**Testbank**

to accompany

**Audit and assurance**

**2nd edition**

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**Chapter 1: Auditing and governance**

**Multiple-choice questions**

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

a. CAANZ, CPA and ASIC.

b. CPA Australia, IPA and AARF.

c. ATO, AUASB and ASIC.

\*d. CAANZ, CPA Australia and IPA.

The correct option is d.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

a. Harris Scarfe.

b. HIH Insurance Ltd.

c. One.Tel.

\*d. All were Australian corporate collapses.

The correct option is d.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

3. In relation to auditing the information hypothesis relates:

a. To ‘does the audit meet the demands of users’.

\*b. To why there is a demand for audits.

c. To what auditing is.

d. To which auditing standards are produced.

The correct option is b.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

a. Ensure that the company is free from all fraud.

b. Provide assurance about the future viability of the entity.

\*c. To express an opinion as to whether the financial report is prepared in all material aspects, in accordance with a financial reporting framework.

d. Ensure the company complies with all aspects of Corporations Law.

The correct option is c.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

a. Be a fit and proper person.

b. Be a member of CPA Australia, CAANZ or other approved body.

c. Has a degree or diploma from a course in accounting (including auditing) of not less than 3 years duration and in commercial law (including company law) of not less than 2 years duration or have other equivalent qualifications acceptable to ASIC.

\*d. All are requirements to be registered as an auditor in Australia.

The correct option is d.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

a. Agency.

b. Explanatory.

\*c. Insurance hypothesis.

d. Information hypothesis.

The correct option is c.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

7. In Australia, the auditor’s opinion in the audit report must state:

a. Whether the financial report is presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

b. Whether the financial report presents a true and fair view, in all material respects, in accordance with the applicable financial reporting framework.

c. Whether the financial report provides a reasonable level of assurance, in all material respects, in accordance with the applicable financial reporting framework.

\*d. a or b.

The correct option is d.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

a. Not-for-profit organisations.

b. Statutory authorities.

\*c. Small proprietary companies.

d. All of the above are required to have an annual audit with no exceptions.

The correct option is c.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

a. Insurance hypothesis.

b. Agency theory.

\*c. Information hypothesis.

d. None of the above.

The correct option is c.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

\*a. An agency problem.

b. The insurance hypothesis.

c. CLERP.

d. An audit expectation gap.

The correct option is a.

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

a. Agency theory.

b. An audit engagement.

c. An assertion engagement.

\*d. An assurance engagement.

The correct option is d.

Learning objective 1.2 ~ describe the nature of assurance and how it relates to auditing.

12. Auditing bears what relationship to assurance?

\*a. Auditing is a sub-category of assurance.

b. Assurance is a sub-category of auditing.

c. They are different names for the same thing.

d. Public accounting firms perform auditing engagements but not assurance engagements.

The correct option is a.

Learning objective 1.2 ~ describe the nature of assurance and how it relates to auditing.

13. Governance is a concept that can be applied to:

a. Not-for-profit organisations.

b. The public sector.

c. Corporations.

\*d. All of the above.

The correct option is d.

Learning objective 1.3 ~ describe the nature of governance.

14. The overall objectives of an auditor are:

a. To obtain a reasonable assurance about whether the financial report as a whole is free from material misstatement.

b. To report on financial reports.

c. To communicate the findings as required by Australian Auditing Standards.

\*d. All of the above.

The correct option is d

Learning objective 1.4 ~ discuss the role of the auditor in governance.

15. Earnings management occurs when:

a. Income and expenses are managed to influence the performance of the entity.

\*b. Financial statements and transactions are manipulated to influence perceptions about the entity.

c. Executive salaries are increased surreptitiously by including the raises in late night meetings.

d. Earnings are manipulated to improve the company’s tax position.

The correct option is b.

Learning objective 1.5 ~ evaluate the issues relating to governance.

16. Incentives for earnings management are inherent in the management structure but are least likely to originate from:

a. Executive remunerations.

b. Situations including financial distress.

c. Political considerations.

\*d. High positive cash flows.

The correct option is d.

Learning objective 1.5 ~ evaluate the issues relating to governance.

17. The COSO enterprise risk management integrated framework covers five components of internal control. Which of the following is not a component?

a. Governance and culture.

b. Strategy and objective-setting.

c. Performance.

\*d. Risk management.

The correct option is d.

Learning objective 1.5 ~ evaluate the issues relating to governance.

18. The SEC proposal on audit committees did not require:

a. The audit committee to be directly responsible for the hiring of an independent auditor.

b. The audit committee to be directly responsible for the oversight of an independent auditor.

\*c. The audit committee to be directly responsible for the internal auditor.

d. The names of the committee members to be disclosed in the annual report.

The correct option is c.

Learning objective 1.5 ~ evaluate the issues relating to governance.

19. The Australian Stock Exchange (ASX) listing rules require an audit committee to be established by:

\*a. All companies on the S&P/ASX All Ordinaries Index.

b. All companies on the S&P/ASX 500 Index.

c. All companies on the S&P/ASX 300 Index.

d. All companies.

The correct option is a.

Learning objective 1.6 ~ explain the role and objectives of an audit committee.

20. The best practice recommendations for audit committees states that the audit committee should consist of:

\*a. At least one member with financial expertise.

b. Both executive and non-executive directors.

c. At least one independent director.

d. At least five members.

The correct option is a.

Learning objective 1.6 ~ explain the role and objectives of an audit committee.

21. The audit committee should report to the board of directors on which of these matters?

a. The use of experts by the independent auditor.

\*b. Recommendations for the appointment or removal of an auditor.

c. Audit procedures carried out by the independent auditor.

d. All of the above.

The correct option is b.

Learning objective 1.6 ~ explain the role and objectives of an audit committee.

22. An effective audit committee:

a. Improves the credibility and objectivity of the accountability process.

b. Assists the directors in discharging their responsibilities with due care, diligence and skill.

c. Fosters an ethical culture throughout the organisation.

\*d. All of the above.

The correct option is d.

Learning objective 1.6 ~ explain the role and objectives of an audit committee.

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

a. The FRC.

b. The IAASB.

c. The AASB.

\*d. The AUASB.

The correct option is d.

Learning objective 1.7 ~ appreciate the audit environment in Australia.

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

a. AASB.

\*b. AUASB.

c. FRC.

d. IAASB.

The correct option is b.

Learning objective 1.7 ~ appreciate the audit environment in Australia.

25. The true statement is:

a. Most countries in the world have auditing standards that are legally enforceable.

\*b. Few countries in the world have auditing standards that are legally enforceable.

c. Australia is the only country in the world that has auditing standards that are legally enforceable.

d. The IAASB produces accounting standards which are legally enforceable in each country which adopts them.

The correct option is b.

Learning objective 1.8 ~ gain an overview of auditing standards.

**Short answer questions**

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

Correct answer:

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

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

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

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

Correct answer:

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

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

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

Learning objective 1.1 ~ explain the fundamental nature and value of audits.

28. Describe the two sides of the enterprise governance framework.

Correct answer:

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

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

 The roles of the chair of the board and top management to ensure accountability and independence.

 The composition, skills base, remuneration and training of the board and its committees, such as the roles of the non-executive directors.

 The adequacy and reasonableness of compensation schemes for executives.

 Internal control structures, risk management, and the role of internal audit.

 The financial reporting and disclosure regime.

 The independence of the audit function and the reporting mechanisms.

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

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

Learning objective 1.3 ~ describe the nature of governance.

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

Correct answer:

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

1. Governance and culture: the board of directors provides oversight and supports management in achieving strategy and business objectives by establishing operating structures in pursuit of such strategy and object gives. the organisation specifies the desired ethical behaviours and demonstrates a commitment to their core values by building human capital aligned with the entity’s strategy and business objectives.

2. Strategy and objective-setting: ERM, strategy and objective-setting are intertwined in the strategic-planning process. The desired level of risk is established and aligned with strategy and operationalised through business objectives which identify, assess and respond to risk.

3. Performance: the organisation identifies risks likely to impact on the performance of strategy and business objectives, assesses the severity of risk, prioritises risks, identifies and selects risk responses, and develops and evaluates a portfolio view of risk.

4. Review and revision: the organisation identifies and assesses changes likely to substantially affect strategy and business objectives by reviewing performance and considering risk in order to improve ERM.

5. Information, communication, and reporting: the organisation leverages the entity’s information and technology systems to support ERM by using communication channels to report on risk, culture and performance at multiple levels including access the entity.

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

Learning objective 1.5 ~ evaluate the issues relating to governance.

30.

1. What is meant by the term Earnings Management?

2. Why has the focus on earnings management increased in recent years?

3. What incentives might there be for companies to engage in earnings management?

Correct answer:

1. Earnings management is when financial statements and transactions are manipulated in order to influence people’s perceptions about the performance of the company, with the aim of showing a desirable outcome rather than the economic substance. Extreme cases can amount to fraud.

2. Failed companies such as Enron and WorldCom used earnings management techniques, and so have increased the focus.

3. Incentives can be inherent in the management structure and may include political considerations, executive remuneration, the ambiguity and inability of accounting standards to deal with complex transactions, or situations including financial distress or related party transactions.

Learning objective 1.5 ~ evaluate the issues relating to governance.

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

Correct answer:

The main objectives include:

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

The ASX suggests that an audit committee should consist of only non-executive directors, a majority of independent directors and an independent chairperson, who is not the chairperson of the board, members who are all financially literate, at least one member with financial expertise and some members who have an understanding of the industry.

Learning objective 1.6 ~ explain the role and objectives of an audit committee.