# *Auditing & Assurance Services 2026 Release 1st edition Louwers Solutions Manual*

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# CHAPTER 01

## Auditing and Assurance Services

### LEARNING OBJECTIVES

| | Review Checkpoints | Multiple Choice | Exercises, Problems, and Simulations |
|---|---|---|---|
| 1. Define *information risk* and explain how the financial statement auditing process helps to reduce this risk, thereby reducing the cost of capital for a company. | 1, 2, 3 | 29, 31, 38 | 65* |
| 2. Define and contrast assurance, attestation, and financial statement auditing services. | 4, 5, 6, 7, 8 | 23, 25, 28, 44, 50 | 60, 65* |
| 3. Describe and define the assertions that management makes about the recognition, measurement, presentation, and disclosure of the financial statements and explain why auditors use them as a focal point of the audit. | 9, 10, 11 | 36, 39, 40, 41, 45, 46, 47, 48, 49, 52, 53, 54, 55, 57, 58, 59 | 62, 63, 67, 68, 69 |
| 4. Define professional skepticism and explain its key characteristics. | 12 | 24, 37 | 61 |
| 5. Describe the organization of public accounting firms and identify the various services that they offer. | 13, 14 | 30, 42, 56 | 72 |
| 6. Describe the audits and auditors in governmental, internal, and operational auditing. | 15, 16, 17, 18 | 26, 27, 32, 34, 35 | 64, 66 |
| 7. List and explain the requirements for becoming a certified public accountant (CPA) and other certifications available to an accounting professional. | 19, 20, 21, 22 | 33, 43, 51 | 70, 71 |

(*) Item relates to multiple learning objectives


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## SOLUTIONS FOR REVIEW CHECKPOINTS

1.1 Business risk is the risk that an entity will fail to meet its business objectives. When assessing business risk, a professional must consider all possible threats to an entity's goals and objectives. Some illustrative examples include the risk that: 1) its existing customers will start buying products or services from its primary competitors; 2) its product lines will become obsolete; 3) its taxes will increase; 4) key government contracts will be lost; 5) key employees will leave the entity; and many other examples exist.

1.2 To help minimize business risk and take advantage of other opportunities presented in today's competitive business environment, decision makers such as chief executive officers (CEOs) demand timely, relevant, and reliable information. There are at least four environmental conditions that increase demand for reliable information. First, complexity which implies that events and transactions in today's global business environment can be complicated. Most investors do not have the level of expertise needed to properly account for complex transactions. Second is remoteness which implies that decision makers are often separated from current and potential business relationships due to distance and time. For example, investors may not be able to visit distant locations to check up on their investments. Third is time-sensitivity which implies that in today's economic environment, investors and other users of financial statements need to make decisions more rapidly than ever before. As a result, the ability to promptly obtain high-quality information is essential. Fourth is a consequence which implies that decisions may very well involve significant investments. As a result, the consequences can be severe if information cannot be obtained

1.3 Of all the different risks discussed in the chapter up to this point, information risk is the one that is most likely to create the demand for independent and objective assurance services is information risk or the probability that the information circulated by an entity will be false or misleading. Because the primary source of information for investors and creditors is the company itself, an incentive exists for that company's management to make their business or service appear to be better than it actually may be, to put their best foot forward. As a result, preparers and issuers of financial information (directors, managers, accountants, and other people employed in a business) might benefit by giving false, misleading, or overly optimistic information. This potential conflict of interest between information providers and users which provides the underlying basis for the demand for reliable information.

1.4 The four major elements of the broad definition of assurance services are

Independence. CPAs want to preserve their reputation and competitive advantage by always preserving integrity and objectivity when performing assurance services.

Professional services. Virtually all work performed by CPAs is defined as "professional services" as long as it involves some element of judgment based on education and experience.

Improving the quality of information or its context. The emphasis is on "information," CPAs' traditional area of expertise. CPAs can enhance quality by assuring users about the reliability and relevance of information, and these two features are closely related to the familiar credibility-lending products of attestation and audit services. "Context" is relevance in a different light. For assurance services, *improving the context of information* refers to improving its usefulness when targeted to particular decision makers in the surroundings of particular decision problems.

For decision makers. As the "consumers" of assurance services, decision makers are the beneficiaries of the assurance services. Decision makers may or may not be the "client" that pays the fee and may or may not be one of the parties to an assertion or other information, but they personify the consumer focus of new and different professional work.

1.5 An *assurance services engagement* is any assignment that improves the quality of information, or its context, for decision makers. Because information (e.g., financial statements) are prepared by managers of an entity who have authority and responsibility for financial success or failure, an outsider may be skeptical


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that the information truly is objective, free from bias, fully informative, and free from material error, intentional or inadvertent. The services of an independent auditor helps resolve those doubts because the auditor's success depends upon his or her independent, objective, and competent assessment of the information (e.g., the conformity of the financial statements with the appropriate reporting framework). The independent auditor's role is to lend credibility to the information; hence, the outsider will likely seek his or her independent opinion about the financial statements.

1.6 An attestation engagement is "an engagement in which a practitioner is engaged to issue or does issue a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party" (SSAE 10, AT 101.01). To attest means to lend credibility or to vouch for the truth or accuracy of the statements that one party makes to another. The attest function is a term often applied to the activities of independent CPAs when acting as auditors of financial statements.

1.7 An assurance service engagement is one that improves the quality of information, or its context, for decision makers. Thus, an attestation service engagement is **one type** of an assurance service. Another way of thinking about the issue is to remember that the financial statement audit engagement is **one type** of an attestation service. Please see exhibit 1.3 in the text which depicts the relationship among assurance, attestation, and auditing engagements.

1.8 According to the American Accounting Association, "*Auditing* is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users." In effect, auditors add reliability to the information that is provided to interested users. Of course, this definition is focused on an external reporting context. Students may also discuss how governmental and internal auditors operate as well.

In response to "What do auditors do?" students can respond by stating that auditors (1) obtain and evaluate evidence about assertions made by management about economic actions and events, (2) ascertain the degree of correspondence between the assertions and the appropriate reporting framework, and (3) issue an audit report (opinion). Students can also respond more generally by stating that auditors essentially lend credibility to the financial statements presented by management.

1.9 Financial accounting refers to the process of recording, classifying, summarizing, and reporting about a company's assets, liabilities, capital, revenues, and expenses in the financial statements in accordance with the applicable financial reporting framework (e.g., GAAP). In so doing, the management team is making several assertions about the financial statements. The financial accounting process is the responsibility of the management team.

Financial statement auditing refers to the process whereby professional auditors gather evidence related to the assertions that management makes in the financial statements, evaluates the evidence and concludes on the fairness of the financial statements in a report.

They differ because accountants produce the financial statements in accordance with the applicable financial reporting framework. After this is complete, financial statement auditors then perform procedures to ascertain whether the financial statements have been prepared in accordance with the applicable financial reporting framework.

1.10 The two major classifications of ASB assertions with several assertions in each classification are:

Assertions About Classes of Transactions and Events, and Related Disclosures

*Occurrence assertion:* The objective is to establish with evidence that transactions giving rise to assets, liabilities, sales, and expenses occurred. Key questions include "Did the recorded sales transactions really occur?"


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*Completeness assertion:* The objective is to establish with evidence that all transactions of the period that should be are included in the financial statements (including footnotes). Completeness also refers to proper inclusion in financial statements of *all* revenue, expense, and related disclosures. Key questions related to completeness include "Are the revenue and expense account balances complete?" and "Were all the transactions that should be included reflected properly in the footnote disclosures?"

*Cutoff assertion:* The objective is to establish with evidence that all transactions that properly belong in the preceding or following accounting periods are excluded. And, that only those transactions that should be included in the financial statements are included. A key question related to the cutoff assertion includes "Were all the transactions recorded in the right period?"

*Accuracy assertion:* The objective is to establish with evidence that transactions have been recorded at the correct amount. Key questions include "Were the expenses recorded at the proper dollar amount?"

*Classification assertion:* The objective is to establish with evidence that transactions were posted to the correct accounts. Key questions include "Was this expense recorded in the appropriate account?"

*Presentation assertion:* The objective is to establish with evidence that the information has been properly presented and described, and that the disclosures are clearly expressed. Key questions include "Was the information in the disclosure properly presented and disclosed?"

Assertions about Account Balances and Related Disclosures

*Existence assertion:* The objective is to establish with evidence that the balance represents assets, liabilities, sales, and expenses that are real and in existence at the balance sheet date. Key questions include "Does this number truly represent assets that existed at the balance sheet date?"

*Completeness assertion:* The objective is to establish with evidence that all balances of the period are in the financial statements. Key questions related to completeness include "Are the asset and liability accounts in the financial statements complete?"

*Rights and obligations assertion*: The objectives related to rights and obligations are to establish with evidence that assets are *owned* (or rights such as capitalized leases are shown) and liabilities are *owed.* Key questions related to this assertion include "Does the company really own the assets? And "Are related legal responsibilities identified?"

*Accuracy, Valuation and Allocation assertions:* The objective is to establish with evidence that balances have been valued correctly. Key questions include "Are the account balances accurate?" "Are the accounts valued correctly?" and "Are expenses allocated to the period(s) benefited?"

*Presentation assertion:* The objective is to establish with evidence that the balance sheet amounts, and related footnote disclosures are complete, properly presented and are understandable to the financial statement users. Key questions relate to "Is the account properly presented in the correct financial statement category" And, "are the footnote disclosures complete and presented to promote an understanding of the nature of the account?"

1.11 In general, management's financial statement assertions are important to auditors because they are used when assessing risks by determining the different types of misstatements that could occur for each assertion related to each significant account and disclosure. Next, auditors use the assertions to develop audit procedures that are appropriate to mitigate the risk of material misstatement for each assertion. In essence, the key questions that must be answered about each of the relevant assertions become the *focal points* for audit procedures. Audit procedures are the means to answer the key questions posed by management's financial statement assertions. In fact, the procedures are completed to provide the evidence necessary to persuade the auditor that there is no material misstatement related to each of the relevant assertions identified for an engagement.


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The ASB assertions differ from the PCAOB assertions in that they provide greater detail and clarity for auditors to conceptualize the type of misstatements that may exist in the financial statements. Thus, the PCAOB assertions are more general than the ASB assertions. Importantly, the PCAOB recognizes that their assertions are more general and do allow auditors to use the more granular and specific ASB assertions when completing the audit. As a result, largely each of the firms auditing public companies with international operations feature the ASB assertions to guide their auditing processes. Importantly, a student of auditing will note that the ASB assertions are in direct alignment with the PCAOB assertions. This is illustrated in the text in Exhibit 1.4

1.12 By having a belief that a potential conflict of interest always exists between the auditor and the management team, auditors will be skeptical when completing the audit. Indeed, even though the vast majority of audits do not contain fraud, auditors have no choice but to consider the possibility of fraud on every audit. Stated simply, errors and financial reporting frauds have happened in the past, and users of financial statements and audit reports expect auditors to detect material misstatements if they exist.

Indeed, auditing firms have long recognized the importance of exercising professional skepticism when making professional judgments. As a student of auditing, you can expect to encounter difficult economic transactions as an auditor. When a difficult transaction is encountered, auditors must take the time to fully understand the economic substance of that transaction and then critically evaluate, with skepticism, the evidence provided by the client to justify its accounting treatment. There are no shortcuts allowed. Rather, auditors must always hold a belief that a potential conflict of interest exist between the auditor and management, and they must be unbiased and objective when making their professional judgments.

1.13 Generally speaking, assurance services involve the lending of credibility to information, whether financial or nonfinancial. CPAs have assured vote counts (e.g., Baseball Hall of Fame), dollar amounts of prizes that sweepstakes have claimed to award, accuracy of advertisements, investment performance statistics, and characteristics claimed for computer software programs. Some specific examples of assurance service engagements performed on **nonfinancial information** include

- eXtensible Business Reporting Language (XBRL) reporting.
- Enterprise risk management assessment.
- Information risk assessment and assurance.
- Third-party reimbursement maximization.
- Rental property operations review.
- Customer satisfaction surveys.
- Evaluation of investment management policies.
- Fraud and illegal acts prevention and deterrence.
- Internal audit outsourcing.

1.14 THERE ARE THREE MAJOR AREAS OF PUBLIC ACCOUNTING SERVICES

- Financial Statement Audit and other types of Assurance services.
- Tax services.
- Consulting and Advisory services.


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1.15 *Operational auditing* is the study of business operations for the purpose of making recommendations about the economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies. The AICPA views operational auditing as a type of consulting or advisory service offered by public accounting firms.

1.16 The GAGAS issued by the GAO is very clear on this point. Specifically, the elements of *expanded-scope auditing* include (1) financial and compliance audits, (2) economy and efficiency audits, and (3) program results audits.

1.17 *Compliance auditing* involves a study of an organization's policies, procedures, and, ultimately, its performance in following applicable laws, rules, and regulations. An example would be a school district's policies and procedures related to a meal program for its students. In these types of situations, there would be a demand for a compliance audit which would be designed to ensure that the school district complies with the stated policies and procedures of the program.

1.18 Other kinds of auditors include Internal Revenue Service auditors who are required to audit the taxable income and deductions taken by taxpayers in tax returns and determine their correspondence with the standards found in the Internal Revenue Code. They also might have to audit for fraud and tax evasion. Other examples include state and federal bank examiners who are responsible for auditing banks, savings and loan associations, and other financial institutions for evidence of solvency and compliance with banking and other related laws and regulations.

1.19 The purpose of the continuing education requirement is to ensure that CPAs in practice maintain their expertise at a sufficiently high level in light of evolving business conditions and new regulations. For CPAs in public practice, 120 hours of continuing education is required every three years with no less than 20 hours in any one year. For CPAs not in public practice, the general requirement is 120 or fewer (90 in some states) every three years.

1.20 Not everything can be learned in the classroom, and some on-the-job experience is helpful before a person is able to be held out to the public as a licensed professional. Also, the experience requirement tends to "weed out" those individuals who are just looking to become certified without ever being involved in actual accounting work.

1.21 State boards administer the state accountancy laws and are responsible for ensuring that candidates have passed the CPA examination and satisfied the state requirements for education and experience before being awarded a CPA certificate. At the same time, new CPAs must pay a fee to obtain a state license to practice. Thereafter, state boards of accountancy regulate the behavior of CPAs under their jurisdiction (enforcing state rules of conduct) and supervise the continuing education requirements. As a result, the state boards play an important role in the CPA certification and licensure process.

1.22 After becoming a CPA licensed in one state, a person can obtain a CPA certificate and license in another state. The process is known as *reciprocity*. CPAs can file the proper application with another state board of accountancy, meet the state's requirements, and obtain another CPA certificate. Many CPAs hold certificates and licenses in several states. From a global perspective, individuals must be licensed in each country. Similar to CPAs in the United States, chartered accountants (CAs) practice in Australia, Canada, Great Britain, and India.


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## SOLUTIONS FOR MULTIPLE CHOICE-QUESTIONS

1.23

| | | |
|---|---|---|
| a. | Incorrect | This is an attestation to the prize promoter's claims. Because attestation and audit engagements are subsets of assurance engagements, this is an example of an assurance engagement. However, each response is an example of an assurance engagement; thus, the answer is (e). |
| b. | Incorrect | This is an audit engagement to give an opinion on financial statements. Because attestation and audit engagements are subsets of assurance engagements, this is an example of an assurance engagement. However, each response is an example of an assurance engagement; thus, the answer is (e). |
| c. | Incorrect | This is an assurance engagement on a newspaper's circulation data. Because attestation and audit engagements are subsets of assurance engagements, all are assurance engagements. Thus, the answer is (e). |
| d. | Incorrect | This is an assurance engagement on the performance of golf balls. Because attestation and audit engagements are subsets of assurance engagements, all are assurance engagements. Thus, the answer is (e). |
| e. | Correct | Because attestation and audit engagements are subsets of assurance engagements, all of the responses are examples of assurance engagements. |

1.24

| | | |
|---|---|---|
| a. | Correct | The management team is generally trying to put its "best foot forward" when reporting their financial statement information. The auditor must make sure that the management team does not violate the accounting rules when doing so. IN essence, this statement characterizes why professional skepticism is required to be exercised by auditors. |
| b. | Incorrect | "Exclusively in the capacity of an auditor" is not an idea that relates to an attitude of professional skepticism. |
| c. | Incorrect | Professional obligations are not related to an attitude of professional skepticism. |
| d. | Incorrect | While it is true that financial statement and financial data are verifiable, this does not related to the reasons why an auditor needs to begin an audit with an attitude of professional skepticism. |

1.25

| | | |
|---|---|---|
| a. | Incorrect | While work on a forecast would potentially be covered by the attestation standards, the auditors must provide assurance about some type of management assertion in an attestation engagement. |
| b. | Correct | This is the basic definition of an attestation service, as articulated in the book and the professional standards. |
| c. | Incorrect | Since there is no assurance about any management assertion when preparing a tax return with information that has not been reviewed or audited, this type of tax work is not considered an attestation service. |
| d. | Incorrect | Since there is no assurance about any management assertion when giving expert testimony about particular facts in an income tax case, this type of work is not considered an attestation service. |

1.26

| | | |
|---|---|---|
| a. | Incorrect | The objective of environmental auditing is to help achieve and maintain compliance with environmental laws and regulations and to help identify and correct unregulated environmental hazards. This answer is therefore incorrect. |
| b. | Incorrect | The objective of financial auditing is to obtain assurance on the conformity of financial statements with generally accepted accounting principles. This answer is therefore incorrect. |
| c. | Incorrect | The objective of compliance auditing is the entity's compliance with laws and regulations. This answer is therefore incorrect. |


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| | | | |
|---|---|---|---|
| | d. | Correct | Operational auditing refers to the study of business operations for the purpose of making recommendations about the economic and efficient use of resources, effective achievement of business objectives, and compliance with company policies. |

1.27

| | | |
|---|---|---|
| a. | Incorrect | This is not the primary objective of an operational audit. However, while completing an operational audit, a professionally skeptical auditor should still be concerned about compliance with financial accounting standards. |
| b. | Correct | This statement exactly characterizes the goal of an operational audit. In addition, the statement is part of the basic definition of operational auditing. |
| c. | Incorrect | An operational audit does not focus on the financial statements of an entity. |
| d. | Incorrect | While analytical tools and skills may be used during an operational audit, they are also a very important aspect of financial auditing. |

1.28

| | | |
|---|---|---|
| a. | Correct | According to the AICPA definition found in AU 200 (paragraph 11) and in your book, “the purpose of an audit is to enhance the degree of confidence that intended users can place in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. As a result, this is the correct response. |
| b. | Incorrect | The AICPA definition is not limited to the FASB for the appropriate reporting framework that is used as the benchmark when completing an audit. The definition is general enough to include other financial reporting frameworks as well, such as IFRS. |
| c. | Incorrect | The AICPA definition does not focus on the SEC as an appropriate reporting framework to be used as a benchmark when completing an audit. The definition is focused on the “applicable” financial reporting framework, such as GAAP or IFRS. The reference to the SEC is wrong. |
| d. | Incorrect | This phrase is not referenced in the AICPA definition found in the auditing standards. This phrase is found in the AAA definition of the audit found in this book. |

1.29

| | | |
|---|---|---|
| a. | Incorrect | While complexity is an important condition that increases the demand for reliable information, the potential conflict of interest between management and the bank is far and away the biggest factor driving the demand for audited financial statements. |
| b. | Incorrect | While remoteness is an important condition that increases the demand for reliable information, the potential conflict of interest between management and the bank is far and away the biggest factor driving the demand for audited financial statements. |
| c. | Incorrect | While the consequences of making a bad decision are an important condition that increases the demand for reliable information, the potential conflict of interest between management and the bank is far and away the biggest factor driving the demand for audited financial statements. |
| d. | Correct | The potential conflict of interest between management and the bank is far and away the biggest factor driving the demand for audited financial statements. Consider for example a company that was desperate for cash in order to survive. Would it be possible that the management team would present unreliable financial statements to the bank in order to get a desperation loan? Because of this possibility, a financial statement audit is needed to add credibility to the financial statements. |

1.30


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| | | |
|---|---|---|
| a. | Incorrect | According to Section 201 of the Sarbanes-Oxley Act, bookkeeping services are prohibited. |
| b. | Incorrect | According to Section 201 of the Sarbanes-Oxley Act, internal audit services are prohibited. |
| c. | Incorrect | According to Section 201 of the Sarbanes-Oxley Act, valuation services are prohibited. |
| d. | Correct | Sarbanes-Oxley prohibits the provision of all of the services listed in answers a, b, and c; therefore, d (all of the above) is the best response. |

1.31

| | | |
|---|---|---|
| a. | Incorrect | Financial statement auditors do not reduce business risk. |
| b. | Correct | After completing a financial statement audit, information risk has been reduced for investors. |
| c. | Incorrect | Complexity creates demand for accounting services but is not an objective of the financial statement audit. |
| d. | Incorrect | Auditors do not directly control the timeliness of financial statements. Management must first provide the information to be audited. |

1.32

| | | |
|---|---|---|
| a. | Incorrect | A financial statement opinion is the objective of a financial statement audit, not a compliance audit. |
| b. | Incorrect | A basis for a report on internal control is the objective of an internal control audit under Section 404 of the Sarbanes-Oxley Act, not a compliance audit. |
| c. | Incorrect | A study of effective and efficient resources is the objective of an operational audit, not a compliance audit. |
| d. | Correct | A compliance audit refers to procedures that are designed to ascertain that the company's personnel are following laws, rules, regulations, and policies. |

1.33

| | | |
|---|---|---|
| a. | Incorrect | While successful completion of the Uniform CPA is necessary to be licensed as a CPA, a candidate also requires the proper experience and proper education. Thus, letter (d.) is correct. |
| b. | Incorrect | While proper experience is necessary to be licensed as a CPA, a candidate also requires the successful completion of the Uniform CPA and proper education. Thus, letter (d.) is correct. |
| c. | Incorrect | While proper education is necessary to be licensed as a CPA, a candidate also requires the successful completion of the Uniform CPA and proper experience. Thus, letter (d.) is correct. |
| d. | Correct | A candidate requires the successful completion of the Uniform CPA, proper experience and proper education to be licensed as a CPA. |

1.34

| | | |
|---|---|---|
| a. | Incorrect | The GIAA is not responsible for monitoring the use of public funds by public officials. This is the responsibility of the GAO. |
| b. | Incorrect | The CIA is not responsible for monitoring the use of public funds by public officials. This is the responsibility of the GAO. |
| c. | Incorrect | The SEC is not responsible for monitoring the use of public funds by public officials. This is the responsibility of the GAO. |
| d. | Correct | The mission of the U.S. Government Accountability Office is to ensure that public officials are using public funds efficiently, effectively, and economically. |

1.35

| | | |
|---|---|---|
| a. | Incorrect | A financial audit is typically not included as part of a performance audit. |
| b. (&d) | Correct | The two categories of performance audits are economy and efficiency audits and program audits. |
| c. | Incorrect | A compliance audit is typically not included as part of a performance audit. |


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| | | | |
|---|---|---|---|
| | d. (&b) | Correct | The two categories of performance audits are economy and efficiency audits and program audits. |
| 1.36 | | | |
| | a. | Incorrect | A review of credit ratings of customers would not provide evidence about the completeness of accounts receivable. Because GAAP requires the accounts receivable balance to be valued at the amount expected to be collected from customers, the review of credit ratings relates to valuation. |
| | b. | Incorrect | A review of credit ratings of customers would not provide evidence about the existence of accounts receivable. Because GAAP requires the accounts receivable balance to be valued at the amount expected to be collected from customers, the review of credit ratings relates to valuation. |
| | c. | Correct | A review of credit ratings of customers' gives indirect evidence of the collectability of accounts receivable. Because GAAP requires the accounts receivable balance to be valued at the amount expected to be collected from customers, the review of credit ratings relates to valuation. |
| | d. | Incorrect | A review of credit ratings of customers would not provide evidence about the rights of accounts receivable. Because GAAP requires the accounts receivable balance to be valued at the amount expected to be collected from customers, the review of credit ratings relates to valuation. |
| | e. | Incorrect | A review of credit ratings of customers would not provide evidence about the occurrence of accounts receivable. Because GAAP requires the accounts receivable balance to be valued at the amount expected to be collected from customers, the review of credit ratings relates to valuation. |
| 1.37 | | | |
| | a. | Incorrect | Rhonda's representations are not sufficient evidence to support assertions made in the financial statements. |
| | b. | Incorrect | Despite Rhonda's representations, Jones must gather additional evidence to corroborate Rhonda's assertions. |
| | c. | Incorrect | Rhonda's representations are a form of evidence (albeit weak) that should neither be disregarded nor blindly regarded without professional skepticism. |
| | d. | Correct | Rhonda's assertions are nice. However, to be considered as sufficient to conclude that all expenses have been recorded, they will need corroboration with documentary evidence. Thus, this is the correct response. |
| 1.38 | | | |
| | a. | Incorrect | Although there is a high level of risk associated with client acceptance, this phrase was created by the authors. |
| | b. | Correct | By definition, information risk is the probability that the information circulated by a company will be false or misleading. |
| | c. | Incorrect | Moral hazard is the risk that the existence of a contract will change the behavior of one or both parties to the contract. |
| | d. | Incorrect | Business risk is the probability an entity will fail to meet its strategic objectives. |
| 1.39 | | | |
| | a. | Correct | This is clearly a test of the completeness as the assertion always includes any issues of transaction cutoff, which means that the recording of all revenue, expense, and other transactions must be included in the proper period in accordance with GAAP. |
| | b. | Incorrect | This is not an existence test. This is clearly a test of the completeness as the assertion always includes any issues of transaction cutoff, which means that the recording of all revenue, expense, and other transactions must be included in the proper period in accordance with GAAP. |
| | c. | Incorrect | This is not a test of valuation. This is clearly a test of the completeness as the assertion always includes any issues of transaction cutoff, which means that the |


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recording of all revenue, expense, and other transactions must be included in the proper period in accordance with GAAP.

d. Incorrect — This is not a test of rights and obligations. This is clearly a test of the completeness as the assertion always includes any issues of transaction cutoff, which means that the recording of all revenue, expense, and other transactions must be included in the proper period in accordance with GAAP.

e. Incorrect — This is not an occurrence test. This is clearly a test of the completeness as the assertion always includes any issues of transaction cutoff, which means that the recording of all revenue, expense, and other transactions must be included in the proper period in accordance with GAAP.

1.40

a. Incorrect — This is not a completeness test. This is clearly a test related to rights and obligations as the question that must be answered with evidence is to establish that amounts reported as assets of the company represent true assets that it really does own and that the amounts reported as liabilities truly represent its obligations. Goods on consignment, by definition, are not owned by the company. Thus, there is a risk that the company is recording assets that they do not own on their balance sheet.

b. Incorrect — This is not an existence test. This is clearly a test related to rights and obligations as the question that must be answered with evidence is to establish that amounts reported as assets of the company represent true assets that it really does own and that the amounts reported as liabilities truly represent its obligations. Goods on consignment, by definition, are not owned by the company. Thus, there is a risk that the company is recording assets that they do not own on their balance sheet.

c. Incorrect — This is not a test of valuation. This is clearly a test related to rights and obligations as the question that must be answered with evidence is to establish that amounts reported as assets of the company represent true assets that it really does own and that the amounts reported as liabilities truly represent its obligations. Goods on consignment, by definition, are not owned by the company. Thus, there is a risk that the company is recording assets that they do not own on their balance sheet.

d. Correct — This is clearly a test related to rights and obligations as the question that must be answered with evidence is to establish that amounts reported as assets of the company represent true assets that it really does own and that the amounts reported as liabilities truly represent its obligations. Goods on consignment, by definition, are not owned by the company. Thus, there is a risk that the company is recording assets that they do not own on their balance sheet.

e. Incorrect — This is not an occurrence test. This is clearly a test related to rights and obligations as the question that must be answered with evidence is to establish that amounts reported as assets of the company represent true assets that it really does own and that the amounts reported as liabilities truly represent its obligations. Goods on consignment, by definition, are not owned by the company. Thus, there is a risk that the company is recording assets that they do not own on their balance sheet.

1.41

a. Incorrect — This is not a test of completeness. This is a test of existence which is completed by auditors to answer the question as to whether the transactions recorded as an asset really represent assets that exist and did add value to the company's equipment as compared to routine repair and maintenance expenses under GAAP. Management's existence assertion states that the reported assets actually exist. If an addition to the equipment account cannot be located or identified as adding value to the equipment balance, it is possible that the amount should have been classified as repair and maintenance expenses under GAAP.



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| | | |
|---|---|---|
| b. | Correct | This is a test of existence. This test is completed by auditors to answer the question as to whether the transactions recorded as an asset really represent assets that exist and did add value to the company's equipment as compared to routine repair and maintenance expenses under GAAP. Management's existence assertion states that the reported assets actually exist. If an addition to the equipment account cannot be located or identified as adding value to the equipment balance, it is possible that the amount should have been classified as repair and maintenance expenses under GAAP. |
| c. | Incorrect | This is not a test of valuation. This is a test of existence which is completed by auditors to answer the question as to whether the transactions recorded as an asset really represent assets that exist and did add value to the company's equipment as compared to routine repair and maintenance expenses under GAAP. Management's existence assertion states that the reported assets actually exist. If an addition to the equipment account cannot be located or identified as adding value to the equipment balance, it is possible that the amount should have been classified as repair and maintenance expenses under GAAP. |
| d. | Incorrect | This is not a test of rights and obligations. This is a test of existence which is completed by auditors to answer the question as to whether the transactions recorded as an asset really represent assets that exist and did add value to the company's equipment as compared to routine repair and maintenance expenses under GAAP. Management's existence assertion states that the reported assets actually exist. If an addition to the equipment account cannot be located or identified as adding value to the equipment balance, it is possible that the amount should have been classified as repair and maintenance expenses under GAAP. |
| e. | Incorrect | This is not a test of occurrence. This is a test of existence which is completed by auditors to answer the question as to whether the transactions recorded as an asset really represent assets that exist and did add value to the company's equipment as compared to routine repair and maintenance expenses under GAAP. Management's existence assertion states that the reported assets actually exist. If an addition to the equipment account cannot be located or identified as adding value to the equipment balance, it is possible that the amount should have been classified as repair and maintenance expenses under GAAP. |

1.42

| | | |
|---|---|---|
| a. | Incorrect | Under Sarbanes-Oxley, public accounting firms are prevented from acting in a managerial decision-making role for an audit client. |
| b. | Incorrect | Under Sarbanes-Oxley, public accounting firms are prevented from auditing the firm's own work on an audit client. |
| c. | Incorrect | Under Sarbanes-Oxley, public accounting firms may only provide tax consulting services to an audit client with the audit committee's approval. |
| d. | Correct | Sarbanes-Oxley prevents public accounting firms from serving an audit client in any of the preceding listed roles. As a result, each of the responses a, b, and c is incorrect and letter d is the correct response. |

1.43

| | | |
|---|---|---|
| a. | Incorrect | Substantial equivalency does not refer to the financial statement auditing process. The term relates to the practice of public accountancy in states other than a CPA's state of licensure. |
| b. | Incorrect | Substantial equivalency does not refer to consulting services. The term relates to the practice of public accountancy in states other than a CPA's state of licensure. |
| c. | Incorrect | Substantial equivalency does not refer to other professional organizations. The term relates to the practice of public accountancy in states other than a CPA's state of licensure. |
| d. | Correct | Substantial equivalency relates to the practice of public accountancy in states other than a CPA's state of licensure. Under the concept of substantial |


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equivalency, as long as the licensing (home) state requires (1) 150 hours of education, (2) successful completion of the CPA exam, and (3) one year of experience, a CPA can practice (either in person or electronically) in another substantial equivalency state without having to obtain a license in that state.

1.44

| | | |
|---|---|---|
| a. | Correct | Auditing is a subset of attestation engagements that focuses on the certification of financial statements. The subject matter is the set of financial statements from management and the criteria is GAAP in the United States. |
| b. | Incorrect | That is not true. Auditing is one example of an attest engagement. The level of assurance provided is not lower for an attestation engagement. |
| c. | Incorrect | That is not true. The auditor is not allowed to provide management support for its audit clients. Rather, consulting engagements can focus on providing clients with advice and decision support. |
| d. | Incorrect | The definition provided is the one for assurance engagements, which is quite broad and includes all engagements that are designed to improve the quality of information, or its context, for decision makers. |

1.45

| | | |
|---|---|---|
| a. | Correct | Management is more likely to overstate assets and understate liabilities. As a result, when auditing an asset balance, the most relevant assertions are likely to be either existence or valuation. In this situation, because of the nature of cash and the fact that is no foreign currency translation calculation, the existence assertion is clearly the most important assertion. |
| b. | Incorrect | Although rights and obligations is an important assertion, it is not the most relevant assertion for the cash balance. Since management is more likely to overstate assets, when auditing an asset balance, the most relevant assertions are likely to be either existence or valuation. In this situation, because of the nature of cash and the fact that is no foreign currency translation calculation, the existence assertion is clearly the most important assertion. |
| c. | Incorrect | Although valuation is an important assertion, it is not the most relevant assertion for the cash balance. In this situation, because of the nature of cash and the fact that is no foreign currency translation calculation, the existence assertion is clearly the most important assertion. If however, there was a foreign currency translation adjustment, valuation of cash would also be relevant. |
| d. | Incorrect | Although occurrence is an important assertion, it is not the most relevant assertion for any balance sheet account. Rather, the occurrence assertion is more closely related to income statement accounts because the question that needs to be answered with evidence is whether the transaction really did occur in accordance with GAAP. In this situation, because of the nature of cash and the fact that is no foreign currency translation calculation, the existence assertion is clearly the most important assertion. |

1.46

| | | |
|---|---|---|
| a. | Incorrect | This evidence would provide evidence about management's assertion about rights and obligations and perhaps existence. However, this evidence would not help to value the investment in accordance with GAAP. |
| b. | Incorrect | While this evidence would potentially be helpful to value an investment in another company, it is not the best answer. If a quote was available from an independent source, this would be a better form of evidence for valuation. |
| c. | Incorrect | This evidence would provide evidence about management's assertion about existence and perhaps rights and obligations. However, this evidence would not help to value the investment in accordance with GAAP. |
| d. | Correct | Always remember that management is more likely to overstate assets. As a result, when auditing an asset balance like investments, a relevant assertion is likely to be valuation. In this situation, to answer the question of what the |


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| | | | |
|---|---|---|---|
| | | | investment should be valued at in the balance sheet, an auditor would first seek to obtain a market quotation from an independent source like the Wall Street Journal. |
| 1.47 | | | |
| | a. | Incorrect | This test is not related to presentation and disclosure. A cutoff test is clearly a test of the completeness assertion as the test is designed to insure that all transactions that should have been included in accordance with GAAP have been recorded. |
| | b. | Correct | A cutoff test is clearly a test of the completeness assertion as the test is designed to insure that all transactions that should have been included in accordance with GAAP have been recorded. |
| | c. | Incorrect | This test is not related to rights and obligations. A cutoff test is clearly a test of the completeness assertion as the test is designed to insure that all transactions that should have been included in accordance with GAAP have been recorded. |
| | d. | Incorrect | This test is not related to existence. A cutoff test is clearly a test of the completeness assertion as the test is designed to insure that all transactions that should have been included in accordance with GAAP have been recorded. |
| 1.48 | | | |
| | a. | Incorrect | This test is designed to test the completeness assertion for the inventory account. It does not provide any evidence related to the rights and obligations assertion. |
| | b. | Correct | This is clearly a test related to rights and obligations as the question that must be answered with evidence is to establish that the inventory reported as assets really is owned by the company. Goods on consignment, by definition, are not owned by the company. Thus, there is a risk that the company is recording assets that they do not own on their balance sheet. |
| | c. | Incorrect | This test is designed to test the completeness assertion for sales revenue. It does not provide evidence related to the rights and obligations assertion for inventory. |
| | d. | Incorrect | This test is designed to test the presentation and disclosure assertion for inventory purchase commitments. It does not provide evidence related to the rights and obligations assertion for inventory. |
| 1.49 | | | |
| | a. | Incorrect | Management is far more likely to understate liabilities than to overstate them. As a result, when auditing the accrued liabilities account, existence or occurrence is not as likely to be violated. Rather, the most relevant assertion is likely to be completeness. |
| | b. | Correct | Management is more likely to understate liabilities. As a result, when auditing the accrued liabilities account, the most relevant assertion is likely to be completeness. |
| | c. | Incorrect | Management is far more likely to understate liabilities. As a result, when auditing the accrued liabilities account, the most relevant assertion is likely to be completeness. Presentation and disclosure may be relevant. However, it is not as likely to contain a material misstatement as completeness. |
| | d. | Incorrect | Management is far more likely to understate liabilities than to overstate them. As a result, when auditing the accrued liabilities account, the most relevant assertion is likely to be completeness. Valuation may be relevant. However, it is not as likely to contain a material misstatement as completeness. |
| 1.50 | | | |
| | a. | Incorrect | This is not correct as an auditing engagement refers to an examination of the financial statements to determine whether the information has been presented in accordance with GAAP. Also, a consulting engagement is one where the professional provides advice and decision support. |


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| | | |
|---|---|---|
| b. | Incorrect | This is not correct as a consulting engagement is one where the professional provides advice and decision support. Also, an assurance engagement can include many more types of information than just the financial statements. |
| c. | Incorrect | This is not correct as an auditing engagement refers to an examination of the financial statements to determine whether the information has been presented in accordance with GAAP. Also, a consulting engagement is one where the professional provides advice and decision support. |
| d. | Correct | This is correct as an auditing engagement refers to an examination of the financial statements to determine whether the information has been presented in accordance with GAAP and an attestation engagement can include a financial statement audit. In addition, An assurance engagement can apply to all types of information and a consulting engagement is one where the professional provides advice and decision support. |

1.51

| | | |
|---|---|---|
| a. | Incorrect | Credibility is a reason to become certified. Because all three responses are reasons, (d) is correct. |
| b. | Incorrect | Advancement and promotion are reasons to become certified. Because all three responses are reasons, (d) is correct. |
| c. | Incorrect | Monetary reward is a reason to become certified. Because all three responses are reasons, (d) is correct. |
| d. | Correct | Credibility, advancement, and monetary rewards are all reasons to become certified. |

1.52

| | | |
|---|---|---|
| a. | Incorrect | Although existence or occurrence is an important assertion, it is not the most relevant assertion for retained earnings. Restrictions on retained earnings from loans, agreements or state law would need to be disclosed in the footnotes to the financial statements. As a result, presentation and disclosure is clearly the most important assertion. |
| b. | Incorrect | Although completeness is an important assertion, it is not the most relevant assertion for retained earnings. Restrictions on retained earnings from loans, agreements or state law would need to be disclosed in the footnotes to the financial statements. As a result, presentation and disclosure is clearly the most important assertion. |
| c. | Incorrect | Although valuation is an important assertion, it is not the most relevant assertion for retained earnings. Restrictions on retained earnings from loans, agreements or state law would need to be disclosed in the footnotes to the financial statements. As a result, presentation and disclosure is clearly the most important assertion. |
| d. | Correct | Restrictions on retained earnings from loans, agreements or state law would need to be disclosed in the footnotes to the financial statements. As a result, presentation and disclosure is clearly the most important assertion. |

1.53

| | | |
|---|---|---|
| a. | Correct | Management is more likely to overstate assets and understate liabilities. As a result, when auditing an asset balance, the most relevant assertions are likely to be either existence or valuation. In this situation, because of the nature of accounts receivable and the fact that valuation is not an option, the existence assertion is clearly the most important assertion. |
| b. | Incorrect | Although completeness is an important assertion, it is not the most relevant assertion for the accounts receivable balance. Since management is more likely to overstate assets and understate liabilities. As a result, when auditing an asset balance, the most relevant assertions are likely to be either existence or valuation. In this situation, because of the nature of accounts receivable and the |


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| | | |
|---|---|---|
| | | fact that valuation is not an option, the existence assertion is clearly the most important assertion. |
| c. | Incorrect | Although presentation and disclosure is an important assertion, it is not the most relevant assertion for the accounts receivable balance. Since management is more likely to overstate assets and understate liabilities. As a result, when auditing an asset balance, the most relevant assertions are likely to be either existence or valuation. In this situation, because of the nature of accounts receivable and the fact that valuation is not an option, the existence assertion is clearly the most important assertion. |
| d. | Incorrect | Although rights and obligations is an important assertion, it is not the most relevant assertion for the accounts receivable balance. Since management is more likely to overstate assets and understate liabilities. As a result, when auditing an asset balance, the most relevant assertions are likely to be either existence or valuation. In this situation, because of the nature of accounts receivable and the fact that valuation is not an option, the existence assertion is clearly the most important assertion. |

1.54

| | | |
|---|---|---|
| a. | Incorrect | Although rights and obligations is an important assertion, it is not the assertion being tested in this situation. Most importantly, the auditor did not select items for testing from any financial statement records. Rather, the auditor selected items to be tested from the warehouse, without considering the financial statement records. As a result, this is a test that is designed specifically to test whether all items that should be recorded on the financial statements actually are included on the financial statements. Thus, the assertion being tested is the completeness assertion. The absolute key to understanding this question is to focus on how the items were selected for testing. |
| b. | Correct | Most importantly, the auditor did not select items for testing from any financial statement records. Rather, the auditor selected items to be tested from the warehouse, without considering the financial statement records. As a result, this is a test that is designed specifically to test whether all items that should be recorded on the financial statements actually are included on the financial statements. Thus, the assertion being tested is the completeness assertion. The absolute key to understanding this question is to focus on how the items were selected for testing. |
| c. | Incorrect | Although existence is an important assertion, it is not the assertion being tested in this situation. Most importantly, the auditor did not select items for testing from any financial statement records. Rather, the auditor selected items to be tested from the warehouse, without considering the financial statement records. As a result, this is a test that is designed specifically to test whether all items that should be recorded on the financial statements actually are included on the financial statements. Thus, the assertion being tested is the completeness assertion. The absolute key to understanding this question is to focus on how the items were selected for testing. |
| d. | Incorrect | Although valuation is an important assertion, it is not the assertion being tested in this situation. Most importantly, the auditor did not select items for testing from any financial statement records. Rather, the auditor selected items to be tested from the warehouse, without considering the financial statement records. As a result, this is a test that is designed specifically to test whether all items that should be recorded on the financial statements actually are included on the financial statements. Thus, the assertion being tested is the completeness assertion. The absolute key to understanding this question is to focus on how the items were selected for testing. |

1.55


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| | | |
|---|---|---|
| a. | Incorrect | Although rights and obligations is an important assertion, it is not the most relevant assertion when testing the pension footnote. The question specifically relates to testing the information contained in the pension footnote. When testing the footnote disclosures, the presentation and disclosure is likely to be the most important assertion being tested. |
| b. | Incorrect | Although existence is an important assertion, it is not the most relevant assertion when testing the pension footnote. The question specifically relates to testing the information contained in the pension footnote. When testing the footnote disclosures, the presentation and disclosure is likely to be the most important assertion being tested. |
| c. | Correct | The question specifically relates to testing the information contained in the pension footnote. When testing the footnote disclosures, the presentation and disclosure is likely to be the most important assertion being tested. |
| d. | Incorrect | Although valuation is an important assertion, it is not the most relevant assertion when testing the pension footnote. The question specifically relates to testing the information contained in the pension footnote. When testing the footnote disclosures, the presentation and disclosure is likely to be the most important assertion being tested. |

1.56

| | | |
|---|---|---|
| a. | Incorrect | Since there is no assurance about any management assertion provided when completing an engagement to implement an ERP system, this is not considered an attestation service. This is a consulting service. |
| b. | Incorrect | Since there is no assurance about any management assertion provided when completing an engagement to develop a more efficient payroll process, this is not considered an attestation service. This is a consulting service. |
| c. | Correct | This is an attestation service. In order to assess the effectiveness of an internal control system, the assurance provider would have to attest to management's assertion that the internal control was effective in accordance with the COSO framework, as this is the most common way of expressing the effectiveness of an internal control system. As a result, this is the definition of an attestation service, as articulated in the book and the professional standards. |
| d. | Incorrect | Since there is no assurance about any management assertion when assisting the client in an IRS audit, this type of work is not considered an attestation service. |

1.57

| | | |
|---|---|---|
| a. | Incorrect | Although rights and obligations is an important assertion, it is not the most relevant assertion for the revenue account. Management is more likely to overstate revenue to improve profitability. As a result, when auditing the revenue account, the most relevant assertions are likely to be either existence/occurrence or valuation. In this situation, because of the nature of revenue and the fact that accuracy is more closely related to valuation, the valuation assertion is clearly the most important assertion. In addition, the existence/occurrence option is not an available option. |
| b. | Correct | Valuation and allocation is the PCAOB assertion that is most likely to be tested. In general, management is more likely to overstate revenue to improve profitability. As a result, when auditing the revenue account, the most relevant assertions are likely to be either existence/occurrence or valuation. In this situation, because of the nature of revenue and the fact that accuracy is more closely related to valuation, the valuation assertion is clearly the most important assertion. In addition, the existence/occurrence option is not an available option. |
| c. | Incorrect | Although presentation and disclosure is an important assertion, it is not the most relevant assertion for the revenue account. Management is more likely to overstate revenue to improve profitability. As a result, when auditing the revenue account, the most relevant assertions are likely to be either existence/occurrence or valuation. In this situation, because of the nature of |


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| | | |
|---|---|---|
| | | revenue and the fact that accuracy is more closely related to valuation, the valuation assertion is clearly the most important assertion. In addition, the existence/occurrence option is not an available option. |
| d. | Incorrect | Although completion is an important assertion, it is not the most relevant assertion for the revenue account. Management is more likely to overstate revenue to improve profitability. As a result, when auditing the revenue account, the most relevant assertions are likely to be either existence/occurrence or valuation. In this situation, because of the nature of revenue and the fact that accuracy is more closely related to valuation, the valuation assertion is clearly the most important assertion. In addition, the existence/occurrence option is not an available option. |

1.58

| | | |
|---|---|---|
| a. | Incorrect | Although existence is an important assertion, it is not the most relevant assertion for goodwill account in this situation. By definition, impairment of goodwill is an accounting charge that companies record when the goodwill account's carrying value on the balance sheet exceeds its fair value. As a result, when auditing the goodwill account to determine whether it is impaired or not, the most relevant assertion is clearly valuation. |
| b. | Incorrect | Although completeness is an important assertion, it is not the most relevant assertion for goodwill account in this situation. By definition, impairment of goodwill is an accounting charge that companies record when the goodwill account's carrying value on the balance sheet exceeds its fair value. As a result, when auditing the goodwill account to determine whether it is impaired or not, the most relevant assertion is clearly valuation. |
| c. | Incorrect | Although presentation and disclosure is an important assertion, it is not the most relevant assertion for goodwill account in this situation. By definition, impairment of goodwill is an accounting charge that companies record when the goodwill account's carrying value on the balance sheet exceeds its fair value. As a result, when auditing the goodwill account to determine whether it is impaired or not, the most relevant assertion is clearly valuation. |
| d. | Correct | Valuation is the correct answer. By definition, impairment of goodwill is an accounting charge that companies record when the goodwill account's carrying value on the balance sheet exceeds its fair value. As a result, when auditing the goodwill account to determine whether it is impaired or not, the most relevant assertion is clearly valuation. |

1.59

| | | |
|---|---|---|
| a. | Correct | Rights and obligations is the correct answer. By definition, consignment inventory is a business model where a product is sold by a retail store but the title/ownership of the product is retained by a third party until the product is actually sold by the retailer. As a result, when auditing the inventory account of an audit client that sells consigned inventory, the rights and obligations assertion is the most relevant assertion to be audited since ownership of the inventory is in question. |
| b. | Incorrect | Although completeness is an important assertion, it is not the most relevant assertion for the inventory account in this situation. By definition, consignment inventory is a business model where a product is sold by a retail store but the title/ownership of the product is retained by a third party until the product is actually sold by the retailer. As a result, when auditing the inventory account of an audit client that sells consigned inventory, the rights and obligations assertion is the most relevant assertion to be audited since ownership of the inventory is in question. |
| c. | Incorrect | Although existence or occurrence is an important assertion, it is not the most relevant assertion for the inventory account in this situation. By definition, consignment inventory is a business model where a product is sold by a retail |


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| | | |
|---|---|---|
| | | store but the title/ownership of the product is retained by a third party until the product is actually sold by the retailer. As a result, when auditing the inventory account of an audit client that sells consigned inventory, the rights and obligations assertion is the most relevant assertion to be audited since ownership of the inventory is in question. |
| d. | Incorrect | Although valuation or allocation is an important assertion, it is not the most relevant assertion for the inventory account in this situation. By definition, consignment inventory is a business model where a product is sold by a retail store but the title/ownership of the product is retained by a third party until the product is actually sold by the retailer. As a result, when auditing the inventory account of an audit client that sells consigned inventory, the rights and obligations assertion is the most relevant assertion to be audited since ownership of the inventory is in question. |

## SOLUTIONS FOR EXERCISES AND PROBLEMS

1.60 **Audit, Attestation, and Assurance Services**

Students may encounter some difficulty with this matching question because the Special Committee on Assurance Services (SCAS) listed many things that heretofore have been considered "attestation services" (long before assurance services were invented). As a result, we believe that this question is a good vehicle for discussing the considerable overlap that exists between attestation and assurance services.

- Real estate demand studies: Assurance service
- Ballot for awards show: Assurance service
- Utility rates applications: Assurance service
- Newspaper circulation audits: Assurance service
- Third-party reimbursement maximization: Assurance service
- Annual financial report to stockholders: Audit service
- Rental property operations review: Assurance service
- Examination of financial forecasts and projections: Attestation service
- Customer satisfaction surveys: Assurance service
- Compliance with contractual requirements: Attestation service
- Benchmarking/best practices: Assurance service
- Evaluation of investment management policies: Assurance service
- Information systems security reviews: Assurance service
- Productivity statistics: Assurance service
- Internal audit strategic review: Assurance service
- Financial statements submitted to a bank loan officer: Audit service


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1.61 **Professional Skepticism**

In general, students should note that they always need to maintain their level of professional skepticism on the financial statement audit. There may be times when skepticism should increase. However, even when it might seem that you can reduce your skepticism, auditors should always maintain their professional skepticism.

a) The chair of the board of your audit client proposed that the company hire its sales manager as their new financial controller.

Increase

b) The financial controller at your client mentions that she has just been on maternity leave for three months and no bank reconciliations were completed during the time she was out of the office.

Increase

c) While auditing the Accounts Receivable account for your audit client, you notice that there is a large amount that is well past due on the aged accounts receivable schedule.

Increase

d) While auditing the year-end investment balances, you find that your client's investment balance exactly agrees to the statement from the investment custodian. The custodian is a large bank.

Stay the same

e) The new chair of the board of Adams Corporation decided to fire the entire internal audit department. The chair believed that the work completed by the annual auditor was enough auditing and that they were already paying enough to the external auditors.

Increase

f) While auditing the inventory balance at your audit client, you visited the client's warehouse during their inventory count. You observed the count and found that the client made no mistakes during your procedures.

Stay the same

g) The sales manager in charge of the Northeast region retired. She was replaced in the region by the assistant sales manager in the same region.

Stay the same

h) While auditing the Interest Expense account, you notice that there was no increase in the amount during the current year. However, you noticed that the long-term debt amount doubled during the current year.

Increase

i) While auditing the inventory balance at your audit client, you perform test counts at their warehouse. While you are counting, you notice a storage bin of inventory that is covered in dust with damaged products. These items are stored near the garbage dumpsters.


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Increase

j) You are auditing cash and during your review of the bank statements you notice unusual cash transfers between two bank accounts which are inconsistent with the client's business.

Increase

k) While auditing accounts payable, the accounts payable clerk told you that the audit client implemented three new internal control procedures. You tested each new control and found that no exceptions in your testing concluding that the controls are operating effectively.

Stay the same

l) The chair of the board of your audit client decided to double the staff of the internal audit department from 10 professionals to 20 professionals. The chair wanted to have the largest internal audit department in the industry and the increase will let the department complete more internal control audits throughout the year.

Stay the same


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1.62 **Management Assertions**

| PCAOB Assertion | Corresponding ASB assertion | Nature of assertion |
|---|---|---|
| Existence or Occurrence | Existence | Balance |
| | Occurrence | Transactions |
| | Cutoff | Transactions |
| Rights and Obligations | Rights and Obligations | Balances |
| Completeness | Completeness | Transactions |
| | | Balances |
| | Cutoff | Transactions |
| Valuation and Allocation | Accuracy | Transactions |
| | | Balances |
| | Valuation and Allocation | Balances |
| Presentation and Disclosure | Presentation | Transactions |
| | | Balances |
| | Classification | Transactions<br>Balances |

1.63 **Management Assertions**

**Existence or Occurrence** - Assertions about existence or occurrence address whether assets or liabilities of the entity exist at a given date and whether recorded transactions have occurred during a given period. For example, management asserts that Accounts Receivable on the balance sheet represent valid amounts actually owed to the company at year end that are due in exchange for goods or services from the company.

**Completeness** - Assertions about completeness address whether all transactions and accounts that should be presented in the financial statements are so included. For example, management asserts that all amounts that should be recorded and included in the financial statements as accounts receivable actually have been recorded (i.e. no accounts are omitted).

**Valuation or Allocation** - Assertions about valuation or allocation address whether asset, liability, equity, revenue, and expense components have been included in the financial statements at appropriate amounts. For example, management asserts that Accounts Receivable are stated at net realizable value and the allowance for uncollectible accounts is adequate.

**Rights and Obligations** - Assertions about rights and obligations address whether assets are the rights of the entity and liabilities are the obligations of the entity at a given date. For example, management asserts that the Accounts Receivable on the balance sheet really are owned by the company. As a result, they have not factored (i.e., sold) any of the balances that are listed on the balance sheet.

**Presentation and Disclosure** - Assertions about presentation and disclosure address whether particular components of the financial statements are properly classified, described, and disclosed. For example, management asserts that the presentation of accounts receivable and the related allowance for doubtful accounts have been presented and are disclosed in accordance with GAAP.

1.64 **Other Types of Auditing**


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For each of the following scenarios, please indicate whether it would be most appropriate to use an internal auditor, a governmental auditor, or a regulatory auditor:

a) The Department of Defense for the United States plans to audit the cost accounting report for a contract signed with a key supplier.

Governmental

b) Bigdeal Corporation manufactures paper and paper products and is trying to decide whether to purchase Smalltek Company. Bigdeal wants to obtain a report on the operational efficiency and effectiveness of the Smalltek sales, production, and research and development departments.

Internal

c) The FDIC plans to audit the collectability of loans at a bank that they insure.

Regulatory

d) The board of directors would like an efficiency audit completed of its manufacturing plant operations.

Internal

e) The city of New York would like an audit done of a major construction project to make sure that the taxpayer's funds were used in an efficient manner.

Governmental

f) A federal bank examiner decides to audit a bank to determine whether it will remain solvent in the upcoming year.

Regulatory

g) The CEO of Franklin Corporation wants to hire an auditor to take responsibility for auditing the company's compliance with environmental laws and regulations.

Internal

h) The IRS would like to audit the tax returns of a popular restaurant chain.

Regulatory

i) The state of Ohio decided to audit the use of educational grants awarded to cities and towns in the state to make sure the funds were spent in accordance with the grant program.

Governmental

j) The Department of the Interior for the United States plans to audit the use of funds spent by all National Parks.

Governmental

1.65 **Auditor as Guarantor**. Loot Starkin appears to be uninformed on the following key points:


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| | |
|---|---|
| The auditors did not *prepare* the Dodge Corporation financial statement. | Inform your neighbor that Dodge management is primarily responsible for preparing the financial statements and deciding upon the appropriate accounting principles. |
| An unqualified opinion does not mean that an investment is *safe*. Rather, it merely means that the financial statements are free of material misstatement. | Tell your neighbor that the financial statements are a historical record of the business' performance. The value of Loot's investment depends on future events, including the many factors that affect market prices. Thus, the financial statements are just one piece of information that should be analyzed. Tell Loot that the unqualified opinion means only that the statements conform to the appropriate reporting framework (e.g., GAAP) and that the financial statements are free of material misstatement. |


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1.66 **Identification of Audits and Auditors**

The responses to this matching type of question are ambiguous. The engagement examples are real examples of external, internal, and governmental audit situations. You might point out to students that the distinctions among compliance, economy and efficiency, and program results audits are not always clear. The "solution" is shown in the following matrix form, showing some engagement numbers in two or three cells. The required schedule follows.

| | Type of Audit Engagement | | | |
|---|---|---|---|---|
| Auditor | Financial Statement | Compliance | Economy and Efficiency | Program Results |
| Independent CPA | 2, 10 | | | |
| Internal auditor | | 6, 8 | 4, 8 | |
| Governmental (GAO) auditor | | | 1, 3 | 1, 3, 9 |
| IRS auditor | | 5 | | |
| Bank examiner | | 7 | | |

| | | Type of Audit | Type of Auditor |
|---|---|---|---|
| 1. | Proprietary school's training expenses | Economy and efficiency or program results | Governmental (GAO) auditors |
| 2. | Advertising agency financial statements | Financial statement | Independent CPAs |
| 3. | Dept. of Defense launch vehicle | Economy and efficiency or program results | Governmental (GAO) auditors |
| 4. | Municipal services | Economy and efficiency | Internal auditors |
| 5. | Tax shelters | Compliance | IRS auditors |
| 6. | Test pilot reporting | Compliance | Internal auditors |
| 7. | Bank solvency | Compliance | Bank examiners |
| 8. | Materials inspection by manufacturer | Compliance or Economy and Efficiency | Internal auditors |
| 9. | States' reporting chemical use data | Program goal | Governmental (GAO) auditors |
| 10. | Sports complex forecast | Financial statement | Independent CPAs |


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1.67 **Financial Assertions and Audit Objectives**

By definition, management financial statement assertions give rise to questions that can be answered with evidence. The objectives for the audit of Spillane's securities investments at December 31 are to obtain evidence about the assertions implicit in the financial presentation, specifically:

1. *Existence.* Obtain evidence that the securities are bona fide and held by Spillane or a responsible custodian.

   *Occurrence.* Obtain evidence that the loan transaction and securities purchase transactions actually took place during the year under audit.

2. *Completeness.* Obtain evidence that all the securities purchase transactions were recorded.

3. *Rights.* Obtain evidence that Spillane owned the securities.

   *Obligation.* Obtain evidence that $500,000 is the amount actually owed on the loan.

4. *Valuation.* Obtain evidence of the cost and market value of the securities held at December 31. Decide whether any write-downs to market are required by the appropriate reporting framework.

5. *Presentation and disclosure.* Obtain evidence of the committed nature of the assets, which should mean they should be in a noncurrent classification like the loan. Obtain evidence that restrictions on the use of the assets are disclosed fully and agree with the loan documents.

1.68 **Financial Statement Assertions and Possible Misstatements**

| **Possible Misstatement/Risk** | **Relevant Assertions** |
|---|---|
| a) Revenue is overstated because the controller made up fraudulent invoices and recorded them. | Occurrence |
| b) Revenue is understated because the accountant closed the sales cycle a week early to go on vacation. | Completeness |
| c) Accounts Receivable is overstated because the accounts receivable clerk forgot to apply available discounts. | Valuation or Allocation |
| d) Accounts Receivable is overstated because sales are falsified. | Existence |
| e) Travel expense is overstated because the sales force charged personal expenses on their corporate credit card. | Occurrence |
| f) Accounts Payable is understated because the office manager lost an invoice for supplies received so it was never recorded. | Completeness |
| g) The cash balance is understated because funds held in Japan were converted to $USD at the wrong rate. | Valuation or Allocation |


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| Possible Misstatement/Risk | Relevant Assertions |
|---|---|
| h) The cash balance recorded on the financial statements is overstated because the treasurer is stealing from the company. | Existence |
| i) Inventory is overstated because it is held on consignment but included in the inventory balance. | Rights and Obligations |
| j) The cost of goods sold is overstated because time sheets have not been submitted for each job. | Valuation or Allocation |
| k) Long Term Debt is overstated due to misclassification by management. | Presentation and Disclosure |

1.69 **Financial Statement Assertions and Audit Procedures**

| Audit Procedure | Relevant Assertions | Significant Account |
|---|---|---|
| a) The auditor sends a letter to the bank confirming the amount of cash in the bank account. | Existence | Cash |
| b) The auditor takes a shipping document and traces it to the sales invoice and sales journal | Completeness | Revenue |
| c) The auditor selects items from the company's inventory list and observes those items in the warehouse | Existence | Inventory |
| d) The auditor compares prices on a vendor invoice to an approved price list from the vendor. | Valuation or allocation | Accounts Payable |
| e) The auditor reviews recorded expenses with vendor invoices. | Valuation or allocation | Expenses |
| f) The auditor determines whether inventory has been pledged as collateral for a loan. | Presentation or Disclosure | Inventory |
| g) The auditor reads the Board of Directors minutes for approval of stock options. | Presentation or Disclosure | Common Stock |
| h) The auditor reviews lease agreements to evaluate whether they have been recorded properly. | Completeness | Capitalized Leases |
| i) The auditor selects inventory items at a retail store to determine whether any are held on consignment. | Rights and obligations | Inventory |


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| Audit Procedure | Relevant Assertions | Significant Account |
|---|---|---|
| j) The auditor sends letters to customers to confirm amounts owed to the company | Existence | Accounts Receivable |

1.70 **Internet Exercise: Professional Certification**

These answers will depend on the student's state of residence. Many states have recently reduced the experience requirements by either (1) reducing or eliminating an audit experience requirement and/or (2) reducing the experience requirement in lieu of additional education. For a quick link to each state, visit the National Association of State Boards of Accountancy (www.nasba.org).

1.71 **Internet Exercise: Professional Certification**

The Institute of Internal Auditors does a good job explaining the benefits of becoming a certified internal auditor. The exam consists of four parts: the Internal Audit Activity's Role in Governance, Risk, and Control; Conducting the Internal Audit Engagement; Business Analysis and Information Technology; and Business Management Skills. You must have at least a bachelor's degree to sit for this exam.

The Institute of Management Accountants also does a good job of explaining the benefits of the certification. The parts of the exam include Business Analysis, Management Accounting and Reporting, Strategic Management, and Business Applications. You must have at least a bachelor's degree to sit for this exam.

The Association of Certified Fraud Examiners also does a good job of explaining the benefits of the certification. The areas of study tested on the exam include criminology and ethics, financial transactions, fraud investigation, and legal elements of fraud. You must have at least a bachelor's degree to sit for this exam.

The Information Systems Audit and Control Association website explains the benefits of becoming certified. You must have at least an associates' degree to sit for this exam.

1.72 **Internet Exercise: Services Offered by the Big Four Public Accounting Firms**

These answers will depend on the specific service picked by each student. Each of the firms now offers a multitude of different services. Thus, these answers are likely to differ substantially. The goal of the question is to expose students to the wide range of services. So, as long as the student lists two services that are in alignment with the instructor's experience, credit should be awarded.

**Apollo Shoes Questions**

**1) List three relevant facts about Apollo Shoes that you think might have an impact on the financial statement audit.**

This question is designed to get the students to examine the Apollo Shoes Form 10K with a critical mindset. There are a number of allowable responses to this question. Three prominent responses would be:

a. Accounts Receivable increased significantly from the prior year.
b. Inventory increased significantly from the prior year.
c. The line of credit balance increased significantly from the prior year.

**2) Define what is meant by a significant account or disclosure.**


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A financial statement account or footnote disclosure is considered significant if there is a chance that the account or footnote disclosure could contain a material misstatement. As a result, an auditor will have to conduct some procedures on each significant account or disclosure.

**3) Identify at least two significant accounts or disclosures from the financial statements of Apollo Shoes. What makes each item significant?**

This question is designed to get the students to examine the Apollo Shoes Trial Balance with a critical mindset. There are a number of allowable responses to this question. Two prominent responses would be:

a. Accounts Receivable is significant because of the magnitude of the account in relation to total assets for Apollo Shoes.
b. Inventory is significant because of the magnitude of the account in relation to total assets for Apollo Shoes.

**4) Define what is meant by a relevant assertion.**

A relevant assertion is "a management assertion is relevant if there is a reasonable possibility that a material misstatement exists related to that assertion for the significant account or footnote disclosure being audited."

**5) Identify at least one relevant assertion for each of the significant accounts or disclosures previously identified from the financial statements of Apollo Shoes. What makes each assertion relevant?**

Once again, there are a number of allowable responses to this question. Two responses that related back to the suggested solution for question #3 would be:

a. Valuation of Accounts Receivable is relevant because of the significant increase in receivables compared to last year. Importantly, this increase occurred without a significant increase in sales. What happened? Why are they unable to collect their receivables this year as compared to last year? Should the allowance for doubtful accounts be increased? As a result of these questions, the risk of material misstatement for this assertion is high.
b. Existence of Inventory is relevant because the inventory balance is a material amount and the auditor must make sure that the inventory does really exist. The inventory balance increased significantly compared to last year. Why? The professional standards require that we conduct a physical inventory observation to validate the existence of inventory. As a result of these considerations, the risk of material misstatement for this assertion is high.


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