Exam Introduction to Auditing (DOR92)

June 27, 2019

Prof. Dr. M. Willekens

KU Leuven

Last Name: ____

First Name: ____________________________________

Student Number: ________________________________

Instructions:

1. This exam consists of four questions. Please respond ONLY in the designated response areas.

2. You have one and a half hours to prepare your responses.

3. The use of calculators, dictionaries, smartphones, etc. is NOT ALLOWED.

Good luck!

QUESTION 1: MULTIPLE CHOICE (25%)

Below six sets of four statements each (labeled a, b, c and d) are provided. Each set of statements includes one (and only one!) wrong statement; the other three statements are correct. Please identity the wrong statement for each of the six sets. Put the appropriate letter (a, b, c or d) in the boxes below. Note that answers written on the statements themselves WILL NOT be considered as a final answer.

You will receive 1 point for a correct answer, -1/3 for a wrong answer.

The total score for Question 1 cannot be lower than 0/6.

SET	1	2	3	4	5	6
ANSWER						

SET 1

(a) Auditors are required to provide ‘reasonable assurance’ about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. Reasonable assurance means that they provide high but not absolute assurance.

(b) In auditing α-risk is the risk that the auditor concludes that the financial statements are not free from material misstatements while the financial statements are in fact free from material misstatements.

c) The higher the effectiveness of the internal controls of a company, the more reliable the audit evidence will be.

d) ISA 500 states that audit evidence is information used by the auditor in arriving at the conclusions on which the auditor’s opinion is based, and that audit evidence includes only information contained in the accounting records underlying the financial statements.

SET 2

a) To test the ‘existence/validity’ of registered sales of the audited company an audit procedure that is tracing whether there exists a delivery note for each sales invoice (in the sample) is a relevant audit procedure.

b) In Belgium the mandate of statutory auditor is a monopoly for registered auditors (members of the IBR/IRE).

c) Numan and Willekens (2012) formulate and test two audit pricing hypotheses derived from spatial competition theory. One of these hypotheses states that the audit fee charged by the incumbent auditor is increasing in the alignment between the incumbent auditor’s cost leadership strategy and the client’s auditor preferences.

d) The empirical evidence about the Belgian audit market documents Big 4 audit price premiums as well as industry specialists price premiums.

SET 3

a) There are two streams of empirical research evidence about how audit firms compete. One stream argues that they compete through a differentiation strategy; another streams argues that they compete through cost leadership.

b) Control risk is a component of the audit risk model and is the risk that a misstatement that could occur in an assertion about a class of transactions, account balance or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity’s internal control.

c) In Belgium there is mandatory external auditor rotation for public interest entities every nine years. There is a possibility to extend the audit firm’s tenure to 18 years (an additional nine years) when the auditee organizes a public tendering process.

d) In the US publicly listed companies have to appoint an auditor and there should be mandatory audit firm rotation every five years.

SET 4

a) According to ISA 320 information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

b) An auditor will issue a qualified audit opinion as a result of scope limitation encountered during the audit procedures or because of an auditee's failure to follow GAAP.

c) A possible test of the completeness of the registered sales of a company is that the auditor checks whether there exists a delivery note for every sales invoice (given that the audited company uses a system of delivery notes).

d) The mandatory audit requirement for certain types of companies is an example of ex ante regulation of audit demand.

SET 5

a) Regulators worry about whether there is sufficient competition among audit suppliers in the audit market because audit demand is mandatory, there are barriers of entry in the market and a high level of market concentration.

b) Some people argue that an auditing service is a credence good meaning that its characteristics, such as its quality, are difficult to observe in advance and can only be ascertained upon consumption.

c) In the European Union HR recruitment is a forbidden non-audit service for the incumbent auditor of the audited company.

d) Since the implantation of EU Reform act of 2014 in Belgium public oversight over the audit profession was once again reformed and the 'College van Toezicht' or the 'Oversight College' was established. The main task of this college is to submit all auditors to quality control as well as organize a system of oversight through inspections.

SET 6

a) The risk of material misstatement is the risk that financial statements are misstated prior to the conduct of the substantive audit tests and can be decomposed in inherent risk and control risk.

b) The evaluation of control risk by the auditor consists of two steps: the study of the internal control system and the test of controls.

c) The following internal control procedure helps to achieve the existence objective: ‘shipping documents are pre-numbered and accounted for weekly’.

d) When an auditor is unable to express an audit opinion (s)he will issue a disclaimer of opinion. This is the consequence of a severe scope limitation, a severe GAAP noncompliance or a lack of auditor independence.

QUESTION 2: AUDIT EVIDENCE (20%)

a) What are the seven types of audit evidence and describe what each type is. Note that only 1 sentence per type of evidence is allowed and more elaborate descriptions will be penalized.

b) What are in your opinion the <u>two most persuasive</u> types of audit evidence and briefly motivate why this is the case.

QUESTION 3: RESEARCH PAPER (25%)

We discussed the paper "The Effect of Mandatory Audit Firm Rotation on Audit Quality and Audit Fees: Empirical Evidence from the Korean Audit Market" (Kwon, Lim and Simnett, 2014)

a) Briefly state the main research questions in this paper.

b) Which data were used in this paper?

c) Do the conclusions of the paper support the EU's initiative for mandatory audit firm rotation for PIEs? Motivate your answer.

QUESTION 4: CONTEMPORARY AUDIT REGULATION (30%)

On p. 12-13 you can find a recent article from the *Financial Times* about proposed audit regulations in the UK by the CMA (NB: the CMA is the UK's financial market authority).

Please read this article carefully, and respond to the questions below.

a. Name two new audit regulations the CMA has been proposing in the UK which were not included in the EU Audit Reform of 2014. Also discuss very briefly why you think the CMA is proposing these two stricter audit regulations.

b. Some opponents of the two stricter UK regulations (that is, the regulations you identified in a. above) express their doubts about the effectiveness of these stricter regulations. What could be their arguments?

c. The author of the article also states that the CMA avoids tackling the 'monopoly power' of the Big Four audit firms. But do the Big Four audit firms actually form a monopoly? Motivate your answer.

Accountancy

Do the CMA auditing proposals make sense?

Two critics of the UK watchdog's plans on how to reform the sector give their views

Atul Shah and Gerry Grimstone APRIL 19, 2019

A spineless and captured watchdog has fallen short, *writes Atul Shah*

We have known since the 2008 financial crash that there are serious problems with British accounting and auditing. The recent failures of Carillion, BHS and Patisserie Valerie have only added fuel to the fire. We face a serious breakdown in the architecture of financial regulation, where proper accountability plays a central role in corporate governance.

The heart of the problem rests with the Big Four accounting firms — KPMG, Deloitte, EY and PwC — and their near total dominance of the auditing of FTSE 350 companies. In my view, research by Prem Sikka, professor of accounting at Sheffield university, and others shows that they are neither professional nor independent and, instead of policing corporate conduct, they have been doing exactly the opposite and have made it easier for multinational corporations to rip off governments, taxpayers, the environment and society.

I had high hopes for the Competition and Markets Authority review of the sector, which announced its conclusions this week. The technical nature of accounting and auditing has made it hard for ordinary people to question the expert language and calculations — and smart suits, talented graduates and exclusive offices — of the Big Four.

But the recommendations have shown the CMA is spineless and captured. The watchdog recommends requiring large companies to hire two auditors, including one firm that is not in the Big Four; seeks to strengthen the role of audit committees; and sets up greater oversight of the audit process. It also recommends that firms be split operationally between audit and consulting to reduce conflicts of interest.

But it avoids tackling directly the monopoly power of the Big Four and the urgent need to break them up to preserve competition and independence.

I am sceptical as to how joint audits will improve audit quality, given the fundamental failure of the profession to reform the way audits are conducted. Today's accounting standards and policies have been significantly influenced by the Big Four firms, so audits are based on weak, compromised and inconsistent rules that make failure "normal". If we are not careful, joint audits can lead to a division of blame and responsibility, making it harder to hold firms accountable in the case of audit failure.

As for the operational split that the CMA recommends, we have already lived through the costly experience of the failure of such "Chinese walls" in banking. Why should we still believe they can and will work here?

The heart of the audit problem is that the Big Four have highly commercial cultures, which will not be transformed if they continue to operate as one firm. As an example, if audit partners continue to profit from their consultancy arms, can their judgment and reporting be truly independent and robust when both sides are selling services to the same large companies? Furthermore, how can society rely on their timely and trenchant challenge of excessive risk-taking by those corporations?

The other major contributor to audit failure is the UK's system of corporate governance. My research into the 2008 collapse of HBOS, the largest corporate failure in British history, shows that the bank's board and audit committee failed to adequately question the business strategy and risk-taking or to police the quality and conduct of audits.

Most non-executive directors rarely challenge the executives they ostensibly oversee. Instead, they have become habituated to rely on auditors to provide them comfort, and the auditors have in turn relied on management.

Everyone has been far too comfortable for far too long, and this CMA review does not change that in the slightest. Since the financial crisis, the UK has quite rightly revamped its system of regulating banking, but powerful corporate interests continue to capture the regulation and governance of accounting.

Sadly, once again, society has been utterly failed.

The writer, a professor at City University, is author of 'The Politics of Financial Risk, Audit and Regulation: A Case Study of HBOS'.