

# 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 12 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 accordance with an applicable financial reporting framework such as U.S. GAAP or IFRS. 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
<b>USER VERIFIES INFORMATION</b>	<ol style="list-style-type: none"> <li>1. User obtains information desired.</li> <li>2. User can be more confident of the qualifications and activities of the person getting the information.</li> </ol>	<ol style="list-style-type: none"> <li>1. High cost of obtaining information.</li> <li>2. Inconvenience to the person providing the information because large number of users would be on premises.</li> </ol>
<b>USER SHARES INFORMATION RISK WITH MANAGEMENT</b>	<ol style="list-style-type: none"> <li>1. No audit costs incurred.</li> </ol>	<ol style="list-style-type: none"> <li>1. User may not be able to collect on losses.</li> </ol>
<b>AUDITED FINANCIAL STATEMENTS ARE PROVIDED</b>	<ol style="list-style-type: none"> <li>1. Multiple users obtain the information.</li> <li>2. Information risk can usually be reduced sufficiently to satisfy users at reasonable cost.</li> <li>3. Minimal inconvenience to management by having only one auditor.</li> </ol>	<ol style="list-style-type: none"> <li>1. May not meet needs of certain users.</li> <li>2. Cost may be higher than the benefits in some situations, such as for a small company.</li> </ol>

**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 and electronic funds transfers, 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 accounting standards, 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.

	<b>OPERATIONAL AUDITS</b>	<b>COMPLIANCE AUDITS</b>	<b>AUDITS OF FINANCIAL STATEMENTS</b>
<b>PURPOSE</b>	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)
<b>USERS OF AUDIT REPORT</b>	Management of organization	Authority setting down procedures, internal or external	Different groups for different purposes — many outside entities
<b>NATURE</b>	Highly nonstandard; often subjective	Not standardized, but specific and usually objective	Highly standardized
<i>PERFORMED BY:</i> <b>CPAs</b>	Frequently	Occasionally	Almost universally
<b>GAO AUDITORS</b>	Frequently	Frequently	Occasionally
<b>IRS AUDITORS</b>	Never	Universally	Never
<b>INTERNAL AUDITORS</b>	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 records 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 U.S. GAAP or IFRS.
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 information technology, including e-commerce, because many of their clients rely extensively on these technologies. 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 12 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. (2) An attestation service other than an audit service
  - 2. (1) An audit of historical financial statements
  - 3. (2) An attestation service other than an audit service
  - 4. (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.)
  - 5. (2) An attestation service other than an audit service
  - 6. (2) An attestation service other than an audit service
  - 7. (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.)
  - 8. (2) An attestation service other than an audit service
  - 9. (2) An attestation service other than an audit service
  - 10. (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, Busch should select the loan from First City 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)**

<b>LENDER</b>	<b>CPA SERVICE</b>	<b>COST OF CPA SERVICES</b>	<b>ANNUAL INTEREST</b>	<b>ANNUAL LOAN COST</b>
Existing loan	None	0	\$ 247,500	\$ 247,500
United National Bank	Review	\$ 20,000	\$ 202,500	\$ 222,500
First City Bank	Audit	\$ 45,000	\$ 157,500	\$ 202,500

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

<b>LENDER</b>	<b>CPA SERVICE</b>	<b>COST OF CPA SERVICES</b>	<b>ANNUAL INTEREST</b>	<b>ANNUAL LOAN COST</b>
Existing loan	None	0	\$ 247,500	\$ 247,500
United National Bank	Review	\$ 20,000	\$ 180,000	\$ 200,000
First City Bank	Audit	\$ 55,000	\$ 157,500	\$ 212,500

- d. Busch may desire to have an audit because of the many other benefits that an audit provides. The audit will provide Busch'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) Altman 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 Altman: existence of the trucks on the night of June 30, 2011, ownership of each truck by Regional Delivery Service, physical condition of each truck and fair market value of each truck.
  - (3) Samantha Altman will *accumulate* and *evaluate* four types of *evidence*:
    - (a) Count the trucks to determine their existence.
    - (b) Use registrations documents held by Burrow 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) Samantha Altman, 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 25 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 Altman 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:

<b>EMPLOYMENT</b>	<b>ADVANTAGES</b>	<b>DISADVANTAGES</b>
INTERNAL REVENUE AGENT	<ol style="list-style-type: none"> <li>1. Extensive training in individual, corporate, gift, trust and other taxes is available with concentration in area chosen.</li> <li>2. Hands-on experience with sophisticated selection techniques.</li> </ol>	<ol style="list-style-type: none"> <li>1. Experience limited to taxes.</li> <li>2. No experience with operational or financial statement auditing.</li> <li>3. Training is not extensive with any business enterprise.</li> </ol>
CPA	<ol style="list-style-type: none"> <li>1. Extensive training in audit of financial statements, compliance auditing and operational auditing.</li> <li>2. Opportunity for experience in auditing, tax consulting, and management consulting practices.</li> <li>3. Experience in a diversity of enterprises and industries with the opportunity to specialize in a specific industry.</li> </ol>	<ol style="list-style-type: none"> <li>1. Exposure to taxes and to the business enterprise may not be as in-depth as the internal revenue agent or the internal auditor.</li> <li>2. Likely to be less exposed to operational auditing than is likely for internal auditors.</li> </ol>
GAO AUDITOR	<ol style="list-style-type: none"> <li>1. Increasing opportunity for experience in operational auditing.</li> <li>2. Exposure to highly sophisticated statistical sampling and computer auditing techniques.</li> </ol>	<ol style="list-style-type: none"> <li>1. Little exposure to diversity of enterprises and industries.</li> <li>2. Bureaucracy of federal government.</li> </ol>
INTERNAL AUDITOR	<ol style="list-style-type: none"> <li>1. Extensive exposure to all segments of the enterprise with which employed.</li> <li>2. Constant exposure to one industry presenting opportunity for expertise in that industry.</li> <li>3. Likely to have exposure to compliance, financial and operational auditing.</li> </ol>	<ol style="list-style-type: none"> <li>1. Little exposure to taxation and the audit of taxes.</li> <li>2. Experience is limited to one enterprise, usually within one or a limited number of industries.</li> </ol>

- (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 or operational
12.	GAO	Compliance

- 1-22**
- a. Financial statement audits reduce information risk, which lowers borrowing costs. An audit also provides assurances to management about information used for decision-making purposes, and may also provide recommendations to improve efficiency or effectiveness of operations.
  - b. Hogan and Czarnecki likely provide tax services, accounting services, and management advisory services. They may also provide additional assurance and attestation services other than audits of financial statements.
  - c. Student answers will vary. They may identify new types of information that require assurance, such as environmental or corporate responsibility reporting. Students may also identify opportunities for consulting or management advisory services, such as assistance with the adoption of international financial reporting standards.

## ■ Internet Problem Solution: CPA Requirements

### Internet Problem 1-1

- a. Answers will vary by state. Most states require 150 hours of education, with specific requirements for number of accounting hours and credit hours in other subject areas.
- b. Most states have frequently addressed questions. Many of these address education requirements, as well as information on how to prepare for the exam, as well as information on applying for licensure.

### Internet Problem 1-1 (continued)

- c. The Elijah Watt Sells award program was established in 1923 by the American Institute of Certified Public Accountants (AICPA) to recognize outstanding performance on the Uniform CPA Examination. The Sells award is presented annually to ten candidates with the highest cumulative scores who completed testing during the previous calendar year and passed all four sections of the Uniform CPA Examination on their first attempt.
- d. Passing information is available on the CPA Examination portion of the AICPA web site. Recent passing rates have been approximately 45% for each section.

(**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](http://www.pearsonhighered.com/arens).)