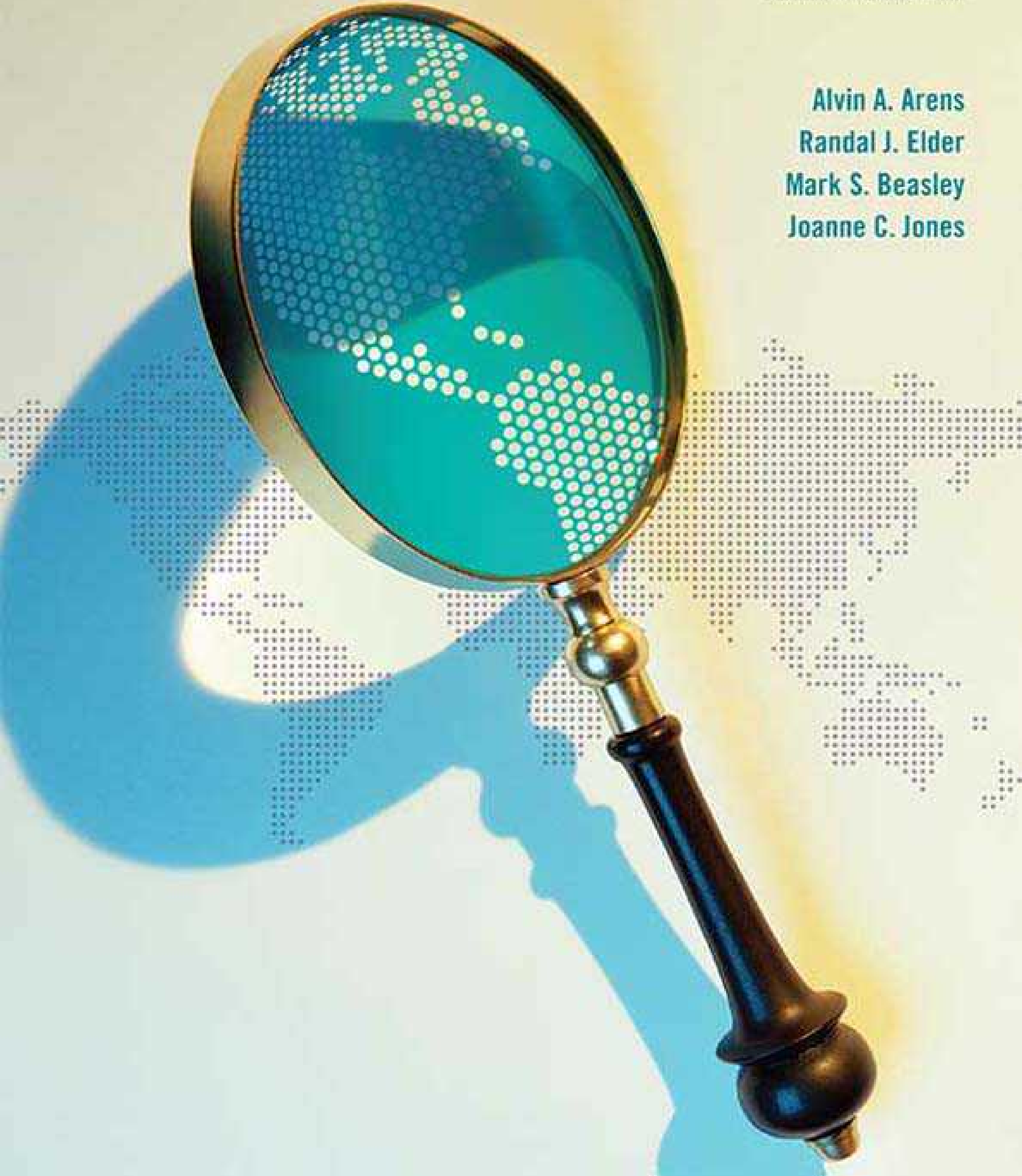
Auditing

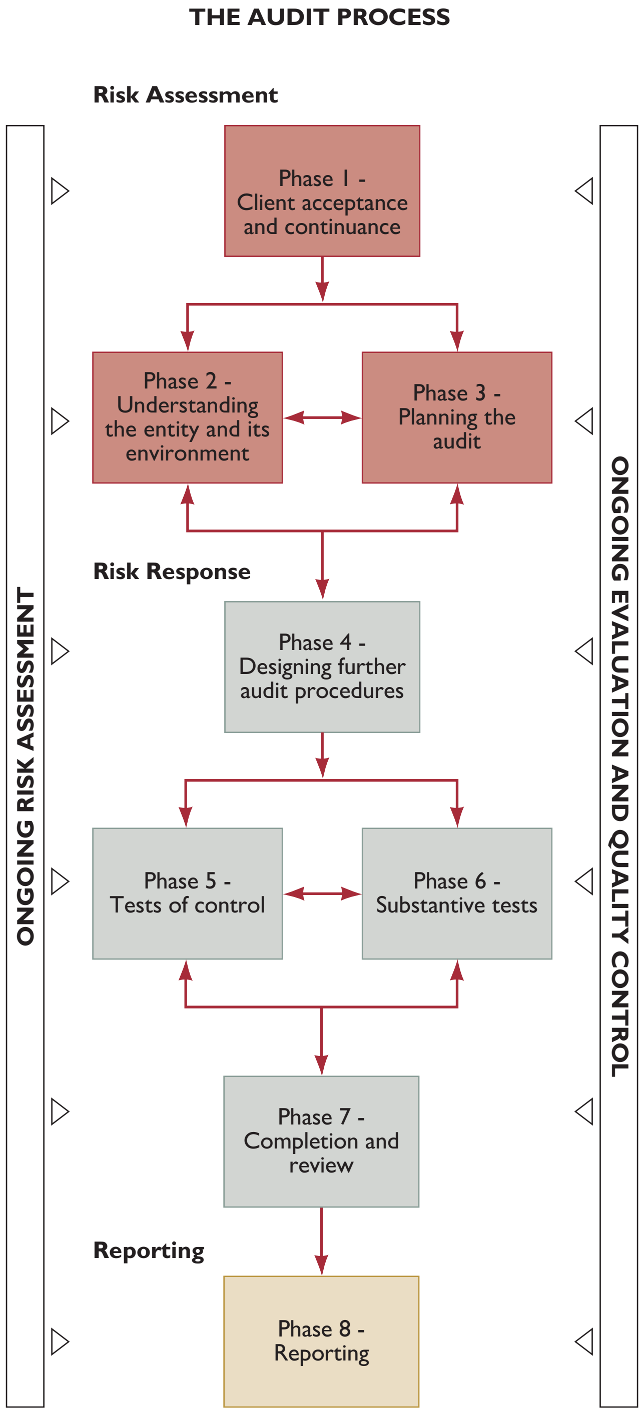
THE ART AND SCIENCE OF ASSURANCE ENGAGEMENTS

Canadian Thirteenth Edition

Alvin A. Arens
Randal J. Elder
Mark S. Beasley
Joanne C. Jones



The Audit Process



Phase	***Components of phase***
Risk Assessment	
Phase 1 - Client acceptance and continuance	Identify client reasons for audit Conduct independence threat analysis Client acceptance or continuance analysis Identify available staff Obtain signed engagement letter
Phase 2 - Understanding the entity and its environment	Understand client's business and industry: • Industry and external environment • Business operations and processes • Management and governance • Objectives and strategy • Measurement and performance Assess client business risk (an ongoing process): • Evaluate management controls affecting business risk • Assess client business risk Perform preliminary analytical procedures
Phase 3 - Planning the audit	Determine audit risk Determine inherent risk Set preliminary materiality levels Understand and document internal controls Evaluate design effectiveness of internal controls Evaluate control risk by assertion Assess risk of material misstatements Assess risks of fraud Identify significant risks or transactions/accounts that require more than substantive tests Determine risks of material misstatement at the financial statement and assertion levels Discuss risks and audit plan with audit team/develop and modify staffing plans as required Develop strategic audit approach overall and by cycle
Risk Response	
Phase 4 - Designing further audit procedures	Develop audit programs
Phase 5 - Tests of control	If the auditor plans to rely upon internal controls or internal controls are needed as part of the testing plan: • Perform tests of control • Assess impact of results of tests upon risks of material misstatement and upon audit programs
Phase 6 - Substantive tests	Perform substantive tests (tests of details of balances, tests of key items and analytical procedures) Assess impact of results of tests upon risks of material misstatement and upon audit programs
Phase 7 - Completion and review	Evaluate results of tests as completed Conduct review of working papers and supervision as audit progresses Reassess risks and materiality as required Modify risk response/audit plans as required Complete final evidence gathering (review for contingent liabilities, review for subsequent events, any additional evidence required) Conduct analytical procedures at the financial statement level Prepare audit summary memorandum and documentation
Reporting	
Phase 8 - Reporting	Determine type of audit report to be issued Communicate with audit committee and management as required Conduct final quality control review (including tax review, second partner review, and risk-review, as required) Issue audit report Initiate file freeze procedures

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Alvin A. Arens

PricewaterhouseCoopers Emeritus Professor,
Michigan State University

Randal J. Elder

Syracuse University

Mark S. Beasley

North Carolina State University, Deloitte Professor of
Enterprise Risk Management

Joanne C. Jones

York University

PEARSON

Toronto

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Contents

Preface

Auditing: The Art and Science of Assurance Engagements is an introduction to auditing and assurance services. It is intended for use in an introductory auditing course, for one-semester or two-semester instruction at the undergraduate or graduate level. The primary emphasis of the book is on the auditors' decision-making process in a financial statement audit and, to a lesser degree, other types of assurance engagements. As the title of book reflects, auditing is an art, as it requires considerable use of professional judgment and skepticism, but it is also a science, resting upon a solid frame of technical skills and knowledge of multiple disciplines associated with auditing, such as accounting, tax, and information systems.

One of the most fundamental concepts in auditing concerns the nature and amount of evidence the auditor should gather after considering the unique circumstances of each engagement. If students of auditing understand the risks to be addressed in a given audit area, the circumstances of the engagement, and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained. In order to help students develop these skills, we provide a professional judgment framework to help students reflect upon common judgment traps and to develop their own judgment and professional skepticism.

Our objective is to provide up-to-date coverage of globally recognized auditing concepts with practical examples of the implementation of those concepts in real-life settings. We integrate the most important concepts in auditing in a logical manner to assist students in understanding audit decision-making and evidence accumulation in today's complex auditing environment. Throughout the book, we emphasize international and Canadian developments affecting auditing in a global and economically volatile environment. Key concepts related to professional judgment and risk assessment are integrated into all the planning chapters, as well as each chapter dealing with particular transaction cycles and related accounts. We provide numerous real-life vignettes and examples from actual audit planning documents to enhance students' understanding of the concepts. We also provide numerous diagrams and visual depictions to help clarify concepts such as materiality and the various substantive tests in the key transaction cycles.

What's New to This Edition?

Those of you who are familiar with the Twelfth Edition of this textbook will find that we have made a significant number of changes to this edition. We highlight the more substantive changes below.

Current Coverage

New auditing standards are released without regard to textbook revision cycles. As auditing instructors, we appreciate how critical it is to have the most current content available. This edition includes coverage of the most recent standards released and highlights impending changes that have been announced by Canada's Auditing and Assurance Board—the most significant one being the changes to the auditors' report.

In addition to ensuring that the coverage of audit standards is the most up-to-date possible, in Chapter 2 we provide an overview and more guidance on the organization of CPA Canada's *Assurance Handbook*, including the principles that provide the framework to help auditors fulfill the objectives of the financial statement audit.

Expanded Coverage on Audit Quality and Expectations Gap

Starting with Chapter 2 and continuing throughout the book, we introduce the various initiatives introduced to improve audit quality. We highlight the various parties responsible for audit quality and how individual auditors, teams, processes within the firms, standard setters, and others all play an important role in contributing to high-quality audits. Chapter 3, which covers legal liability, now includes an expanded discussion of the expectations gap.

A Greater Emphasis on Professional and Ethical Judgment

In Chapter 4, we introduce a professional judgment framework, which is based upon the various frameworks developed by several national accounting bodies. This framework provides students with a methodical approach to addressing audit issues. We elaborate on the framework and introduce judgment traps and biases that can erode judgment quality. We have also updated ethical decision-making and highlight the various biases and ethical blind spots that can inhibit the auditors' decisions. Throughout the textbook, we revisit and integrate these frameworks into our discussion of the auditing concepts and illustrate their application in various vignettes, audit studies conducted by the profession and academics, homework problems, and research activities.

Expanded Coverage on Professional Skepticism

With the profession's continued focus on the importance of applying appropriate levels of professional skepticism, we have expanded coverage of this topic starting with Chapter 1. We discuss the importance of a questioning mindset and the need to critically evaluate audit evidence to strengthen student awareness of the elements of effective professional skepticism. We have introduced several vignettes and homework problems that help students think further about challenges and threats to applying professional skepticism in the context of an audit.

Risk Assessment and the Audit Process

As in the previous edition, we emphasize and incorporate risk assessment procedures required by the risk assessment standards throughout the text. Chapter 6 covers client acceptance and continuance and planning. Chapter 7 highlights audit risk and the risk of material misstatement, Chapter 8 emphasizes the importance of internal control as part of the risk assessment process, and Chapter 10 brings it all together in its discussion of audit strategy. Subsequent chapters that focus on the transaction cycles include extensive coverage of fraud risk, inherent risk, and internal control risk. We have also updated the coverage on three of the transaction cycles (revenue, acquisition and payment, and inventory) to include discussion of fraud procedures and to provide real-life examples that compare and contrast the different types of audit strategies employed in these three cycles. The revenue cycle is now consolidated into one chapter and has expanded coverage on the risks associated with revenue recognition and auditing complex revenue contracts.

Expanded Coverage on Materiality

We have expanded our coverage on materiality and provide actual examples of the benchmarks used at a variety of client organizations and the policies at different firms. We clarify the characteristics of overall, performance, and specific materiality, and discuss the impact on evidence collection. Consistent with our emphasis on professional judgment, we provide vignettes that help students understand the subjective nature of materiality. We revisit materiality in Chapter 19, and highlight its importance in completing the audit and evaluating the results.

Updated Internal Control Guidance

This chapter uses the 2013 COSO framework and its 17 principles of effective control as the basis of discussion. This framework more closely reflects the current environment in which businesses operate—in particular, there is much more emphasis and integration of IT controls. We have included material to help students understand the different types of controls and how to apply professional judgment in evaluating control deficiencies. The chapter has been updated to include the role of the IT specialist on the audit team as well as auditing outsourced controls and the role of the service centre auditor.

New Coverage on Substantive Analytical Procedures

We have expanded our coverage on analytical procedures and the importance of professional judgment and skepticism in developing rigorous substantive analytical procedures necessary for the level of risk. We have added several problems that focus on analytical procedures.

Updated Sampling Guidance

The sampling chapter has been rewritten to clarify and simplify the application of sampling concepts. The restructuring of the chapter to include and update all the relevant material on sampling from other chapters should improve student understanding of core sampling concepts for both nonstatistical and statistical sampling.

Updated Audit Report Guidance

This chapter now includes a decision-making framework to help guide students through the process of deciding what type of audit report to issue. There is also more guidance on auditing the going concern assumption and a variety of real-life examples of the modifications to the audit report. Finally, the chapter concludes with an overview of the new audit reporting standards, which will be adopted in Canada in the near future.

Other Assurance Services

Our coverage of other assurance services in Chapters 1 and 20 highlights emerging opportunities for public accountants to provide assurance about corporate social responsibility and sustainability reports. Chapter 20 also reflects the impending standards for review engagements and reporting on supplemental information. In addition, numerous actual reports and several new homework questions are provided to help students focus on the users and their assurance needs.

New Integrated Case—Pinnacle Manufacturing

The Pinnacle Manufacturing integrated case is based on a large multi-division company. The four parts of the case are included at the end of the chapters to which the parts relate. Each part of the case is designed to give students hands-on experience, and the parts of the case are connected so that students will gain a better understanding of how the parts of the audit are integrated by the audit process.

New and Revised Problems and Cases

All chapters include multiple choice questions as well as research activities that require students to use the Internet to research relevant auditing issues. All chapters include several new and revised professional judgment problems and cases. Many of the problems are based upon actual companies.

Organization

This text is divided into four parts. The chapters are relatively brief and designed to be easily read and comprehended by students.

Part 1: The Auditing Profession (Chapters 1–4)

The book begins with an opening vignette featuring the Government of Canada's Sponsorship Scandal and the role of a former auditor general, Sheila Fraser, in investigating this high profile fraud. Chapter 1 aims to answer the question, "Who are the auditors and why are they important?" The chapter explains the different types of auditors and assurance services. Chapter 2 covers the public accounting profession, with a particular emphasis on the standard setting responsibilities of the International Auditing and Assurance Standards Board (IAASB) and the Canadian Auditing and Assurance Standards Board (AASB). Chapter 2 provides an overview of the CPA Canada *Assurance Handbook*, Canadian auditing standards, and auditors' responsibilities. It also provides a discussion of audit quality. Chapter 3 is an investigation of the expectations gap and auditors' legal liability, with a discussion of some recent Canadian cases. The final chapter of this part presents professional judgment and ethical decision-making frameworks as well as discussion of the rules of professional conduct and how to conduct an independence threat assessment.

Part 2: The Audit Process (Chapters 5–10)

Part 2 presents the strategic audit process. The concepts in this part of the book represent the foundation of the book. Chapter 5 describes the overall objectives of the audit, the auditor's responsibilities in conducting the audit, and the specific objectives the auditor tries to accomplish. We introduce Hillsburg Hardware Limited in Chapter 5, which is used to illustrate planning and development of an audit strategy as well as many other concepts throughout the book. Chapter 6 deals with client acceptance and continuance and planning the engagement, including understanding the client's business and environment as part of the auditors' risk assessment procedures and using analytical procedures as an audit tool. Chapter 7 introduces materiality and risk and how the auditor responds to risks of significant misstatement with further audit procedures. Chapter 8 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements. Chapter 9 links evidence decisions to assessed risks and includes general concepts of evidence accumulation. Chapter 10 provides an overall strategic risk-based audit strategy, linking planning to assertion-based audit programs.

Part 3: Application of the Audit Process: Audit of Cycles and Accounts (Chapters 11–17)

These chapters apply the concepts from Part 2 to planning a sample and to the specific transaction cycles. We begin in Chapter 11 with a general discussion of audit sampling for tests of controls, substantive tests of transactions, and tests of details of balances. The chapter, which uses the revenue cycle as the basis for its examples, covers both nonstatistical and statistical sampling. The remaining chapters deal with a specific transaction cycle or part of a transaction cycle. We start with the most significant cycle for most organizations—revenue. We provide an overview of the cycle and then consider the inherent and fraud risks associated with revenue and discuss how to design and conduct internal control and substantive tests in response to the significant risks, as well as specific fraud procedures. We conclude the chapter by providing an illustration of applying professional judgment in the development of the audit strategy for the revenue cycle of two actual organizations. Throughout the chapter, we provide numerous real-life examples to illustrate key concepts. The remaining chapters follow a similar format. Cash is studied late in the text to demonstrate how the audit of cash is related to most other audit areas.

Part 4: The Audit Process: Completion and Reporting and Other Assurance Services (Chapters 18–20)

This part begins with two chapters on the final two phases of the audit process—completion and reporting. The first chapter deals with performing additional tests to address presentation and disclosure objectives, summarizing and evaluating the results of audit tests, reviewing audit documentation, communicating with those charged with governance, and all other aspects of completing an audit. The next chapter begins with a discussion of the debate of the upcoming changes to the auditor's report, which has remained virtually the same for the past sixty years. The chapter provides a detailed discussion of audit reports, including the recently released international reporting standards, which Canada will be adopting in the near future. The chapter emphasizes conditions affecting the type of report the auditor must issue and the type of audit report application to each condition under varying levels of materiality. The last chapter, on other assurance services, deals with the various types of engagements and reports, other than the audit of financial statements. Topics covered include review and compilation services, agreed-upon procedures engagements, and assurance engagements of nonfinancial information. We conclude by discussing the future of assurance services and the continued evolution of assurance standards in the face of changing assurance needs.

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Instructional Support Materials

INSTRUCTOR'S RESOURCE MANUAL The Instructor's Resource Manual assists the instructor in teaching the course more efficiently. The features include instructions for assignments, practical examples to help the students understand the material, and helpful suggestions on how to effectively teach each chapter. It also includes a sample course outline and mapping the chapters' topics to the CPA Competency Map.

INSTRUCTOR'S SOLUTIONS MANUAL This comprehensive resource provides detailed solutions to all the end-of-chapter review questions, multiple-choice questions, problems, and cases.

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Joanne C. Jones

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Joanne C. Jones
Bartosz Amerski

About the New Canadian Authors

Joanne C. Jones, PhD, CPA, CA

This is the first Canadian edition to be authored by Joanne C. Jones, who is an associate professor of auditing at York University. Joanne teaches auditing and her research focuses on the accounting profession and explores issues such as professionalism and ethics, the impact of regulation on audit practice, and the globalization of the accounting profession. She also investigates academic ethics and accounting education and has published several instructional audit cases in academic peer-reviewed journals. Joanne is an active reviewer for several academic journals, is active with the education committee of the Canadian Academic Accounting Association (CAAA), and currently serves as the associate editor at *Issues in Accounting Education*. Prior to earning her PhD, she worked for several years as an external auditor with KPMG and as the associate director of education with the Institute of Chartered Accountants of Ontario (now CPA Ontario).

Bartosz Amerski, CPA, CA

We are pleased to have Bartosz Amerski as contributing author for the Thirteenth Edition. Bartosz teaches auditing and accounting at York University, where he has received recognition and awards for his excellence in teaching and creating a positive learning environment for his students. Bartosz also teaches in the new CPA Ontario's Professional Educational Program (PEP) and the Prerequisite Educational Program (PREP). He is currently pursuing a Masters of Laws (LL.M.) at Osgoode Hall Law School and is an audit manager with the office of the auditor general of Ontario. Prior to that, Bartosz worked at Ernst & Young as an external auditor.

1

The Auditing Profession

Who are auditors, and why are they important? These first four chapters provide background for performing strategic financial statement audits, which is our primary focus. This background will help you understand why auditors perform audits the way they do.

Our book begins with a who's who of assurance services and describes the role of accountants, public accounting firms, and other organizations in doing audits. The chapters in Part 1 emphasize the regulation and control of public accounting through auditing and ethical standards and discuss the legal responsibilities of auditors. We also talk about audit reports, which are the final products of audits.

1 The Demand for Audit and Other Assurance Services

This chapter aims to answer a question: *Who are auditors and why are they important?* Do you think that all auditors are accountants? Would you be surprised to learn that the answer is "no"? In reality, auditors do not account for anything. If it is not yet clear what this means, you will (hopefully) understand after reading this chapter. You will learn about the purpose of auditing and why there is a demand for auditing services, the many different kinds of auditors, and the variety of skills needed to be a good auditor.

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe auditing.
2. Distinguish between auditing and accounting.
3. Explain the importance of auditing in reducing information risk.
4. List the causes of information risk, and explain how this risk can be reduced.
5. Identify major types of audits and auditors.
6. Describe assurance services provided by public accountants and distinguish the audit of financial statements from other assurance and nonassurance services.

Auditors Have a Great Responsibility

In 1996, Allan Cutler, a senior civil servant with the federal Department of Public Works, reported irregularities in the department's advertising contracting process. As a result, Ernst & Young was brought in to conduct a compliance audit. Ernst & Young and Public Works' own internal audit group, in subsequent audits, consistently found noncompliance to policies and procedures. These were not minor lapses. Auditors found contracts worth millions of dollars with no documentation or apparent value. For several years, the government ignored Cutler and the audit reports. Throughout that time period, Cutler was labelled "not a team player" and was forced to move out of Public Works. That was until 2000, when the media got wind of it and what is now known as the "Sponsorship Scandal" or "AdScam" began.

The new minister of public works, Don Boudria, called in Sheila Fraser, the auditor general of Canada, to investigate. Her report found an "appalling lack of documentation" and a "blatant misuse" of public funds. Fraser went on to say that "the nature of the findings is such that I have referred the matter to the RCMP" (Canada's national police).

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The next year, Fraser went further, tracking the flow of funds and assisting the RCMP. Forensic auditors Kroll Lindquist Avey were hired as well. All concluded that fraud and corruption had indeed incurred. There were breaches of the Financial Administration Act, Treasury Board and departmental policies, overbilling, lack of competitive bidding for contracts, suspicious variations in hourly rates, and poor record management. In the end, several people were charged with fraud and went to jail.

In addition to the various audits and investigations, the new prime minister, Paul Martin, set up a commission to investigate the legal ramifications of the scandal. As a result of the scandal, the government was toppled. An internet poll reported that 57 percent of Canadians wanted Sheila Fraser to be the next prime minister! People admired her forthright and candid manner and liked that she was checking on their behalf.

As you read through the chapter, consider the following questions:

- What is the role of auditing? (LO 1, 3)
- Why do organizations obtain audit and assurance services? (LO 3)
- What are the different types of audits? (LO 5, 6)
- What are the different types of auditors? (LO 5)

Sources: Benoit and Franks, "For want of a nail: The role of internal audit in the Sponsorship Scandal," *Restoring Accountability Research Studies Volume 2: The Public Service and Transparency* (Ottawa: Public Works and Government Services Canada, 2006), pp. 233–304. Kenneth Dye, "Corruption and fraud detection by supreme audit institutions," in Anwar Shah (ed.), *Performance Accountability and Combating Corruption* (Washington, D.C.: The World Bank, 2007). John Gray, "Auditing the auditor general," *The Walrus* (December 2010).

THIS opening vignette about Sheila Fraser and the Sponsorship Scandal illustrates the importance of internal controls and the role of auditors in detecting fraud and corruption. It also provides examples of a wide variety of assurance services that auditors can perform—compliance audits, fraud audits, internal audits, and forensic audits. Who says that auditors are simply bean counters?

Nature and Relevance of Auditing

LO 1 Describe auditing.

Auditing is both an art and a science. It takes a combination of the auditor's professional judgment and skepticism (the art) and knowledge of the rules and procedures (the science) to perform a high-quality audit. The definition of **auditing**, below, includes several key words and phrases (emphasis added).

> Auditing is the *accumulation and evaluation of evidence* about information to determine and *report* on the degree of correspondence between the *information and established criteria*. Auditing should be done by a *competent, independent person*.

Auditing—the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria.

We will now look at each of these key phrases.

Information and Established Criteria

To do an audit, there must be information in a verifiable form and some standards (criteria) by which the auditor can evaluate the information. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns. Auditors also perform audits of more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations. The focus of this text is the audit of financial statement information, commonly referred to as the financial statement audit.

The criteria against which information is evaluated vary depending on the information being audited. For example, in the audit of historical financial statements conducted by public accounting firms, the criteria are based on an accounting framework such as International Financial Reporting Standards (IFRS), Accounting Standards for Private Enterprises (ASPE), or Accounting Standards for Not-for-Profit Organizations (ASNPO). To illustrate, this means that in the audit of the financial statements of RONA Inc. (**www.rona.ca**), the public accounting firm Raymond Chabot Grant Thornton LLP (**www.rcgt.com**) determines whether the financial statements have been prepared in accordance with the IFRS accounting standards. In contrast, **Canada Revenue Agency (CRA) auditors** use the provisions of the Income Tax Act to audit tax returns. In a CRA audit of RONA's corporate tax return, the CRA auditor uses the provisions of the Income Tax Act as the criteria rather than IFRS, as would be the case with the RONA financial statement audit.

Canada Revenue Agency (CRA) auditors—auditors who work for the Canada Revenue Agency and conduct examinations of taxpayers' returns.

For more subjective information, such as auditing the effectiveness of computer operations, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For a computer application, one of the criteria might be the absence of input or output errors.

Accumulation and Evaluation of Evidence

Evidence—any information used by the auditor to assess whether the information being audited is stated in accordance with established criteria.

Audit strategy—a planned approach to the conduct of audit testing based upon assessed risks.

Evidence is defined as any information used by the auditor to assess whether the information being audited is stated in accordance with the established criteria. The quality and amount of evidence collected depends upon the risks of material misstatement, whether due to error or to fraud. Based upon a risk analysis, which includes the auditor's assessment of internal controls, the auditor devises an **audit strategy** to effectively plan the evidence-gathering process. Evidence takes many different forms, including oral representation of the auditee (client), written communication with outsiders, and observations by the auditor. Certain evidence (from a third party) is considered more reliable than other evidence (from the client). It is important to obtain a sufficient quality and volume of evidence to mitigate the risks of the audit. The process of determining the amount of evidence necessary and evaluating whether the information corresponds to the established criteria in the context of identified risks is a critical part of every audit. The strategic audit approach is the focus of this text.

Competent, Independent Person

Professional judgment—analytical, systematic, and objective judgment carried out with integrity and recognition of responsibility to those affected by its consequences.

Integrity—the quality of being honest and courageous.

Professional skepticism—an attitude that includes a questioning mind, a critical assessment of audit evidence, and the willingness to challenge the auditee's assertions.

The auditor must be qualified to understand the engagement risks and the criteria used, and be competent in selecting the types and amount of evidence to accumulate and in effectively evaluating evidence to reach the proper conclusion. While having the appropriate technical knowledge and skills are key to being competent, in order to reach the proper conclusion (which means exercising **professional judgment**), an auditor must act with **integrity** and with **professional skepticism**, be independent, and recognize responsibility to the users of the audit report.

Professional skepticism underlies auditors' professional judgment. It is an attitude that includes a questioning mind, a critical assessment of audit evidence, and a willingness to challenge the auditee's assertions. Sound professional judgment requires the auditor to exercise objectivity (be free of biases, conflicts of interest, or undue influence). This is referred to as having **independence in mind**. The competence of the individual performing the audit is of little value if he or she is biased in the accumulation and evaluation of evidence. It is likely that a biased auditor will not use the appropriate level of professional skepticism, which can result in inadequate evidence and insufficiently critical evaluation of the evidence.

Independence in mind—the auditor's ability to exercise objectivity.

Auditors reporting on company financial statements are **independent auditors**. Even though an auditor of published financial statements is paid a fee by a company, he or she is normally sufficiently independent to conduct audits that can be relied on by users. Absolute independence is impossible, but auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Although **internal auditors** work for the company, to help maintain independence from the units being audited, they report directly to top management and the board of directors.

Independent auditors—public accountants or accounting firms that perform audits of commercial and noncommercial entities.

Internal auditors—auditors employed by a company to audit for the company's board of directors and management.

Report

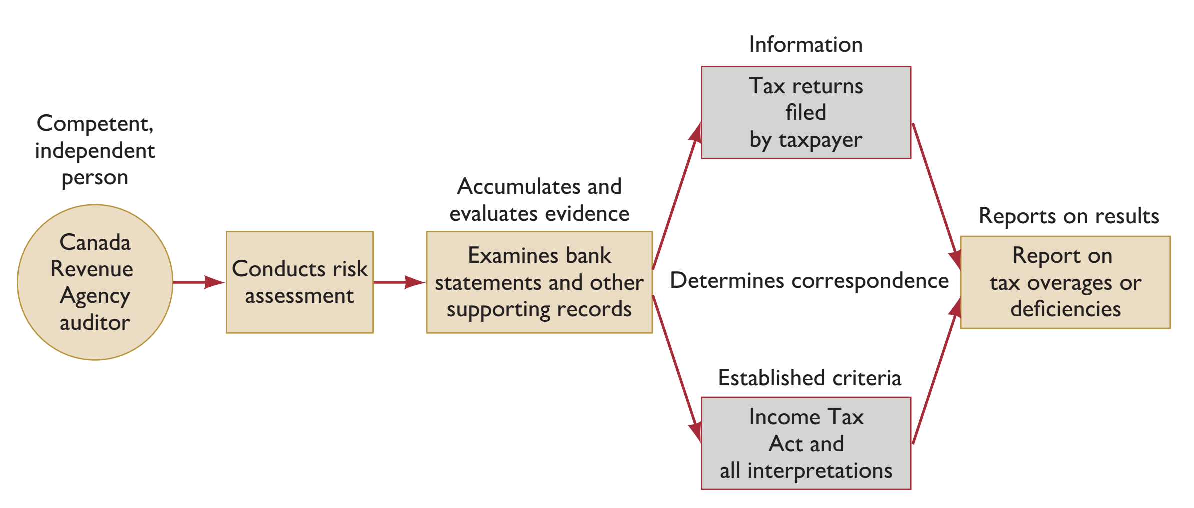
The final stage in the audit process is the **independent auditor's report**—the communication of the audit findings to users. Reports differ in nature, but in all cases they must inform readers of the degree of correspondence between the information and established criteria. Reports also differ in form and can vary from the auditor's standard opinion usually associated with financial statements to a customized report in the case of an audit of effectiveness of computer systems or an audit of the efficiency of manufacturing operations.

Independent auditor's report—the communication of audit findings to users.

Figure 1-1 summarizes the important ideas in the definition of auditing by illustrating an audit of an individual's tax return by a Canada Revenue Agency auditor.

The objective is to determine whether the tax return was prepared in a manner consistent with the requirements of the Income Tax Act. The auditor first considers the potential risk of incorrect or fraudulent tax reporting by comparing the statistics of the tax return with other tax returns and by considering factors such as the taxpayer's industry and past income. The auditor next examines supporting records provided by the taxpayer and from other sources, such as the taxpayer's employer or bank. After completing the audit, the Canada Revenue Agency (**www.cra-arc.gc.ca**) auditor will issue a report to the taxpayer assessing additional taxes, advising that a refund is due, or stating that there is no change in the status of his or her return.

Figure 1-1 Audit of a Tax Return



LO 2 Distinguish between auditing and accounting.

Distinction Between Auditing and Accounting

Many financial statement users and members of the general public confuse auditing and accounting. The confusion occurs because most auditing is concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title "public accountant" to individuals who are qualified to perform the external audit function. However, as noted in this chapter's introduction, financial statement auditors do not account for anything.

Accounting—the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making.

Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. The function of accounting is to provide certain types of quantitative and qualitative (notes to the financial statements) information that management and others can use to make decisions. Accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. Accountants also help to develop the systems used to record an entity's economic events in a timely way and at a reasonable cost.

Materiality—amount of misstatements, individually or in the aggregate, that would likely influence the economic decisions of users.

When auditing accounting data, the concern is with evaluating whether recorded information reasonably reflects the economic events that occurred during the accounting period within specified dollar ranges (called **materiality**). Misstatements are considered to be material if, individually or in the aggregate, they would likely influence the economic decisions of the users. Since accounting standards are the criteria for evaluating whether the accounting information is properly recorded, auditors must understand the relevant accounting standards. These standards are constantly evolving as business practices and standards change—there are different accounting standards for public companies, private enterprises, not-for-profit organizations, and public sector entities.

In addition to understanding accounting, the auditor must also possess expertise in internal controls, risk assessment processes, and the accumulation and interpretation of audit evidence. It is this expertise that distinguishes financial statement auditors from accountants. Determining the proper audit procedures that mitigate risks, deciding on the number and types of items to test, and evaluating the results are tasks that are unique to the auditor.

LO 3 Explain the importance of auditing in reducing information risk.

Economic Demand for Auditing

Businesses, governments, and not-for-profit organizations use auditing services extensively. Publicly accountable organizations, such as businesses listed on securities exchanges or large not-for-profit organizations, are legally required to have an annual financial statement audit.

A look at the economic reasons for auditing highlights why auditing is valuable. Consider a bank manager's decision to make a loan to a business. The decision will be based on such factors as previous financial relations with the business and the financial condition of the business as reflected by its financial statements. Assuming the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

1. *Risk-free interest rate.* This is approximately the rate the bank could earn by investing in Canada Treasury bills for the same length of time as the business loan.
2. *Business risk for the customer.* This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions such as a recession, poor management decisions, or unexpected competition in the industry.
3. *Information risk.* **Information risk** reflects the possibility that the information upon which the business decision was made was inaccurate. A likely cause of the information risk is inaccurate financial statements.

Information risk—the risk that information upon which a business decision is made is inaccurate.

Auditing has no effect on either the risk-free interest rate or business risk. It can have a significant effect on information risk, however. If the bank manager is satisfied that there is low information risk, the risk is lowered and the overall interest rate to the borrower can be reduced. For example, assume that a large company has total interest-bearing debt of approximately $1 billion. If the interest rate on that debt is reduced by only 1 percent, the annual savings in interest is $10 million. Many lenders such as banks require annual audits for companies with large bank loans outstanding.

Causes of Information Risk

LO 4 List the causes of information risk, and explain how this risk can be reduced.

As society becomes more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this, including the existence of complex exchange transactions, bias and motives of the provider, remoteness of information, and voluminous data.

Complex Exchange Transactions

In the past few decades, exchange transactions between organizations have become increasingly complex and therefore more difficult to record properly. The increasing complexity in transactions has also resulted in increasingly complex accounting standards. For example, the correct accounting treatment of the acquisition of one entity by another poses relatively difficult accounting problems, especially as it relates to fair value estimations.

Biases and Motives of the Provider

If information is provided by someone whose goals are inconsistent with those of the decision maker, the information may be biased in favour of the provider. The reason can be honest optimism about future events or an intentional omission or emphasis designed to influence users. In either case, the result is a misstatement of information. For example, when a borrower provides financial statements to a lender, there is considerable likelihood that the borrower will bias the statements to increase the chance of obtaining a loan. The misstatement could be incorrect dollar amounts or inadequate or incomplete disclosures of information.

Remoteness of Information

In a global economy, it is nearly impossible for a decision maker to have much first-hand knowledge about the organization with which it does business. Information provided by others must be relied upon. When information is obtained from others, its likelihood of being intentionally or unintentionally misstated increases.

Voluminous Data

As organizations become larger, so does the volume of their exchange transactions. This increases the likelihood that improperly recorded information is included in the records—perhaps buried in a large amount of other information. For example, if a large government agency overpays a vendor's invoice by $2000, the overpayment is unlikely to be uncovered unless the agency has instituted reasonably complex procedures to find this type of misstatement. If many minor misstatements remain undiscovered, the combined total can be significant or even material. As mentioned previously, material misstatements can have serious implications for users' economic decisions. Managers of businesses and the users of their financial statements may conclude that the best way to deal with information risk is simply to have the risk remain reasonably high. A small company may find it less expensive to pay higher interest costs than to increase the costs of reducing information risk (e.g., by having an audit). Similarly, the bank is willing to accept more information risk because of the higher interest it is receiving from the small business.

Assurance engagement—an engagement in which the assurance professional obtains sufficient evidence to express a conclusion to users about the outcome of the measurement or evaluation of an underlying subject matter against criteria.

Attestation engagement—a special form of assurance engagement, such as a financial statement audit, in which the auditor evaluates the information provided by one party, using suitable criteria, and issues a report about the reliability of this information to another party.

concept check

C1-1 List and explain the five key elements of the definition of auditing.

C1-2 Explain the difference between accounting and auditing.

C1-3 Describe the economic reasons for conducting an audit.

C1-4 Explain the causes of information risk and how users can reduce the risk.

C1-5 Explain the difference between an attestation and a direct report engagement.

C1-6 Explain how and why the auditor makes information trustworthy and credible.

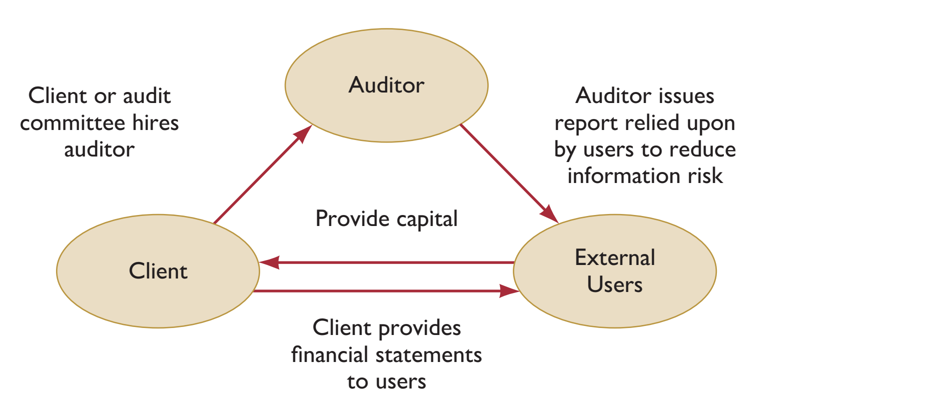
For larger businesses, it is usually practical to incur such costs to reduce information risk. There are three main ways to do so:

1. *User verifies information.* The user may go to the business premises to examine records and obtain information about the reliability of the statements. Normally, this is impractical because of cost. However, some users perform their own verification. For example, the CRA does considerable verification of business and individual tax returns. Similarly, if a business intends to purchase another business, it is common for the purchaser to use a special audit team to independently verify and evaluate key information of the prospective business.
2. *User shares information risk with management.* Considerable legal precedent indicates that management is responsible for providing reliable information to users. If users rely on inaccurate financial statements and as a result incur a loss, they may have the basis for a lawsuit against management. However, users may not be able to collect on losses (as in the case of bankruptcy).
3. *Provider submits audited financial statements.* This is the most common way for users to obtain more reliable information. Typically, management of a private company or the audit committee for a public company engages the external auditor to provide assurances to users that the financial statements are reliable. The external audit of financial statements is a type of **assurance engagement**.

External users (such as shareholders and lenders) who rely on financial statements to make business decisions look to the independent auditor's report as an indication of the statements' reliability. They value the auditor's assurance because of the auditor's integrity, independence, expertise, and knowledge of financial statement reporting matters. This makes the information credible and trustworthy. Figure 1-2 illustrates the relationships among the auditor, client, and financial statement users. The three party accountability relationship depicted in Figure 1-2 applies to all assurance engagements. The client is accountable to the users and, because the users rely upon the auditor's report, the auditors are also accountable to the users.

In the case of the financial statement audit, management (usually referred to as "the client") prepares the financial statements (in other words, presents the subject matter information in a report or statement) and provides the auditor with a written assertion that the financial statements are in accordance with the applicable accounting framework (in the case of RONA, it would be IFRS). The auditor evaluates the information, using suitable criteria, and issues a report that attests to the reliability of the information. This type of engagement is called an **attestation engagement.**

Figure 1-2 Relationships Among Auditor, Client, and External Users of Financial Statements



In some assurance engagements, the auditee does not make a public assertion or prepare a report such as a set of financial statements or a tax return. In these types of engagements, the assertion is implied. The auditor directly measures or evaluates the underlying subject matter against the criteria, and issues a report that includes the subject matter information and a conclusion as to whether the subject matter conforms to the applicable criteria. One of the best examples of a direct reporting engagement is the Report of the Auditor General of Canada. This type of engagement is called a **direct engagement**.

Direct engagement—a special form of assurance engagement, such as the Report of the Auditor General of Canada, in which the auditor directly measures and evaluates the underlying subject matter against the criteria, and issues a report that includes the subject matter information and a conclusion as to whether the subject matter conforms to the applicable criteria.

Types of Audits and Auditors

LO 5 Identify major types of audits and auditors.

Table 1-1 summarizes the type of information, criteria, and evidence used in three common types of audits—the financial statement audit, the compliance audit, and the operational audit.

What type of auditing would you like to specialize in? A **financial statement audit** is conducted by public accountants skilled in accounting and auditing. Financial statement audits are attest engagements—management measures the subject matter and makes a primary assertion that the statements are fairly presented in accordance with the applicable accounting standards. The auditor gathers evidence to determine whether the statements contain a material error and makes an opinion, or attests, on management's assertion.

Financial statement audit—an audit conducted to determine whether the financial statements of an entity are presented fairly, in all material respects, in conformity with an applicable financial reporting framework.

A **compliance audit**, such as in our opening vignette, requires expert knowledge of the relevant legislation, regulations, or policies (the criteria), as well as knowledge of controls-related processes. Compliance audits may be attestation or direct engagements. What distinguishes the two is whether or not the entity provides an assertion that it is in compliance with the relevant criteria (as in the case of an attestation engagement) or the auditor directly measures the compliance. Auditors perform compliance audits for private businesses and various government divisions and units. For example, the CRA audit of an individual's or corporation's tax return is a compliance audit.

Compliance audit—an audit performed to determine whether an entity complied with specific laws, regulations, rules, or provisions of contracts or grant agreements.

An **operational audit** evaluates the efficiency and effectiveness of any part of an organization's operating procedures and methods. At the completion of an operational audit, management normally expects recommendations for improving operations. In operational auditing, the reviews are not limited to accounting, but can include

Operational audit—a review of any part of an organization's operating procedures and methods for the purpose of evaluating economy, efficiency, and effectiveness.

Table 1-1 Examples of Three Types of Audits

Type of Audit and Description	Example	Information	Established Criteria	Available Evidence
Financial statement audit: an audit conducted to determine whether the overall financial statements of an entity are stated in conformity with an applicable reporting framework	Perform the annual audit to determine if Canadian Tire Corporation's financial statements are in conformity with IFRS	Canadian Tire's financial statements	The reporting framework is IFRS	Documents, records, inquiries, and outside sources of evidence
Compliance audit: an audit performed to determine whether an entity has complied with external criteria (i.e., specific laws, regulations, rules, or provisions of contracts or grant agreements) or internal criteria (i.e., organizational policies and procedures)	Determine if bank covenants for loan continuation have been met	Company records	Loan agreement provisions	Financial statements and calculations by the auditor
Operational audit: a review of any part of an organization's operating procedures and methods for the purpose of evaluating economy, efficiency, and effectiveness	Evaluate whether the computerized payroll processing for subsidiary H is operating economically, efficiently, and effectively	Number of payroll records processed in a month, costs of the department, and error rate	Company standards for economy, efficiency, and effectiveness in payroll department	Error reports, payroll records, and payroll processing costs