditor competence.
- b. auditor rotation.
- *c. auditor independence.
- d. auditor appointment.

The correct option is c.

Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

6. Which of these is not a reform introduced by CLERP 9 in relation to Auditors and annual general meetings (AGMs)?

- a. Shareholders can submit written questions to the auditor before the AGM relating to the auditor's report and the conduct of the audit.
- b. The auditor must attend the AGM.
- *c. The auditor must address the AGM.
- d. A reasonable opportunity must be allowed for members as a whole to ask questions of the auditor and for the auditor to respond.

The correct option is c.

Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

7. The statutory body that is responsible for hearing applications in Australia as to whether auditors and liquidators have breached the Corporations Act is:

- a. ASIC.
- *b. CALDB.
- c. FRC.
- d. AUASB.

The correct option is b.

Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

8. In relation to auditing the information hypothesis relates:

- a. to 'does the audit meet the demands of users'.
- *b. to why there is a demand for audits.
- c. to what auditing is.
- d. to which auditing standards are produced.

The correct option is b.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

9. Under ASA 200/ IAS 200 the primary objective of a financial report audit is to:

- a. ensure that the company is free from all fraud.
- b. provide assurance about the future viability of the entity.
- *c. to express an opinion as to whether the financial report is prepared in all material aspects, in accordance with a financial reporting framework.
- d. ensure the company complies with all aspects of Corporations Law.

The correct option is c.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

10. It is not a requirement to be registered as an auditor in Australia to:

- a. be a fit and proper person.
- b. be a member of CPA Australia, CAANZ or other approved body.
- c. has a degree or diploma from a course in accounting (including auditing) of not less than 3 years duration and in commercial law (including company law) of not less than 2 years duration or have other equivalent qualifications acceptable to ASIC.
- *d. all are requirements to be registered as an auditor in Australia.

The correct option is d.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

11. Investors shift financial responsibility for audited financial information to the auditor in order to lower the expected loss from litigation or related settlements. This describes which theory of auditing?

- a. Agency.
- b. Explanatory.
- *c. Insurance hypothesis.
- d. Information hypothesis.

The correct option is c.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

12. In Australia, the auditor's opinion in the audit report must state:

- a. whether the financial report is presented fairly, in all material respects, in accordance with the applicable financial reporting framework.
- b. whether the financial report presents a true and fair view, in all material respects, in accordance with the applicable financial reporting framework.
- c. whether the financial report provides a reasonable level of assurance, in all material respects, in accordance with the applicable financial reporting framework.
- *d. a or b.

The correct option is d.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

13. In Australia, all of the following are required to have an annual audit, except:

- a. not-for-profit organisations.
- b. statutory authorities.
- *c. small proprietary companies.
- d. all of the above are required to have an annual audit with no exceptions.

The correct option is c.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

14. Which theory of auditing focuses more towards the decision usefulness role of accounting?

- a. Insurance hypothesis.
- b. Agency theory.
- *c. Information hypothesis.
- d. None of the above.

The correct option is c.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

15. In relation to changes to auditing regulation it is true that:

- a. the CLERP reforms and the Sarbanes-Oxley reforms are very similar in approach.
- b. the CLERP reforms in Australia are more rules-based than the Sarbanes-Oxley reforms.
- c. the Sarbanes-Oxley reforms in the USA are principles-based.
- *d. the Sarbanes-Oxley reforms are more rules-based and the CLERP reforms are more principles-based.

The correct option is d.

Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

16. The separation of ownership and control in large organisations has resulted in:

- *a. an agency problem.
- b. the insurance hypothesis.
- c. CLERP.
- d. an audit expectation gap.

The correct option is a.

Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

17. Any situation where information is prepared by one party and then attested as to its accuracy by another party is known as:

- a. agency theory.
- b. an audit engagement.
- c. an assertion engagement.
- *d. an assurance engagement.

The correct option is d.

Learning objective 1.2 ~ describe how assurance relates to auditing.

18. Auditing bears what relationship to assurance?

- *a. Auditing is a sub-category of assurance.
- b. Assurance is a sub-category of auditing.
- c. They are different names for the same thing.
- d. Public accounting firms perform auditing engagements but not assurance engagements.

The correct option is a.

Learning objective 1.2 ~ describe how assurance relates to auditing.

19. The oversight structure of financial reporting in Australia had many levels. CALDB is part of which level?

- a. Regulation by the firm.
- b. Regulation by the profession.
- *c. Government regulation.
- d. Self or peer regulation.

The correct option is c.

Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

20. Which body has a mission ‘to develop, in the public interest, high-quality auditing and assurance standards and related guidance to enhance the relevance, reliability and timeliness of information provided to users of audit and assurance services’?

- a. The FRC.
- b. The IAASB.
- c. The AASB.
- *d. The AUASB.

The correct option is d.

Learning objective 1.5 ~ explain the importance of national and international auditing standards.

21. The body that is responsible for setting the auditing standards in Australia is:

- a. AASB.
- *b. AUASB.
- c. FRC.
- d. IAASB.

The correct option is b.

Learning objective 1.5 ~ explain the importance of national and international auditing standards.

22. The true statement is:

- a. most countries in the world have auditing standards that are legally enforceable.
- *b. few countries in the world have auditing standards that are legally enforceable.
- c. Australia is the only country in the world that has auditing standards that are legally enforceable.
- d. the IAASB produces accounting standards which are legally enforceable in each country which adopts them.

The correct option is b.

Learning objective 1.5 ~ explain the importance of national and international auditing standards.

23. The term audit expectation gap refers primarily to differences in expectations between:

- *a. auditors and users of audited financial reports.
- b. auditors and their clients.
- c. CPA Australia/CAANZ and the ASIC.
- d. auditors and the ASIC.

The correct option is a.

Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

24. The best test to decide if audits provide good value is:

- a. by examining how often audits are associated with company failure.
- b. by examining whether the audit report is correct.
- c. by examining the premium, the market places on a share price for independently audited information.
- *d. it is not possible to designate any one test as being the best to decide if audits provide good value.

The correct option is d.

Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

25. Which of these actions is most likely to remove the audit expectation gap?

- a. Improving auditing standards.
- b. Educating audit users about what are reasonable expectations.
- c. Improving auditor's performance.
- *d. It will require a comprehensive approach combining all three of the above.

The correct option is d.

Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

26. An area where auditors in Australia have generally not expanded their role is:

- a. detection of fraud.
- b. evaluation of whether an entity is a going concern.
- *c. reporting on internal controls.
- d. all of the above are areas in Australia where auditors have not expanded their role.

The correct option is c.

Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

27. In the HIH Royal Commission Report it was stated that current audit reports:

- *a. are not very informative about the nature and scope of audit services.
- b. are useful in informing users about the message that auditors are trying to get over.
- c. are generally a waste of the paper they are written on.
- d. are often wrong.

The correct option is a.

Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

28. A variety of parties may be interested in audited reports of a public company. Which user group is the primary user?

- a. Management of the company.
- *b. Current shareholders.
- c. Creditors.
- d. Government.

The correct option is b.

Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

29. The reasonableness gap is:

- a. The difference between what financial statement users believe the audit provides and what an audit actually provides.
- b. The gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve.
- c. The gap comprising deficient performance and deficient standards.
- *d. the gap between what society expects auditors to achieve and what they can be reasonably expected to accomplish.

The correct option is d.

Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

Short answer questions

30. Identify which of these entities that are associated with the public accounting profession that are (1) private sector organisations, (2) standard setting bodies.

- Australian Securities and Investment Commission (ASIC)
- Companies Auditors and Liquidators Disciplinary Board (CALDB)
- Other accounting bodies, e.g., ACCA, CIMA
- CPA Australia
- Chartered Accountants Australia New Zealand (CAANZ)
- The Institute of Public Accountants (IPA)
- Practice entities (e.g., KPMG, PricewaterhouseCoopers, Deloitte, Ernst & Young)
- Australian Stock Exchange (ASX)
- Financial Reporting Council (FRC)
- Auditing & Assurance Standards Board (AUASB).

Correct answer:

Private sector organisations:

- CPA Australia
- Chartered Accountants Australia New Zealand (CAANZ)
- The Institute of Public Accountants (IPA)
- Other accounting bodies, e.g., ACCA, CIMA
- Practice entities (e.g., KPMG, PricewaterhouseCoopers, Deloitte, Ernst & Young)
- Australian Stock Exchange (ASX).

Regulators and Standard setting bodies:

- Financial Reporting Council (FRC)
- Auditing & Assurance Standards Board (AUASB)
- Australian Securities and Investment Commission (ASIC)
- Companies Auditors and Liquidators Disciplinary Board (CALDB).

Reference: Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

31. Describe the principal – agent relationship and how it is used to explain the development of auditing.

Correct answer:

When one or more of the principals engage others as agents to perform a service on their behalf, a principal-agent relationship arises. In the case of companies, the shareholders are considered the principals and management is the agent. The managers are employed to conduct the business in the interests of the shareholders. However, management may pursue self-interest which is to the detriment of the shareholders. As management also produces information regarding the performance of the company that information's reliability is questionable.

The theory suggests that auditors are used to align the interests of management with the shareholders. Auditors evaluate the credibility of a company's financial information which restores confidence in the financial information. It is suggested that the existence of the principal-agent relationship and the problems associated with it caused the demand for auditing.

Reference: Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.

32. List the areas of audit reform contained in the CLERP 9 Act.

Correct answer:

- Non-audit services
- Audit partner rotation
- Restrictions on auditors working for the client after they leave an audit firm
- The role of the Financial Reporting Council
- Greater role for auditor at AGM's.

Reference: Learning objective 1.4 ~ discuss the importance of the environment, case law and regulation to auditing.

33. Describe the components of the audit expectation gap.

Correct answer:

The audit expectation gap is the difference between the expectations of financial statement users and the service that is actually provided by the auditor. This gap is partly due to the unreasonable expectations of users. Users expect auditors to provide assurance concerning material fraud, irregularities and the viability of the business and its management. However, auditors cannot provide absolute assurance due to the limitations of financial reporting and the auditing process. This is why only reasonable or limited assurance is given. Users that expect auditors to provide absolute assurance are exhibiting unreasonable expectations. The result is that auditors who are performing above the approved standards are still perceived as performing inadequately.

The audit expectation gap can also be partly attributed to inadequate performance by auditors. The recent reforms aimed at improving audit quality and auditor independence aim to reduce this part of the gap.

Reference: Learning objective 1.3 ~ evaluate whether audits meet the demands of users.

34. Identify three arguments for the existence of a demand for auditing and briefly explain each.

Correct answer:

Agency theory: this theory recognises that there are costs involved in aligning the principal and the agent's interests. External auditing is considered a monitoring cost and it allows the principal to assess the agent's performance. The agent also recognises the benefit of audit as it can lower the cost of capital.

Information hypothesis: investors demand audited financial information because it is useful for decision making. An audit improves the quality of financial information making it more reliable for investors to use in assessing the expected returns and risks associated with their investment. Audited information is also useful for internal decision making as it can detect errors and motivate employees to exercise more care in preparing records.

Insurance hypothesis: an audit allows management to shift the financial responsibility for the reported information to the auditors. Using auditors indicates that management exercised reasonable care. Therefore, the expected loss from litigation for management is lower than if the statements were not audited.

Reference: Learning objective 1.1 ~ explain what an audit is, what it provides, and why it is demanded.