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to accompany

Modern Auditing and Assurance Services 5e

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WILEY

John Wiley & Sons Australia, Ltd 2011

Chapter 2

Governance and the auditor

Multiple Choice

1. Enterprise governance is perceived as a model that can be applied to:
 - a. corporations.
 - b. not-for-profit organisations.
 - c. the public sector.
 - d. all of the above.

The correct option is d.

Feedback: Section 2.1 What is governance?

2. The conformance aspect of enterprise governance covers all these issues except:
 - a. the roles of the chair of the board and top management.
 - b. resource use
 - c. internal control structures.
 - d. the adequacy and reasonableness of compensation schemes for executives.

The correct option is b.

Feedback: Section 2.1 What is governance?

3. Earnings management occurs when:
 - a. income and expenses are managed to influence the performance of the entity.
 - b. financial statements and transactions are manipulated to influence perceptions about the entity.
 - c. executive salaries are increased surreptitiously by including the raises in late night meetings.
 - d. earnings are manipulated to improve the company's tax position.

The correct option is b.

Feedback: Section 2.3 Issues in governance

4. Incentives for earnings management are inherent in the management structure but are least likely to originate from:
 - a. high positive cash flows.
 - b. political considerations.
 - c. executive remunerations.
 - d. situations including financial distress.

The correct option is a.

Feedback: Section 2.3 Issues in governance

5. The COSO enterprise risk management integrated framework has four categories of risk objectives which are:
- strategic, operations, reporting and business unit.
 - strategic, control activities, reporting and business unit.
 - strategic, control activities, reporting and compliance.
 - strategic, operations, reporting and compliance.

The correct option is d.

Feedback: Section 2.3 Issues in governance

6. The SEC proposal on audit committees did not require:
- the audit committee to be directly responsible for the hiring of an independent auditor.
 - the audit committee to be directly responsible for the oversight of an independent auditor.
 - the audit committee to be directly responsible for the internal auditor.
 - the names of the committee members to be disclosed in the annual report.

The correct option is c.

Feedback: Section 2.5 Enhancing accountability through the audit committee

7. The Australian Stock Exchange (ASX) listing rules require an audit committee to be established by:
- all companies.
 - all companies on the S&P/ASX 300 Index.
 - all companies on the S&P/ASX 500 Index.
 - all companies on the S&P/ASX All Ordinaries Index.

The correct option is d.

Feedback: Section 2.5 Enhancing accountability through the audit committee

8. The best practice recommendations for audit committees states that the audit committee should consist of:
- an independent chairperson who is not chairperson of the board.
 - both executive and non-executive directors.
 - at least one independent director.
 - at least five members

The correct option is a.

Feedback: Section 2.5 Enhancing accountability through the audit committee

9. The audit committee should report to the board of directors on which of these matters?
- the use of experts by the independent auditor.
 - recommendations for the appointment or removal of an auditor.
 - audit procedures carried out by the independent auditor.

- d. all of the above

The correct option is b.

Feedback: Section 2.5 Enhancing accountability through the audit committee

10. The statement that best describes internal auditing is:
- a. an activity located within an entity, primarily to detect fraud.
 - b. an independent and objective assurance activity within an entity.
 - c. an accounting function located within an entity.
 - d. an activity to reduce risk.

The correct option is b.

Feedback: Section 2.2 The auditor and governance

11. The key benefit to management of there being an internal audit function is that:
- a. It provides assurance to management that the organisation is complying with its legal requirements.
 - b. External audit costs are reduced.
 - c. It provides assurance to management that fraudulent activities will be detected.
 - d. It aids management in the areas of risk management, control and governance processes.

The correct option is d.

Feedback: Section 2.2 The auditor and governance

12. The types of operational audit reports issued by an internal auditor are:
- a. financial report or compliance report.
 - b. varied, and are based on auditor judgment of how best to present the findings.
 - c. examination report, review report or compilation report.
 - d. unqualified, qualified, adverse or a disclaimer of opinion.

The correct option is b.

Feedback: Section 2.2 The auditor and governance

13. The Auditor General has a legislative mandate to:
- a. audit the financial statement of all entities controlled by the government except government business enterprises
 - b. conduct a performance audit of all government agencies, authorities and companies other than government business enterprises
 - c. audit the financial statement of all entities controlled by the government
 - d. a. and b.

The correct option is c.

Feedback: Section 2.6 Governance in the public sector

14. Operational auditing:
- a. has a main purpose of helping management to improve the entity's effectiveness and efficiency
 - b. refers to an entity's financial operations

- c. is historical in focus
- d. all of the above are correct

The correct option is a.

Feedback: Section 2.4 Internal and operational auditing in the governance process

15. The approach that has been suggested for operational audits is:
- a. the risk based audit approach
 - b. the value-for-money audit approach
 - c. the process audit approach
 - d. all three of the above approaches have been suggested for operational audits

The correct option is d.

Feedback: Section 2.4 Internal and operational auditing in the governance process

16. Which of these is not one of the key trends in auditing as identified by the 2007 PricewaterhouseCoopers study?
- a. a widening role for internal audit in managing risk
 - b. an emerging 'capability crisis' among internal audit staff
 - c. fewer younger people entering the audit profession
 - d. rotational staffing as a key strategy to refresh and renew talent

The correct option is c.

Feedback: Section 2.4 Internal and operational auditing in the governance process

17. Which of these is a type of public sector performance audit?
- a. audit of a program or activity in a single entity
 - b. protective security audit
 - c. follow-up audit
 - d. all of the above are types of public sector performance audits

The correct option is d.

Feedback: Section 2.6 Governance in the public sector

18. An audit specifically designed to investigate the value of strategic initiatives such as mergers and acquisitions, prospectuses and investment decisions is known as:
- a. a performance audit
 - b. a forensic and probity audit
 - c. a due diligence audit
 - d. a social audit

The correct option is c.

Feedback: Section 2.2 The auditor and governance

19. The Australian National Audit Office (ANAO) reports directly to:
- a. the Commonwealth Parliament.
 - b. the ASIC.
 - c. the Commonwealth Parliament.
 - d. the ATO.

The correct option is a.

Section 2.6 Governance in the public sector

20. Which of these is not a function of the Australian National Audit Office (ANAO)?

- a. auditing the statements of government bodies
- b. carrying out performance audits
- c. commenting on government policy
- d. all are functions of the ANAO

The correct option is c.

Section 2.6 Governance in the public sector.

21. The audit trinity concept refers to:

- a. external audit, internal audit, audit committee
- b. conformance, performance, assurance
- c. past, current and future approaches
- d. none of the above

The correct option is a.

Section 2.2 The auditor and governance.

22. The Joint Committee of Public Accounts and Audit (JCPAA) is not charged with:

- a. inquiring into matters raised by the auditor-general and referred to it by the houses of Parliament.
- b. examine the accounts of the receipts and expenditure of the Australian government.
- c. examine the financial affairs of Australian government authorities.
- d. reporting to the Prime Minister.

The correct answer is d.

Feedback: Section 2.6 Governance in the public sector

23. The independence of the Auditor General is:

- a. assured by the houses of Parliament.
- b. prescribed by the *Auditor General Act 1997 (Cwlth)*.
- c. prescribed by the Australian Constitution.
- d. approved by the Governor General.

The correct option is b.

Feedback: Section 2.6 Governance in the public sector

24. The Auditor General is appointed by:

- a. the Parliament.
- b. the Prime Minister.
- c. the Joint Committee of Public Accounts and Audit.
- d. the Governor General on the recommendation of the responsible minister.

The correct option is d.

Feedback: Section 2.6 Governance in the public sector

25. The Auditor General's powers to gather information are legislated. These powers do not include the power to:
- a. direct a person to provide any information.
 - b. obtain information under oath.
 - c. access private property.
 - d. all of the above are legislated powers of the Auditor General.

The correct option is c.

Feedback: Section 2.6 Governance in the public sector

26. The Auditor General must report on an exception basis if:
- a. all the necessary information and explanations were obtained.
 - b. proper accounting records have been kept.
 - c. records have not been made available for inspection.
 - d. records have been retained for at least 10 years.

The correct option is c.

Feedback: Section 2.6 Governance in the public sector

27. For consolidated financial statements, the Auditor General must report:
- a. the name of a subsidiary for which he/she has not acted as an auditor.
 - b. the name of a subsidiary for which the financial statements have not been qualified.
 - b. the procedures and methods used in arriving at amounts for consolidations.
 - c. all of the above.

The correct option is a.

Feedback: Section 2.6 Governance in the public sector

Short Answer

Short Answer 2-1

Describe the two sides of the enterprise governance framework.

Answer 2-1 (Short Answer)

Enterprise governance comprises on one side, the corporate governance concept of conformance and assurance and on the other the strategic direction concept of performance and resource use.

The conformance aspect is based mainly on corporate governance best practice and covers issues such as:

- The roles of the chair of the board and top management to ensure accountability and independence.
- The composition, skills base, remuneration and training of the board and its committees, such as the roles of the non-executive directors.
- The adequacy and reasonableness of compensation schemes for executives.
- Internal control structures, risk management, and the role of internal audit.
- The financial reporting and disclosure regime.
- The independence of the audit function and the reporting mechanisms.

The conformance aspect is directly related to the role of the auditor, in that the audit function provides the verifiability, assurance of compliance and accountability of the organisation.

The performance dimension refers to the different tools and practices that are applied to enhance the value of the organisation. It includes setting strategic directions, comprehending and managing risk, and the key drivers of performance and decision-making processes. Auditing and assurance services can add significant value to the organisation particularly through the identification of risks and the assessment of risk management processes, or through due diligence audit and assurances.

Reference: Section 2.1 What is governance

Short Answer 2-2

Describe the essential components of enterprise risk management (ERM) as put forward by the Committee of Sponsoring Organisations (COSO of the Treadway Commission).

Answer 2-2

The COSO framework for ERM consists of eight interrelated components derived from the way management runs a business:

1. In the internal environment, management establishes a risk management philosophy, the risk-taking approach, in order to form a risk culture while integrating risk management with related initiatives.
2. Risk objectives are set in four categories – strategic, operations, reporting and compliance. Some organisations include the objective of safeguarding resources. These objectives allow management and the board to focus on separate aspects of risk management.

3. Event identification is a process where both external and internal factors that might affect event occurrence are considered. The identification methodology may use a combination of techniques and tools, looking at both past and the future.
4. Risk assessment then allows an entity to consider how potential events might affect the achievement of objectives. Two perspectives are determined: likelihood and impact.
5. Risk response options are identified by management that considers the impact of the event in relation to risk tolerances, evaluates costs and benefits, and designs and implements response options.
6. Control activities are the policies and procedures that ensure risk responses are properly executed throughout the organisation, at all levels and in all functions. Control activities are closely aligned with general and application controls.
7. Pertinent information and effective communication are required to allow enterprise risk management responses to changing conditions in real time. Information can be quantitative, qualitative, internal and external. Communication channels should also ensure personnel can communicate risk-based information across business units, processes or functional areas.
8. Monitoring, a process that assesses both the presence and functioning of the ERM components and quality of their performance over time, can be done either as an ongoing exercise or as a separate evaluation process.

The assessment of inherent and control risks can be helped by the ERM framework.

Reference: Section 2.3 Issues in governance

Short Answer 2-3

- 1 What is meant by the term Earnings Management?
- 2 Why has the focus on earnings management increased in recent years?
- 3 What incentives might there be for companies to engage in earnings management?

Answer 2-3

- 1 Earnings management is when financial statements and transactions are manipulated in order to influence people's perceptions about the performance of the company, with the aim of showing a desirable outcome rather than the economic substance. Extreme cases can amount to fraud.
- 2 Failed companies such as Enron and WorldCom used earnings management techniques, and so have increased the focus.
- 3 Incentives can be inherent in the management structure and may include political considerations, executive remuneration, the ambiguity and inability of accounting standards to deal with complex transactions, or situations including financial distress or related party transactions.

Reference: Section 2.3 Issues in governance

Short Answer 2-4

What are the main objectives of the audit committee?

Companies listed on the S&P/ASX All Ordinaries Index are subject to a listing rule obliging them to have an audit committee. What does the ASX suggest should be the makeup of an audit committee?

Answer 2-4

The main objectives include:

- Assisting the directors in discharging their responsibilities with due care, diligence and skill.
- Improving the credibility and objectivity of the accountability process.
- Improving the effectiveness of the internal and external audit functions and providing an objective forum for improving communication between the board and the internal and external auditors.
- Facilitating the independence of the internal and external auditors
- Strengthening the role and influence of the non-executive directors.
- Fostering an ethical culture throughout the organisation.

The ASX suggests that an audit committee should consist of only non-executive directors, a majority of independent directors and an independent chairperson, who is not chairperson of the board.

Reference: Section 2.5 Enhancing accountability through the audit committee

Short Answer 2-5

What is the objective of a performance audit of a public sector entity?

Answer 2-5

To provide the parliament with assurance relating to the administration of government programs and to assist public sector managers by identifying and promoting better administrative and management practices.

Reference: Section 2.6 Governance in the public sector

Short Answer 2-6

How has the role of the internal auditor changed since the advent of the Sarbanes-Oxley Act in the USA in 2002?

Answer 2-6

Prior to 2002, most internal auditors used a risk-based approach to performing a range of audits of controls over operational effectiveness, compliance with applicable laws and regulations and the integrity of financial reporting. Value was added by identifying areas of operational improvement as well as opportunities to improve controls and reduce risk. With the introduction of the Sarbanes-Oxley Act, many internal auditors shifted their work to a compliance driven controls focus. In addition to focusing on financial reporting compliance, internal auditors had to also cover a wider range of risks, including fraud, major programs, contracts and transactions. Internal auditors are also charged with improving their organisation's overall performance.

Reference: Section 2.4 Internal and operational auditing in the governance process

Short Answer 2-7

What is the definition of internal auditing put forward by the Institute of Internal Auditors? Discuss the key components of the definition.

Answer 2-7

The definition of internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.

The key parts of the definition are as follows: 'Internal' indicates that the auditing is carried on within an organisation by employees of the organisation or by personnel contracted for that purpose. 'Independent and objective' suggests that internal auditing is an activity carried out without bias or prejudice with unrestricted access to people, records, facilities and products. 'Assurance and consulting activity designed to add value and improve operations' notes that the internal auditing function provides a certain level of assurance for subject matters that assist in better management decisions and operations. 'A systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes' refers to the structure and approach of internal auditing. The nature of internal auditing involves a search for facts and a systematic process of evaluating the results of operations, identifying risks, giving risk-reduction advice, assessing the adequacy of controls, implementing improvements in control procedures and ensuring an effective governance structure.

Reference: Section 2.4 Internal and operational auditing in the governance process

Short Answer 2-8

Explain the difference between external and internal auditors.

Answer 2-8

External auditors are either individual practitioners or members of public accounting firms who render professional auditing services to clients. The clients of external auditors include profit-making business enterprises, not-for-profit organisations, government agencies and individuals.

Internal auditors are employees of the entities they audit and they are involved in an independent appraisal activity within an organisation, as a service to the organisation.

Reference: Section 2.2 The auditor and governance