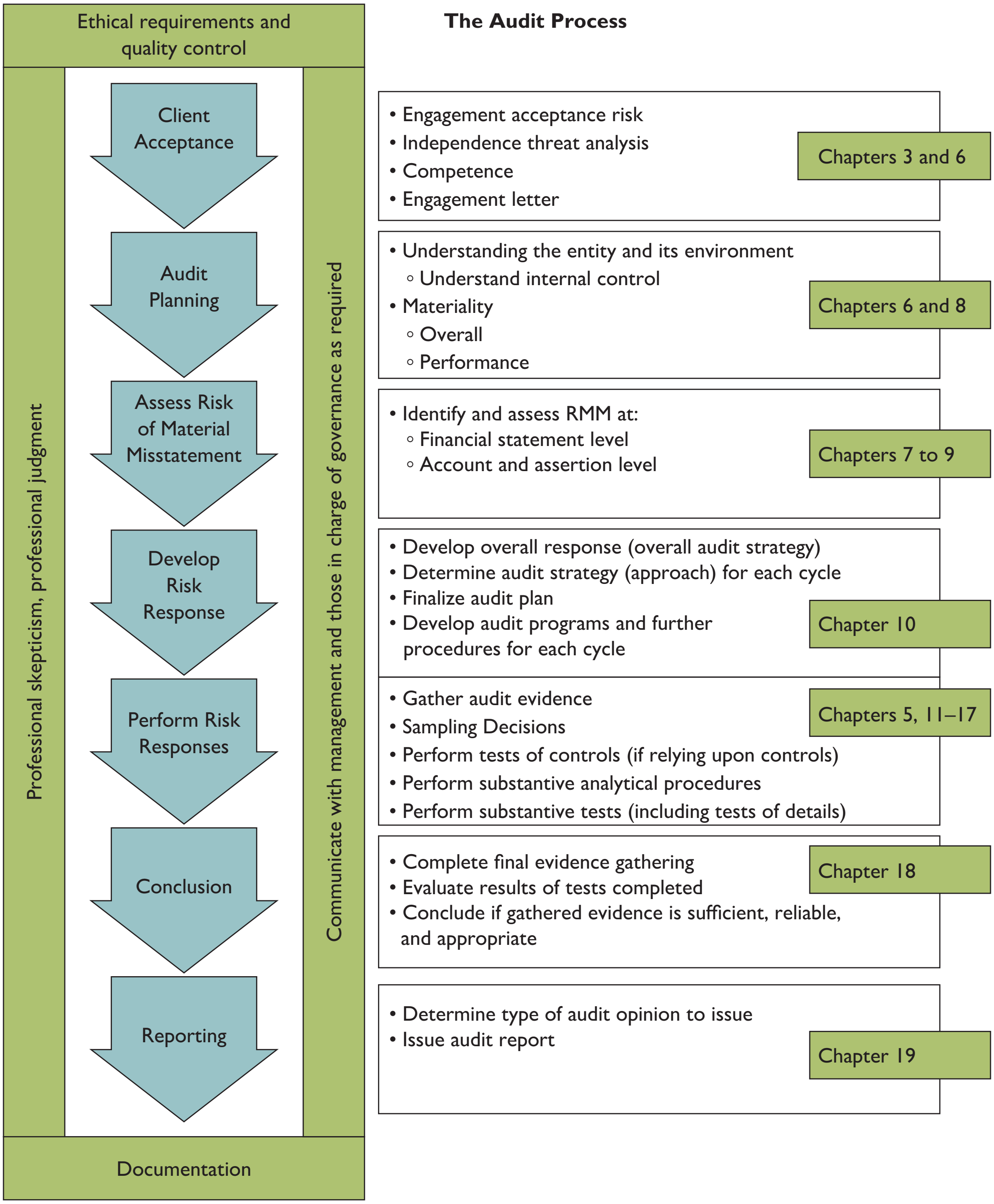
ALVIN A. ARENS RANDAL J. ELDER MARK S. BEASLEY CHRIS E. HOGAN JOANNE C. JONES

Auditing

FOURTEENTH CANADIAN EDITION

THE ART AND SCIENCE OF ASSURANCE ENGAGEMENTS

The Audit Process



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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 book's primary emphasis is on the auditor's decision-making process in a financial statement audit and, to a lesser degree, other types of assurance engagements. As the title of the 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 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 context. 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, decision frameworks, and visual depictions to help clarify concepts such as independence, control activities, materiality, and the various substantive tests in the key transaction cycles.

What's New to This Edition?

Despite its practical nature, many students often view auditing as an abstract subject. To address this, we continue to work on revising the book so that the material is more accessible and understandable to students. We highlight the more substantive changes below.

Current Coverage of Auditing Standards

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 (the most significant being the changes to the auditor's report) and highlights impending changes that have been announced by Canada's Auditing and Assurance Board. As with the previous edition, we continue to revise the book so that the concepts and terminology are closely aligned with Canadian Audit Standards.

In addition to ensuring current coverage, we provide several vignettes to illustrate that, despite the constraining effect of standards, there is considerable variation in audit practices within the profession. Unlike accounting standards, which define how to consistently measure and report economic events, audit standards outline the process of verifying the accounting. This means that there is no one "right" answer and there may be many acceptable ways in which to reach the goal of providing reasonable assurance that the information is fairly presented.

New Audit Reporting Standards

The new and revised audit reporting standards are perhaps one of the most significant changes in audit standards in the last 40 years. We introduce the new audit report in Chapter 4, providing a sample audit report of a private company. Throughout the textbook, we provide excerpts from audit reports from jurisdictions that have already adopted the new international standards to illustrate key audit matters. We revisit the new and revised audit reporting standards in Chapter 19 and use a consolidated public company to illustrate the different elements of the audit report. Given the significant changes, Chapter 19 has been significantly revised, with new vignettes and homework problems.

Professional Ethics and the *CPA Code of Professional Conduct*

We introduce new material in Chapter 3 to help clarify the role of the professional in society and to define professional ethics. We also include some simple tests that professionals use to decide the "right" thing to do. Chapter 3 has also been revised to provide an overview of the key elements of the *CPA Code of Professional Conduct* and to include a decision tree to assess independence threats. We introduce several new vignettes to illustrate the high cost of an auditor's lack of independence.

New Coverage of Auditor's Responsibilities

To reflect recent changes in auditing standards, Chapter 4 has been revised to include the auditor's responsibilities to assess going concern. We revisit this important responsibility in Chapter 18, on completing the audit, and again in Chapter 19, which discusses audit reports. Chapter 18 also discusses the revised standards concerning the auditors' responsibility for other information.

Emphasis on Professional Judgment and Skepticism

The essence of being a competent auditor is the ability to exercise professional judgment and to apply the appropriate level of professional skepticism. While an understanding of the appropriate level of skepticism is achieved through experience, we believe that introducing this concept early in students' professional journey will assist in their development. 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 new vignettes and homework problems that help students think further about challenges and threats to applying professional skepticism in the context of an audit.

The Logic of the Audit Process—Risk Identification and Risk Response

We continue to refine the textbook material to promote deeper learning and to enable students to better understand the underlying logic of the audit process. To assist with these goals, we start with simplifying the visualization of the audit process, which is first introduced in Chapter 4. To further reinforce this, we start each relevant chapter with the audit process diagram and highlight which objectives and activities are covered in that chapter.

We start our examination of the audit process with Chapter 5, on audit evidence. Given that evidence is the foundation of the audit, in this edition we have placed the chapter on audit evidence earlier in the book. The chapter has been revised to help clarify concepts and focuses on how to determine whether the audit evidence is persuasive. To help students develop this important skill, we have developed several task-based simulations and professional judgment questions. We have also reorganized Chapters 6 to 10 to follow the logical sequence of the audit process. We have expanded our coverage of the auditor's performance of risk assessment procedures, including identification of significant risks, and have clarified the distinction between pervasive risks and risks that are specific to particular accounts and assertions. Chapter 6 covers client acceptance and continuance, planning, and materiality. Chapter 7 highlights audit risk and the risk of material misstatement. Chapters 8 and 9 emphasize the importance of internal control as part of the risk assessment process, and Chapter 10 brings the discussion together in its focus on audit strategy. Subsequent chapters that address the transaction cycles include extensive coverage of fraud risk, inherent risk, and internal control risk. We continue to provide up-to-date, real-life examples drawn from actual audit plans and audit reports to illustrate the different types of audit strategies employed in the various transaction cycles.

Expanded Coverage of Control Risk and the Role of Information Technology

Our coverage in Chapters 8 and 9 of internal controls has been restructured to first introduce the COSO's *Internal Control—Framework* in Chapter 8, followed by the auditor's assessment of control risk in Chapter 9, which has been revised to better integrate the auditor's consideration of entity-level controls and transaction cycle controls. We have also added new material to help students understand the different types of controls and how to apply professional judgment in evaluating control effectiveness. Building upon the 13th edition, we continue to emphasize IT controls and integrate them into the audit process. We provide new material and vignettes to illustrate the challenges of auditing in complex IT environments.

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, which focuses on other services outside of the financial statement audit provided by public accountants, covers the new standards for review engagements and the attestation standards for engagements other than audits or reviews of historical financial information (CSAE 3000) and direct reporting engagements (CSAE 3001). New material has been added to help clarify the difference between an attestation and a direct reporting engagement. Sample reports based upon the new standards are provided, and new vignettes (including the recent Oscars™ snafu) and homework questions are provided to help students appreciate the various issues related to providing assurance for non-financial information.

A New Approach to Hillsburg Hardware Limited

Those of you who are familiar with Hillsburg Hardware Limited, which has been a feature of this book for a very long time, will note some significant changes. To increase realism and more accurately reflect the Canadian business environment, we have revised the nature of the organization. We have also reframed the presentation of the financial information and company background as a simulation, which now includes excerpts of interviews with client personnel. New questions are included in Chapter 10 that require students to consider the changes that have occurred since the preliminary planning and the impact of those changes on the current year's audit.

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. Additionally, each chapter identifies new or revised Discussion Questions and Problems that instructors can use in class to generate discussion about important topics. These problems are highlight by an "in-class" discussion icon in the margin next to the related question. Each chapter also identifies questions that may require students to research standards as well other material using the Internet. While many of these research problems expose students to the *CPA Canada Handbook—Assurance*, other questions require students to examine recently issued financial statements or other corporate filings, or they expose students to best practices thought papers as part of the assignment.

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 1–3)

The book begins with an opening vignette that provides as an example the Corporate Sustainability Report issued by United Parcel Services (UPS) to help students see the increasingly important role of auditors in providing assurance on a broad range of information important to key stakeholders. 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 Handbook—Assurance*, Canadian auditing standards, and auditors' responsibilities. It also provides a discussion of audit quality. Chapter 3 starts with a discussion of professional ethics, the rules of professional conduct, and the importance of independence and how to assess independence threats. The chapter concludes with an investigation of the expectations gap and auditors' legal liability, with a discussion of some recent Canadian cases.

Part 2: The Audit Process (Chapters 4–10)

Part 2 presents the audit process. The concepts in this part of the book represent the foundation of the book. The first chapter describes the overall objectives of the audit, auditor and management responsibilities, professional skepticism, a professional judgment framework, audit objectives, and management assertions. The chapter concludes with an overview of the audit process and introduces Hillsburg Hardware Limited, which is used to illustrate planning and development of an audit strategy as well as many other concepts throughout the book.

Chapter 5 discusses the general concepts of evidence quality, the development of audit procedures, and audit documentation. Chapter 6 deals with client acceptance and continuance, and the preliminary planning of the engagement, including understanding the client's business and environment as part of the auditor's risk assessment procedures, using analytical procedures as an audit tool and making preliminary judgments about materiality. Chapter 7 provides expanded coverage of the auditor's performance of risk assessment procedures used to assess the risk of material misstatement due to fraud or error, and how the auditor responds to risks of significant misstatement with further audit procedures. Chapter 8 outlines the key components of an effective system of internal controls over financial reporting consistent with the 2013 revision of COSO's *Internal Control—Integrated Framework*. Because most internal control systems are heavily dependent on information technologies, this chapter integrates coverage of IT general controls and application controls. Chapter 9 shows how effective internal controls can reduce planned audit evidence in the audit of financial statements, and it outlines procedures auditors perform as tests of those controls to support a low or moderate control risk assessment. Chapter 10 provides an overall strategic risk-based audit strategy, linking planning to assertion-based audit programs.

Part 3: Application of the Audit Process (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: Completing the Audit, Reporting, and Other Assurance Engagements (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. Chapter 19 provides a detailed discussion of the new and revised audit reporting standards. The chapter covers all the potential elements of the new audit report, which has changed dramatically. The chapter emphasizes conditions affecting the type of report the auditor must issue and the type of audit report applicable to each condition under varying levels of materiality. The last chapter, on other assurance services, deals with 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 dealing with 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.

MyLab Accounting

MyLab Accounting delivers proven results in helping individual students succeed. It provides engaging experiences that personalize, stimulate, and measure learning for each student, including a personalized study plan.

MyLab Accounting for the Fourteenth Canadian Edition of *Auditing: The Art and Science of Assurance Engagements* includes many valuable assessments and study tools to help students practise and understand key concepts from the text. Students can practise an expanded number of select end-of-chapter questions, review key terms with glossary flashcards, and explore integrated case content.

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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 second 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 issues such as professionalism and ethics in accounting, 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 and currently serves as the associate editor at *Accounting Perspectives*. 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 again pleased to have Bartosz Amerski as contributing author for the Fourteenth Canadian 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 has completed a Masters of Laws (LL.M.) at Osgoode Hall Law School and is an audit director with the office of the Auditor General of Ontario. Prior to that, Bartosz worked at Ernst & Young as an external auditor.

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PART 1

The Auditing Profession

Who are auditors, and why are they important? These first three chapters provide background for performing 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.

CHAPTER 1

THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. Describe auditing and its purpose.
2. Distinguish between auditing and accounting.
3. Explain how auditing reduces information risk.
4. Determine the causes of information risk.
5. Explain how information risk can be reduced.
6. Identify major types of audits and auditors.
7. Explain the general characteristics of an assurance engagement.
8. Describe assurance and nonassurance services provided by public accountants and distinguish the audit of financial statements from other assurance services.

Brown Goes Green

United Parcel Service (UPS) is one of the largest shipment and logistics companies in the world, delivering more than 15 million packages a day in more than 220 countries. At the peak of the holiday season, UPS delivers 34 million packages daily. That's a lot of packages moved by planes and delivery trucks, and it obviously comes with a large carbon footprint. The UPS company nickname is "Brown" because of the company's brown delivery trucks and uniforms, but that does not capture the company's commitment to sustainability.

Recently, the company reduced its annual carbon emissions by 1.5 percent, even though delivery volume increased by 3.9 percent. One way the company reduces carbon emissions is through its proprietary On-Road Integrated Optimization and Navigation (ORION) IT system, which uses an advanced algorithm and customized map data to provide optimal route advice to drivers. The system reduced fuel usage by 5.7 million litres in 2014, resulting in a reduction in annual CO_2 emissions of 14 000 metric tons. ORION is not only good for the environment, but it helps the bottom line. UPS estimates that a reduction of 1.6 kilometers driven per delivery driver per day will save the company up to $50 million per year.

The UPS Corporate Sustainability Report is prepared in accordance with the G4 framework established by the Global Reporting Initiative (GRI). The company received the "Materiality Matters" check from the GRI, indicating that it had fulfilled the necessary general standards of disclosures. The increase in sustainability reporting by companies such as UPS has also resulted in increased interest in the accuracy of the reported information, and the GRI recommends external assurance by accountants or other qualified experts to provide users with increased confidence in the accuracy of the information. The UPS Corporate Sustainability Report includes a limited assurance report along

continued >

with a reasonable assurance report on the company's global statement of greenhouse gas emissions from a Big 4 public accounting firm. Many predict this form of assurance will be a frequent service performed by tomorrow's Chartered Professional Accountants (CPAs).

Sources: UPS, *The Road Ahead: UPS 2016 Corporate Sustainability Report*, accessed June 27, 2017, at **https://sustainability.ups.com/media/ups-pdf-interactive-2016/index.html**. Global Reporting Initiative, *The External Assurance of Sustainability Reporting,* Amsterdam, 2013, accessed June 27, 2017, at **https://www.globalreporting.org/resourcelibrary/GRI-Assurance.pdf**.

This opening vignette involving the UPS *Corporate Sustainability Report* illustrates the increasingly important role of auditors in providing assurance on sustainability and other information of interest to a broad range of stakeholders. Of course, reporting on financial statements of public companies, as well as private companies, government agencies, and non-profit entities, remains the primary role of auditors in public accounting.

This chapter introduces the purpose of auditing and other assurance services, as well as the auditor's role in society. The chapter also explains why there is a demand for auditing and other assurance services, the many different kinds of auditors, and the variety of skills needed to be a good auditor.

NATURE AND RELEVANCE OF AUDITING

LO 1 Describe auditing and its purpose.

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 relevant subject matter, rules, and procedures (the science) to perform a high-quality audit. We will now examine auditing more specifically using the following definition.

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

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

The definition includes several key words and phrases. For ease of understanding, we'll discuss the terms in different order than they occur in the description.

Assertions, Information, and Established Criteria

The objective of an audit is to provide a conclusion (or assurance) by assessing the assertions made and the information provided by the preparer. This is performed by considering the established criteria, gathering evidence, and reaching conclusions on the fair presentation of the information. In order to do this, the information must be in a verifiable form.

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 financial statement audit.

The criteria used to evaluate the assertions made and the information provided varies depending on the information being audited. For example, in the audit of historical financial statements conducted by public accounting firms, the criteria is the relevant accounting framework such as International Financial Reporting Standards (IFRS), Accounting Standards for Private Enterprises (ASPE), or Accounting Standards for Not-for-Profit Organizations (ASNPO). This means in the case of Canadian Tire, for instance, that management asserts that the financial statements are prepared in accordance with the IFRS accounting standards. It is the job of the auditors to determine whether the financial statements have been prepared in accordance with IFRS and to provide reasonable assurance to the users that the financial statements accurately reflect the management's assertions.

In our opening vignette, the management of UPS asserted that the Corporate Sustainability Report (the information) was prepared in accordance to the G4 framework (the criteria) established by the Global Reporting Initiative (GRI) (the standard setter). In this case, the auditors evaluated this assertion by considering the criteria and gathering evidence, and then reporting their conclusion on the fair presentation of the information.

For more subjective information, or when there are no generally accepted standards, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For example, in an audit of the effectiveness of specific aspects of computer operations, the criteria might include the allowable level of input or output errors as defined by the organization.

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.

Evidence is any information used by the auditor to assess whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including:

- Electronic and documentary evidence about transactions
- Written and electronic communication from outsiders
- Observations by the auditor
- Oral testimony of the auditee (client)

To satisfy the purpose of the audit, auditors must obtain sufficient quality and quantity of evidence. In order to determine what types and amount of evidence is necessary, auditors must assess the risk of material misstatement. Based upon the evidence gathered, the auditor will then determine the degree of correspondence between the information and established criteria. Deciding what evidence to gather and evaluating the evidence are critical aspects of every audit and the primary 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.

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

The auditor must be qualified to understand the engagement risks and the criteria used, and be competent to know the types and amount of evidence to accumulate in order to reach the proper conclusion after examining the evidence. 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.

Auditors strive to maintain a high level of independence in order to keep the confidence of users relying on their reports. Auditors reporting on company financial statements are **independent auditors**. Even though such auditors are paid a fee by a company, they are normally sufficiently independent to conduct audits that can be relied on by users. Even **internal auditors**—those employed by the companies they audit—usually report directly to top management and the board of directors, keeping auditors independent of the operating units they audit.

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 preparing the **independent auditor's report**, which communicates the outcome of the auditors' evaluation to interested users. Reports differ in nature, but all inform readers of the degree of confidence that the auditor has that the assertions made and the information provided by management corresponds to the established criteria. Reports also differ in form and can follow a standardized format, as in the case of the financial statements auditor's report, or can be highly customized report, as in the case of an audit of effectiveness of computer systems or an audit of the efficiency of manufacturing operations.

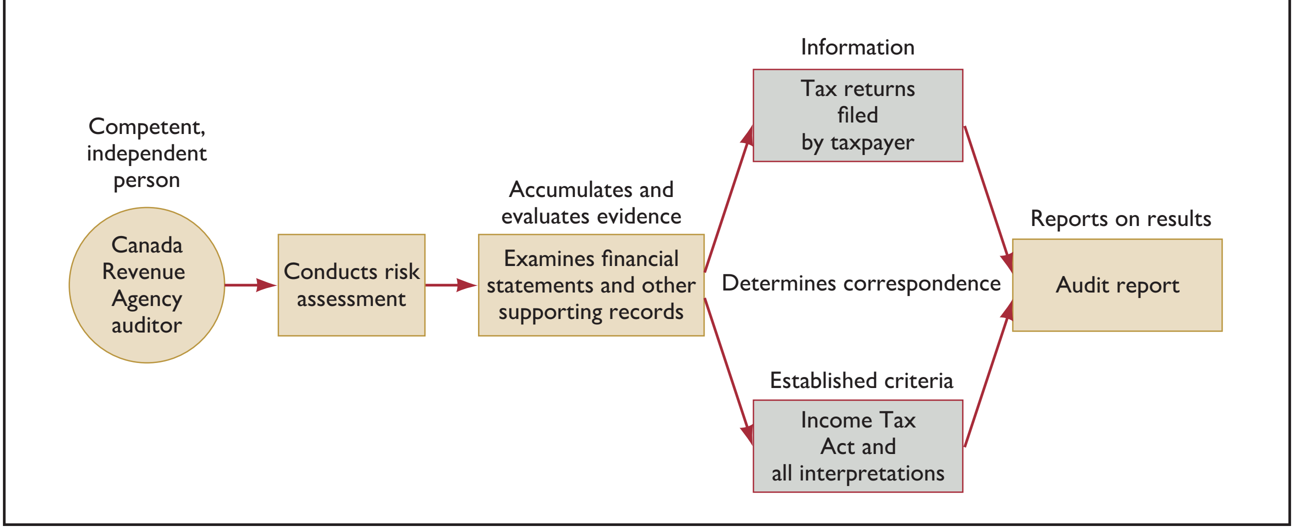
Independent auditor's report—the communication of audit findings to users.

An Illustration of the Definition of Auditing

The key parts in the description of auditing are illustrated in Figure 1-1 using the audit of a large corporate tax return by a team of Canada Revenue Agency auditors.

The audit team would likely include auditors who are competent in auditing and corporate taxes, as well as knowledgeable about the particular industry and the related complex tax issues. The auditors first perform a risk assessment based upon several factors, such as past tax audit history, industry sector issues, unusual or complex transactions, corporate structure, participation in aggressive tax planning, and openness and transparency. The auditors next accumulate and examine the relevant evidence, such as the organization's financial statements, books, and records, as well as information from third parties that do business with the organization. The procedures selected would depend upon the auditors' professional judgment. After completing the audit, the audit team will issue an audit report that provides their conclusion, based upon evidence gathered and their interpretation of tax law, as to whether the tax return is in compliance with the Income Tax Act. The taxpayer receives a notice of reassessment that reflects the audit report's findings.

Figure 1-1 Audit of a Corporate 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 provide assurance on the financial statements. However, 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.

As we are all aware, financial statements are prepared using many judgmental evaluations or estimates. Therefore, it is not possible to produce financial statements that are absolutely precise. For instance, when management provides an allowance for doubtful accounts, it represents management's best estimate of the likelihood of collectability. When auditing accounting data, the concern lies in evaluating whether recorded information reasonably reflects the economic events that occurred during the accounting period within specified dollar ranges (called **materiality**). Misstatements or omissions are considered to be material if, individually or in the aggregate, they would likely influence the economic decisions of users who rely upon the financial statements. In simple terms, if the users would have reached a different opinion of the financial statements if they had received a set of financial statements with the corrected misstatement or omission, then that misstatement or omission is material. As one can imagine, establishing materiality requires considerable professional judgment.

Materiality—amount of misstatements, individually or in the aggregate, that would likely influence the economic decisions of 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 how auditing reduces 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 decision to make the loan 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, but it can have a significant effect on information risk. If the bank manager is satisfied that there is minimal information risk because a borrower's financial statements are audited, the bank's risk is substantially reduced 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 Determine the causes of information risk.

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 remoteness of information, bias and motives of the provider, voluminous data, and complex exchange transactions.

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.

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.

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.

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. Other examples include properly combining and disclosing the results of operations of subsidiaries in different industries and properly valuing and disclosing derivative financial instruments.

LO 5 Explain how information risk can be reduced.

REDUCING INFORMATION RISK

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.

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 **Canada Revenue Agency (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.* There is considerable legal precedent indicating 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. A difficulty with sharing information risk with management is that users may not be able to collect on losses (as in the case of bankruptcy).
3. *Audited financial statements are provided.* The most common way for users to obtain reliable information is to have an independent audit. 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.

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

CONCEPT CHECK

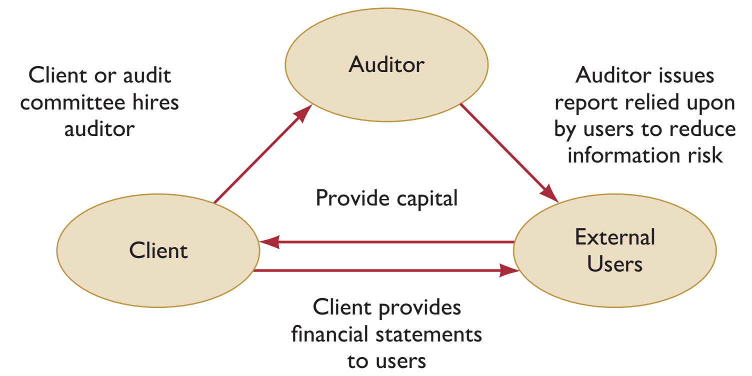
C1-1 What is meant by determining the degree of correspondence between information and established criteria? What are the criteria for the audit of a company's financial statements?

C1-2 What are the major causes of information risk? How can information risk be reduced?

C1-3 Explain how and why the auditor makes information trustworthy and credible.

External users (such as shareholders and lenders) rely on financial statements to make business decisions. They look to the independent auditor's report as an indication of the statements' reliability. Decision makers can then use the audited information on the assumption that it is reasonably complete, accurate, and unbiased. They value the auditor's assurance because of the auditor's integrity, independence, expertise, and knowledge of financial statement reporting matters. As a result, in order for the audit to be effective, the interests of external users must be protected throughout the engagement. Figure 1-2 illustrates the accountability relationships among the auditor, client, and financial statement users.

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



COMMON TYPES OF AUDITS

LO 6 Identify major types of audits and auditors.

There are many different types of audits depending upon the subject matter under consideration. 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.

A **financial statement audit** is conducted to determine whether the financial statements (the information verified) are stated in accordance with specified criteria (the applicable accounting framework).

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** requires expert knowledge of the relevant legislation, regulations, or policies (the criteria), as well as knowledge of controls-related processes. A compliance audit is conducted to determine whether the auditee is following specific procedures, rules, or regulations set by some higher authority. Auditors perform compliance audits for private businesses and various government

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

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