

FIFTEENTH CANADIAN EDITION

AUDITING

The Art and Science of Assurance Engagements



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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 audits and assurance engagements.

To offer a deeper learning experience, we recommend pairing the text content with **MyLab Accounting**, which is the teaching and learning platform that empowers you to reach every student. By combining trusted author content with digital tools and a flexible platform, MyLab personalizes the learning experience and will help your students learn and retain key course concepts while developing skills that future employers are seeking in their candidates. Learn more at www.pearson.com/mylab/accounting.

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 relatable 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 and that are effective January 1, 2022, (early adoption is encouraged). The edition has been revised to include CAS 315 (Revised), *Identifying and Assessing Risks of Material Misstatement*, CSRS 4200, *Compilation Engagements* and CSRS 4600, *Agreed-Upon Procedures Engagements*. As with the previous edition, we continue to revise the book so that the concepts and terminology are closely aligned with the Canadian Audit Standards.

New Coverage of Audit Data Analytics and Other Automated Tools and Techniques

The internet and extensive use of technologies and automation by entities to engage in all types of business transactions and services have dramatically increased the amount of data available for analysis. The audit profession is rapidly exploring how audit data analytics (ADAs) and advanced technologies might allow them to increase both audit quality and efficiency. The 15th edition of this textbook includes new coverage of how ADAs are being used in all phases of the audit, spanning from initial planning through the completion of the audit.

We provide an extensive introduction to ADAs in Chapter 5, including coverage of best practices related to accessing and preparing the data, evaluating the relevance and reliability of that data, addressing large numbers of exceptions for further consideration, and documenting the use of ADAs. We also include coverage of different types of automated tools and techniques, including artificial intelligence, robotics, machine learning, and deep learning. In Chapters 6 and 7, we discuss, and provide several examples, of how ADAs are used to perform risk assessment procedures and to identify unusual transactions and account balances. In Chapter 11, we explain the difference between ADAs and sampling and how they complement each other. In Chapters 12 to 16, which cover the financial statement cycles, we highlight different ways auditors are using ADAs and various automated tools and techniques to perform risk assessment procedures, control tests, substantive tests, and fraud procedures. Throughout the textbook, we provide several Auditing in Action boxes that provide real examples of auditors using various ADAs and other automated tools and techniques, such as drones and machine learning.

New Dataset for Students to Perform Audit Data Analytics

To provide students hands-on experience in using various audit data analytics tools, we have developed

an entirely new dataset that includes different files of transaction data related to the sales and collection cycle for a hypothetical company, JA Tire Manufacturing. This dataset, which students can access from MyLab Accounting, includes different sub-files that contain transaction data related to JA Tire Manufacturing's sales orders, bills of lading, invoices, cash receipts, customer master file, and product master file (an excerpt of a summary of the sub-files is shown below). We have developed several new homework problems included in Chapters 5, 6, 7, and 12 that require students to analyze data in the various sub-files of the dataset for JA Tire Manufacturing. Because the dataset is in Excel, the new homework problems allow students to use any software, such as AuditBond (formerly ACL), Excel, IDEA, Power BI, or Tableau, to conduct their data analysis. Thus, instructors have the flexibility to choose which software tool they would like students to use to perform the analyses.

New Case for Students to use MindBridge Ai

In partnership with MindBridge Ai, Pearson Canada has worked with a subject matter expert and the author of this text to include the addition of an entirely new case to the 15th edition. This includes a general ledger dataset that provides students hands-on experience with using the machine learning tool, MindBridge Ai, the world's first AI-powered auditing solution. We introduce the case in Chapter 6 and provide information on the company and its environment. In this component of the case, students learn how to use MindBridge Ai and perform preliminary analytical review of two years of general ledger data in order to identify high risk areas. As we develop more components to the case, they will be added to the MyLab Accounting.

Recognized as a technology pioneer by the World Economic Forum in 2020 for their innovative strength in transforming the accounting and financial services professions, MindBridge Ai provides deeper insights that go beyond traditional audit techniques, covering entire data sets to extract new value in data and reporting.

Additional Audit Data Analysis Problems

In addition to the new JA Tire Manufacturing homework problems and the MindBridge Ai case, we have also included several other problems in the text that can be completed using Excel templates that are available in MyLab Accounting.

The Impact of the COVID-19 Pandemic

The COVID-19 pandemic has had a significant impact on the audit profession. This provides a unique opportunity to have students and instructors “think outside the box” and address the challenges auditors face when clients are working remotely or when past historical financial information is no longer relevant in identifying misstatements or evaluating estimates. Throughout the textbook, we have provided numerous examples of the impact of the pandemic on various business models and the risk of misstatement. We have also developed questions, Concept Checks, and Auditing in Actions to help students develop their change management skills, which is one of the key skills that has emerged during the pandemic.

The Expectations Gap

We have introduced new material in Chapter 3 to help deepen students' understanding of the expectations gap, its underlying causes and the role of the auditor in society.

A Refresh of Risk Assessment and Risk Response

We continue to refine the textbook material to promote deeper learning and to enable students to better understand how to perform a risk assessment and develop an appropriate risk response. In addition to incorporating automated tools and techniques into Chapters 6 to 10, we have significantly revised those chapters to reflect changes in CAS 315 (Revised).

In Chapter 6, which covers client acceptance and continuance, preliminary planning, and materiality, we have revised our discussion of engagement risk and understanding the entity and its environment. We have also placed a greater emphasis on the accounting framework. In Chapter 7, to enhance students' understanding of the underlying logic of the audit process, we have revised our discussion of components of the audit risk model and have introduced new diagrams. Reflective of revised CAS 315, Chapter 7 introduces the five new inherent risk factors to aid in risk assessment and the spectrum of inherent risk. For both Chapter 6 and 7, we have developed new diagrams to illustrate these concepts.

Chapters 8 and 9 have also been revised to help students understand how to apply professional judgment in evaluating control effectiveness and designing tests of controls. We distinguish between direct and indirect

controls and have developed several diagrams to illustrate the underlying logic of the control risk assessment and its connection with risk of material misstatement. Consistent with the CAS 315 (Revised), we include much more on information technology, particularly general controls.

Chapter 10 brings the discussion together in its focus on overall audit strategy and approach. The subsequent chapters that address the transaction cycles have been revised to be consistent with CAS 315 (Revised) as well as provide examples of ADAs for risk assessment procedures, tests of controls, substantive tests, and fraud procedures. 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 approaches employed in the various transaction cycles.

Emerging Technologies and Cybersecurity Risk

Building upon the 14th edition, we continue to emphasize the role of the IT system and provide new material on the entity's use of information technology, including emerging technologies, and its impact on the system of internal control and the conduct of the audit. We provide new material on cybersecurity risk, the internet of things, smart contracts and blockchain, and artificial intelligence. We have also developed vignettes to illustrate the challenges of auditing in complex IT environments.

Other Audits, Assurance Engagements, and Related Services

Our coverage of other audits, assurance engagements, and related services in Chapters 1 and 19 highlights those engagements that are beyond the financial statement audit. Chapter 19, which focuses on other audits and engagements that fall outside of the traditional financial statement audit, has been revised to include discussion of audits of special purpose financial statements as well as the new standards for compilations and agreed-upon procedures engagements. New material has been added to explain how auditors decide which standards apply to the relevant information.

Still Confused? Read This.

We have developed several conversations in which the two junior auditors, Mitch and AJ, ask questions about various concepts that, through our years of teaching, we

have found students tend to find confusing. The conversations are light in tone, but are designed to provide analogies or examples that students can relate to and, hopefully, they will “get it.” We cover questions such as “Audit Opinions—Clean or Dirty?” and “Data Analytics and Artificial Intelligence in Audit. What, How, and Why?”

Applying Your Professional Judgment to Hillsburg Hardware Limited

We continue to develop Hillsburg Hardware Limited, which has been a feature of this book for a very long time, to reflect the ever-evolving Canadian business environment. At the end of each chapter, we provide a transcript of a conversation among the various audit team members that cover the concepts in the chapters. Students are then asked to apply their professional judgment and answer the related questions. Many of the questions highlight issues that have occurred due to the impact of COVID on Hillsburg's operations.

New and Revised Problems and Cases

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 highlighted by an “in-class” discussion icon in the margin next to the related question.

A Focus on Enhancing Teaching and Learning

As the title of the book suggests, auditing is both an art and a science. To be a good auditor, it requires a combination of the professional judgment (the art) and knowledge of the relevant standards, rules, and procedures (the science). This text aims to both build students' knowledge of auditing and the audit profession as well as develop their critical thinking skills.

These first three chapters provide background to help students understand why there is a demand for audits and auditors perform audits the way they do. These chapters introduce students to key threshold concepts and emphasizes the role of auditing and ethical standards, as well as various organizations, in ensuring audit quality.

Chapter 4 explains auditors' and management's responsibilities as well as assertions, provides a framework for professional judgment, and introduces the audit process. The remaining chapters focus on the activities related to planning—in particular, risk assessment and developing an appropriate risk response.

To understand how auditing is done in practice, it is important to understand how auditing concepts are applied to specific auditing areas. Chapter 11 focuses on the sampling process, while the remaining chapters demonstrate the application of the risk-based audit process to classes of transactions and account balances in the following cycles: revenue, acquisition and payment, inventory and distribution, human resources and payroll, and cash. Each of the cycle chapters follows the same format, starting with an overview of the cycle, inherent risk factors and significant risks, key controls, overall approach, tests of controls, and substantive tests. Each chapter highlight ADAs and some chapters also highlight fraud procedures.

Chapters 17 and 18 cover the final two phases of the audit process—conclusion and reporting. The last chapter, Chapter 19, expands upon Chapter 1's discussion of other audits, assurance engagements, and related services. In this chapter, we explore the other Canadian standards that apply to engagements that fall outside the audit of general purpose financial statements.

Chapter Format

In order to enhance student learning and to ensure future success in their career as well as their professional education, all chapters include the following core features:

LEARNING OBJECTIVES AND STANDARDS REFERENCED IN THE CHAPTER Each chapter starts with learning objectives designed to reflect the expected level of competency for an undergraduate student, as described in the CPA Canada Competency Map. The textbook covers all the standards as outlined in the competency map.

OPENING VIGNETTE To help students connect the important auditing concepts to real-world situations, each chapter begins with an opening vignette that illustrates practice issues relevant to that chapter's content.

DETAILED ILLUSTRATIONS OF KEY DECISION PROCESSES These illustrations help students understand complex concepts and to visualize the decision-making process involved in key audit judgments, including ethical and professional judgment.

CONCEPT CHECKS All chapters include several concept checks, which appear periodically within each chapter and highlight short-answer questions to help

students recap content covered within different sections of the chapter. These short in-chapter review questions are intended to help call students' attention to key concepts and test their comprehension as they read the material in the chapter.

STILL CONFUSED? READ THIS Each chapter includes conversation transcripts in which two junior auditors ask their audit senior or manager questions to explain key audit concepts. The explanations provided use analogies to which students can relate and are designed to make the concepts less abstract.

AUDITING IN ACTION Each chapter includes short vignettes referred to as Auditing in Action. These vignettes provide real-world events or insights from audit research to help students understand the concepts covered.

APPLYING YOUR PROFESSIONAL JUDGMENT TO HILLSBURG HARDWARE Each chapter concludes with a transcript of a conversation among various members of the Hillsburg audit team that address several concepts from the chapter. Students apply their professional judgment to answer questions related to the issues discussed.

In addition to those core features, the chapters that focus on the audit process and its application, Chapters 5 to 18, include the following:

AUDIT PROCESS DIAGRAM Each chapter provides a diagram of the audit process, detailing the relevant phase(s) of the process, along with the primary objectives of the applicable phase and the related activities in the chapter.

DETAILED ILLUSTRATIONS OF REAL-LIFE AUDIT PRACTICE Many chapters include working papers that illustrate how auditors document and perform key parts of the audit, such as develop the overall audit strategy and determine materiality.

EXCERPTS FROM REAL-LIFE AUDIT PLANS AND REPORTS Many chapters have excerpts from actual audit plans, such as the City of Toronto and the Regional Municipality of Halifax, and other communications such as excerpts of the results of the audit report for the City of Ottawa and from the key audit matters section of audit reports of a different types of entities from around the world to illustrate how auditors assess the risk of material misstatement and develop an appropriate risk response.

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 Fifteenth 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 and be assessed on an expanded number of select end-of-chapter questions (an assignment map is available within the instructor resources tab on the MyLab), data analytics projects, review key terms with glossary flashcards, and explore integrated case content.

MyLab Accounting can be used by itself or linked to any learning management system. To learn more about how MyLab Accounting combines proven learning applications with powerful assessment, visit www.pearson.com/mylab

Instructional Support Materials

INSTRUCTOR'S RESOURCE MANUAL The Instructor's Resource Manual assists the instructor in teaching the course more effectively. The features include instructions for assignments, practical examples to help the students understand the material, and helpful suggestions on how to teach each chapter effectively. 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.

COMPUTERIZED TESTBANK Pearson's computerized test banks allow instructors to filter and select questions to create quizzes, tests, or homework. Instructors can revise questions or add their own, and may be able to choose print or online options. These questions are also available in Microsoft Word format.

POWERPOINT SLIDES Electronic colour slides are available in Microsoft PowerPoint. The slides illuminate and build on key concepts in the text.

IMAGE LIBRARY The Image Library is an impressive resource that helps instructors create vibrant lecture presentations. Almost all figures and tables in the text are included and organized by chapter for convenience. These images can easily be imported into Microsoft PowerPoint to create new presentations or to add to existing ones.

PEARSON eTEXT Pearson eText gives students access to their textbook anytime, anywhere. In addition to note taking, highlighting, and bookmarking, the Pearson

eText offers interactive and sharing features. Instructors can share their comments or highlights, and students can add their own, creating a tight community of learners within the class.

DIGITAL LEARNING MANAGERS Pearson's learning solutions managers work with faculty and campus course designers to ensure that Pearson technology products, assessment tools, and online course materials are tailored to meet your specific needs. This highly qualified team is dedicated to helping schools take full advantage of a wide range of educational resources, by assisting in the integration of a variety of instructional materials and media formats. Your local Pearson Canada sales representative can provide you with more details on this service program.

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Joanne C. Jones

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Joanne C. Jones
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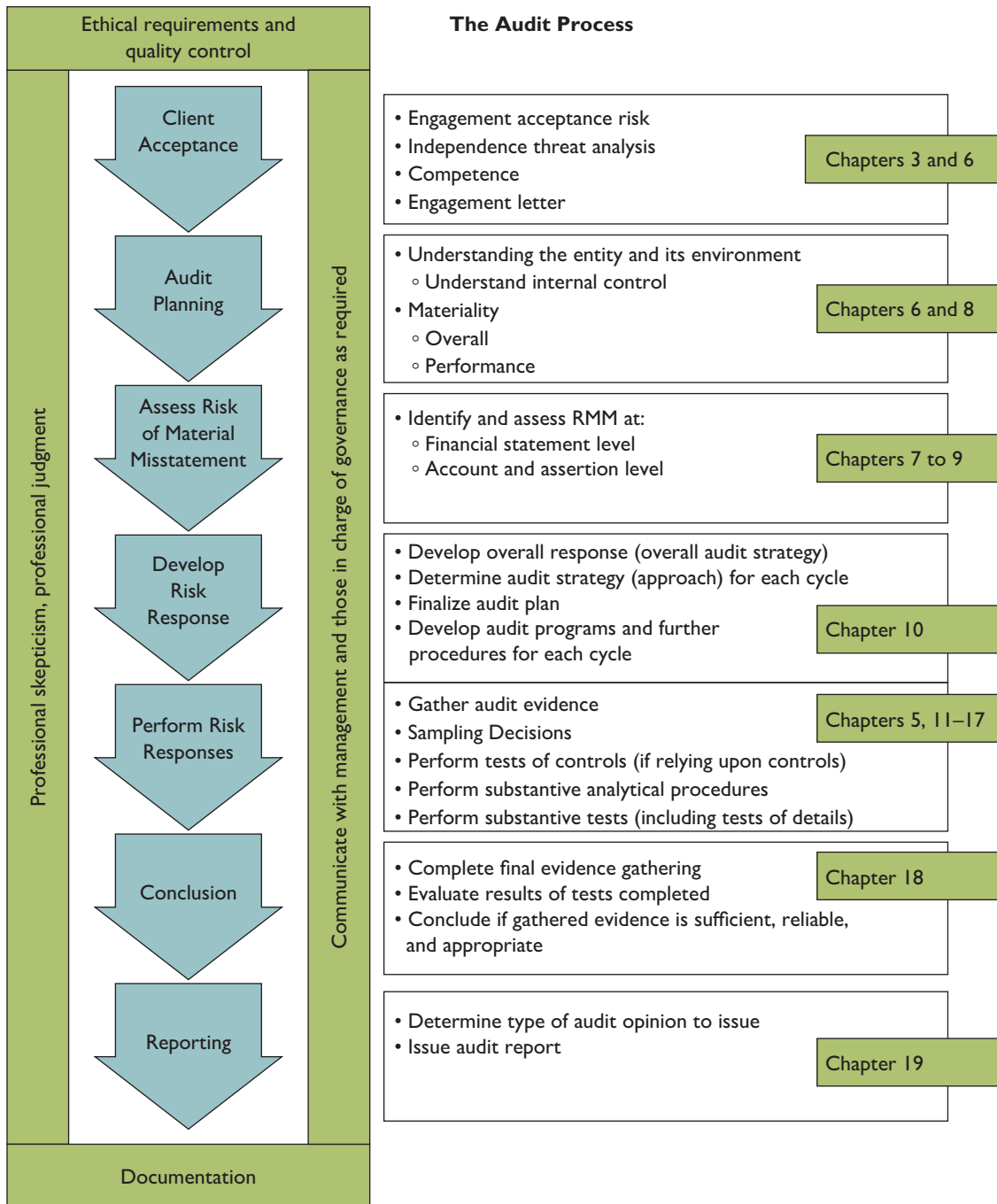
This is the third Canadian edition to be authored by Joanne C. Jones, who is an associate professor of auditing at York University. Joanne teaches graduate and undergraduate auditing and her research focuses on issues such as professionalism and ethics in accounting, audit practice, and globalization and the diversity 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 an editor for *Issues in Accounting Education* and is an 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, LL.M.

We are again pleased to have Bartosz Amerski as contributing author for the Fifteenth Canadian Edition.

Bartosz teaches graduate and undergraduate 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 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.



THE DEMAND FOR AUDIT AND OTHER ASSURANCE SERVICES

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

- 1 Define an *assurance engagement*.
- 2 Define *auditing* and its purpose.
- 3 Explain why there is a demand for audit and other assurance services.
- 4 Describe major types of assurance engagements and auditors.
- 5 Distinguish between accounting and financial statement auditing.
- 6 Describe assurance and nonassurance services provided by public accountants and distinguish the financial statement audit 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 CO₂ 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 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).

continued >

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.

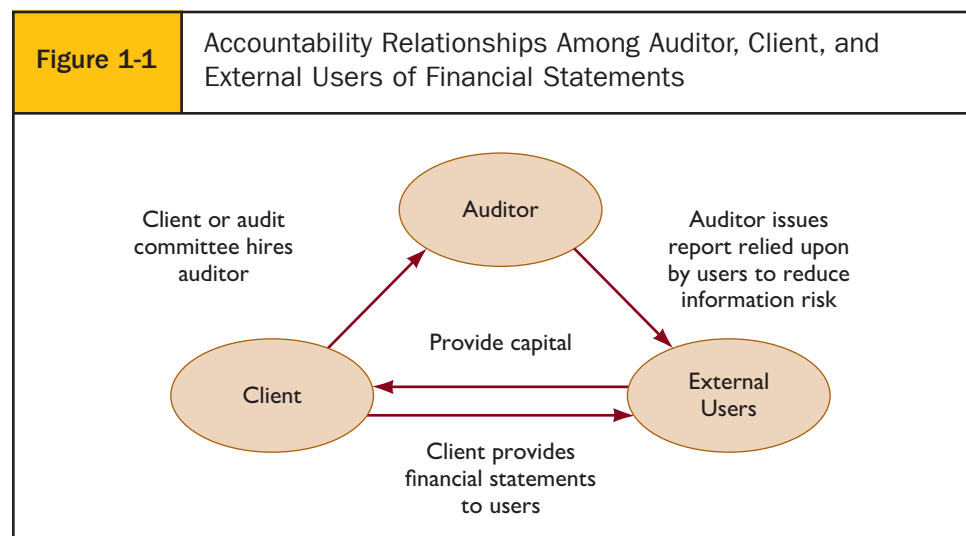
LO 1 Define an assurance engagement.

Assurance engagement—an engagement in which the practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users about the outcome of the measurement or evaluation of a subject matter against criteria for which an accountable party is responsible.

WHAT ARE ASSURANCE ENGAGEMENTS?

An **assurance engagement** is an independent professional service in which the practitioner (usually referred to as the auditor) expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of an evaluation or measurement of a subject matter against criteria. Such services are valued because the auditor is independent and perceived to be unbiased with respect to the information being examined. For individuals making business decisions, such services improve the reliability and the relevance of the information used as the basis for their decisions.

In order to have an assurance engagement, there must be an accountability relationship, where the accountable party is answerable to another party for the subject matter. Figure 1-1 illustrates the three-party accountability relationship with respect to a financial statement audit, the assurance engagement, which is the focus of this book. 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. The subject matter and the criteria for assurance engagements can vary widely. The *subject matter* refers to the information, which can be financial or nonfinancial, that the accountable party has prepared. In the case of the opening vignette, there is reference to two sources of information, the *UPS Sustainability Report* as well as its global statement of greenhouse gas emissions. The criteria for some information may be well-established standards, such as IFRS or, in the case of the *UPS Sustainability Report*, the G4 reporting framework for sustainability reporting. In other situations, such as organic foods, there may not be one agreed-upon standard. The criteria may be specific to a particular agreement, or it may be agreed upon between the auditor and the users.



Levels of Assurance

Assurance engagements can be either moderate or high assurance, which directly impacts what is judged to be sufficient and appropriate evidence needed to make the appropriate conclusion. To help understand what this means, think about **assurance** in terms of the degree of confidence that the auditors have on the reliability of the subject matter. Assurance is what the auditor aims to obtain in order to express a conclusion that should enhance the degree of confidence of the intended users that the subject matter is free of material misstatement.

For instance, the *UPS Corporate Sustainability Report* referred to in the opening vignette was a **limited assurance** (a moderate level of assurance) engagement, and the auditor's report provided a conclusion that the report was prepared, in all material respects, in accordance with the applicable criteria and stated, "nothing has come to our attention." In order to reach that conclusion, or to provide that limited degree of confidence or moderate level of assurance to the users, the auditor would rely primarily upon analytics and inquiry.

In contrast, for the **reasonable assurance** (a high level of assurance) report on the company's global statement of greenhouse gas emissions, the auditor provided a positive opinion that the statement was prepared, in all material respects, in accordance with the applicable criteria. In order to provide that opinion, or to be reasonably confident that the statements are free of material errors, the report would have to involve much more persuasive evidence. It is important to note that while reasonable assurance is considered high assurance, it does not represent absolute assurance on the reliability of the subject matter.

Materiality

In the discussion of assurance, it was highlighted that the practitioner provides assurance that the relevant information (subject matter) is free of material misstatement. Misstatements or omissions are considered to be material if, individually or in aggregate, they would likely influence the economic decisions of users who rely upon the information of a specific reporting entity, such as the financial statements. Therefore, when planning an assurance engagement, the practitioner designs procedures that aim to discover material errors. 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.

WHAT IS AUDITING?

Assurance represents the level of confidence or certainty that the auditor has that the subject matter is reliable. In order to reach the conclusion that the subject matter is free of material error, the auditor must collect sufficient and appropriate evidence. This requires 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.

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.

Assurance—a measure of the level of certainty that the auditor has that the subject matter is free of material misstatement.

Limited assurance—assurance that provides negative assurance on the reliability of the subject matter.

Reasonable assurance—assurance that provides high but not absolute assurance on the reliability of the subject matter.

Materiality—amount of misstatements, individually or in the aggregate, that would likely influence the decisions of users taken on the basis of the financial statements.

LO 2 Define *auditing* and its purpose.

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.

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.

As we have already discussed, 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 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 management's assertions.

In our opening vignette, the management of UPS asserted that the *Corporate Sustainability Report* (the information) was prepared in accordance with 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 the following:

- 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. 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

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 an 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 an 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 an 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.

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.

An Illustration of the Definition of Auditing

The key parts in the description of auditing are illustrated in Figure 1-2 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

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.

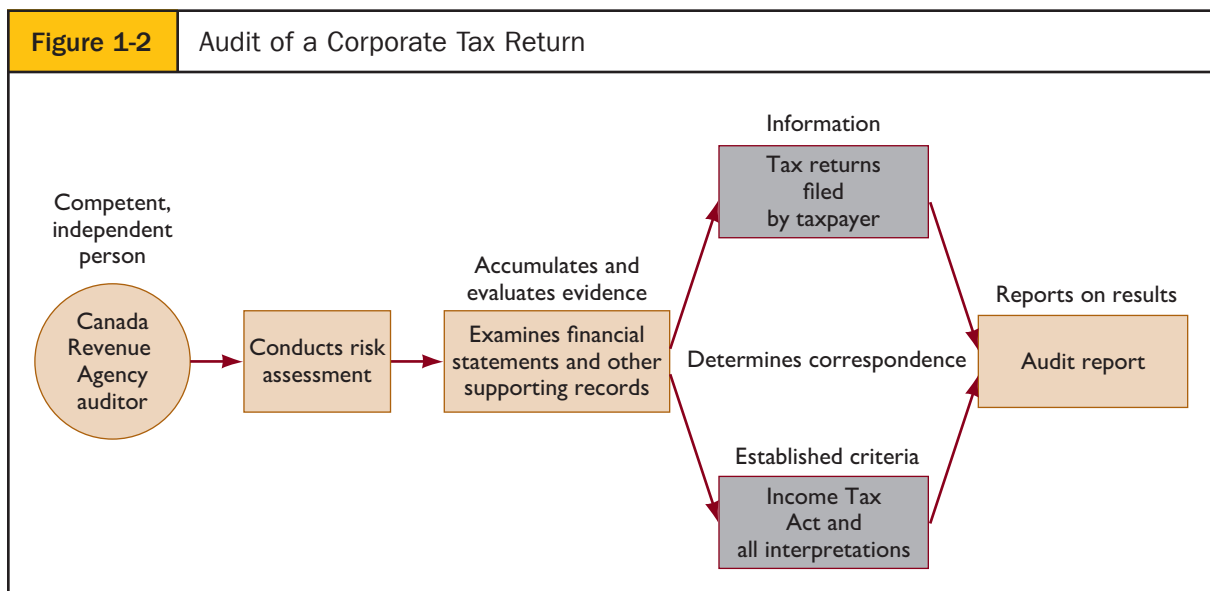
Professional skepticism—an attitude that includes a questioning mind, a critical assessment of audit evidence, and the willingness to challenge the auditee's assertions.

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

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.

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



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.

STILL CONFUSED? READ THIS.

Audit Lessons at Hillsburg Hardware

As this is likely the first time that you are learning about auditing, you may encounter new concepts that at first you may find difficult to understand. To help you understand these concepts, in each chapter, there will be conversations involving various audit team members of an audit client — Hillsburg Hardware Limited. Each of these conversations will include an explanation of some key audit concepts and will illustrate how they apply to an actual audit engagement and real life.

Many students who pursue their CPA designation, start their careers as junior auditors, at public accounting firms. Assume that you have just been hired, as a junior auditor at BKK LLP, a

Canadian public accounting firm with offices located in each of the major cities across Canada.

Hillsburg Hardware Limited (Hillsburg) is a privately owned company located in Halifax, Nova Scotia. Hillsburg is a wholesale distributor of hardware equipment such as power and hand tools and a wide selection of paint products. (For more background on the company, refer to Appendix A at the end of the book.)

The audit team assigned to Hillsburg includes Partner Joe Anthony (JA), Audit Manager Leslie Nagan (LN), Audit Senior Fran Moore (FM), and two audit juniors, Mitch Bray and you, Audit Junior (AJ). Hillsburg is your and Mitch's first audit engagement, so you have lots of questions.

STILL CONFUSED? READ THIS.

Assurance vs. Auditing—What's the Difference?

AJ: Hi Leslie, BKK is a public accounting firm, which offers Assurance Services, but all my friends keep asking me what that means—they thought I was doing audits. Leslie, I am kind of embarrassed to say, but I am not totally clear on the difference between assurance and auditing.

FM: Don't worry. When I started working at BKK, I didn't understand the difference either.

I heard that you prefer to eat organic food, is that right?

AJ: Yes.

FM: Well how do you know that the more expensive "organic" labelled food that you buy has actually been organically grown? Maybe the store where you purchase your organic food wants to make an extra profit and is mislabelling non-organic food as "organic" and selling it to you for a higher price?"

AJ: Oh, I never thought about that. Yes, that is possible.

FM: Well, wouldn't you want some assurance, or in other words, certainty, from someone, who is independent and competent, that the organic food which you buy has actually been organically grown?

AJ: Yes, of course, that would make me more confident that I am actually buying organically grown food.

FM: Well, just like you may want assurance about organic food, readers of Hillsburg's financial statements, such as a bank, want assurance that the information Hillsburg's management presents in the financial statements is correct overall. BKK provides such assurance in the form of an audit opinion. The audit opinion that is attached to Hillsburg's financial statements gives readers more confidence that the presented financial information is correct. However, before

continued >

BKK can issue an audit opinion, in other words, provide assurance, we must first do some work. This work is called “auditing.” You can think of auditing as “checking.” In the case of Hillsburg, our audit team will check if the information presented in the financial statements is overall correct. We will do that by gathering and evaluating evidence, such as bank statements, loan agreements, invoices, shipping, and many other types of documents.

AJ: Oh! I think I understand now. So, before someone could give me assurance about the organic food that I buy, they would first need to do some work to check if the food has actually been organically grown. That work is called auditing?

FM: You got it. For instance, auditing organic food could involve gathering evidence that proves that the food has been grown according to established organic farming practices.

AJ: Can CPAs do this kind of work?

FM: Sure, they can, as long as they remain independent and possess the necessary knowledge and experience to perform that type of assurance engagement.

AJ: Leslie, thanks for the explanation! I think I now better understand the difference between auditing and assurance. Auditing is the work that we do; it’s sort of like checking, where we gather and evaluate evidence. Based on the outcome of this work, BKK provides assurance in the form of an audit opinion, which gives readers of the financial statements confidence that the presented information is correct overall.

FM: I see that you are a quick learner. I am glad that we hired you!

AJ: I can’t wait to explain all of this to my friends. I think that I will also be asking the store owner where I buy my organic food some questions!

WHY ARE AUDITS AND OTHER ASSURANCE ENGAGEMENTS NEEDED?

LO 3 Explain why there is a demand for audit and other types of assurance services.

Businesses, governments, and not-for-profit organizations use audit and assurance 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. Apart from the legal requirement, why do various stakeholders demand and value financial statement audits and other types of assurance engagements?

The Economic Demand for Audits

A look at the economic reasons for the financial statement audit 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

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 firsthand 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 \$2 000, 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.

Reducing Information Risk

As mentioned earlier, material misstatements can have serious implications for users' decisions (economic and otherwise). 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. However, as highlighted in Auditing in Action 1-1, investors who choose to solely rely upon management's assertions without independent verification run the risk of being duped.

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.

AUDITING IN ACTION 1-1

Would You Invest Millions of Dollars Without Audited Financial Statements?

Theranos' founder, Elizabeth Holmes, raised \$700 million through private placements, with mostly wealthy investors, without ever having to provide audited financial statements. Instead of providing the promised high return, the blood-testing start-up, which was once valued by investors at \$9 billion, proved to be worth significantly less than the company claimed. In 2018, the company and Holmes settled what the U.S. Securities and Exchange Commission (the SEC) described as "massive" fraud charges. The SEC concluded that Theranos had misled investors and regulators about its technology, operations and finances. In the end, the claims that the blood-testing technology could test for over 200 diseases and viruses using a single fingerprick of blood proved to be inaccurate, and Holmes appeared to be more interested in publicity than getting a handle on the numbers.

Although the company intended to go public, SEC rules exempt companies from providing audited financial statements if the investors are "accredited investors"—individuals with a net

worth in excess of \$1 million or who consistently have made \$200 000 per year as well as companies that have more than \$5 million in assets. The potential investors were provided with lots of information: a cover letter drafted and signed by Holmes, lots of articles about Holmes, a company overview slide-deck presentation, reports of clinical trials, and financial statements and projections on spreadsheets created by the CFO. However, the financial statements provided were unaudited. Surprisingly, none of the investors ever asked for audited financial statements. In the case of Theranos, taking management's reports at face value certainly does not appear to be managing information risk.

Source: Francine McKenna, "The investors duped by the Theranos fraud never asked for one important thing" *MarketWatch*, March 20, 2018, accessed December 30, 2019 at www.marketwatch.com/story/the-investors-duped-by-the-theranos-fraud-never-asked-for-one-important-thing-2018-03-19.

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). Auditing in Action 1-2 illustrates the high costs of these risks.
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.

Why Users Demand Audits and Other Assurance Engagements

External users (such as investors, lenders, suppliers, customers, employees, governments, and the general public) rely on financial statements to make various decisions. They look to the independent auditor's report as an indication of the financial 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.

AUDITING IN ACTION 1-2

Canada's Provincial Auditors General: Patrolling Effectiveness and Protecting the Public Interest

The types of audits conducted by Canada's provincial auditors general cover a broad range of subjects. For instance, the 2013 Nova Scotia Auditor General's report concluded that the province's welfare system was failing to adequately monitor foster children and other kids in care and that investigations into alleged abuse were taking too long. In Ontario, the Auditor General concluded that the Ministry of Education had inadequate oversight of private schools and, as a result, there were several significant deficiencies in the system. For instance, 30 private schools issued 1500 more diplomas than the number of Grade 12 students enrolled in those schools, raising the possibility of diploma fraud. Many of the significant findings in the British Columbia Auditor General's 2013 report were related to serious security flaws in the province's computerized criminal justice database. The auditors found that attackers could gain

access to sensitive information related to criminal cases, such as details on sealed court records, youth cases, and pardoned people. Perhaps even more disturbing, the Department of Justice would never know that unauthorized access had occurred.

As these examples highlight, while the auditors generally help to identify inefficiencies within government, they also help to fortify public institutions, even if their findings shake things up!

Sources: Dirk Meissner, "Auditor-general flags security flaws in justice database," *Globe and Mail*, January 13, 2013. Allison Auld, "Nova Scotia auditor general finds deficiencies in oversight of foster kids," *Huffington Post Politics*, December 2, 2013. Karen Howlett, "Ontario schools handed out 1,500 fraudulent diplomas in one year," *Globe and Mail*, December 13, 2013. Office of the Auditor General, "Minimal ministry oversight means parents need to be vigilant in selecting their children's private school, auditor general finds," News Release, December 10, 2013.

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.

LO 4 Describe major types of assurance engagements and auditors.

COMMON TYPES OF ASSURANCE ENGAGEMENTS

There are many different types of assurance engagements depending upon the subject matter under consideration. Table 1-1 summarizes the type of information, criteria, and evidence used in three common types of assurance engagements—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).

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 divisions and units. The following are examples of compliance audits for a private business:

- Determine whether accounting personnel are following the procedures prescribed by the company controller.
- Review wage rates for compliance with minimum wage laws.
- Examine contractual agreements with bankers and other lenders to be sure the company is complying with legal requirements.
- Determine whether a supplier is in compliance with the organization's supplier code of conduct or child labour laws.

Governmental agencies and departments are subject to considerable compliance auditing because of extensive regulation, while many private and not-for-profit

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.

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 Assurance Engagement	Example	Information	Established Criteria	Available Evidence
<i>Financial statement audit:</i> 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
<i>Compliance audit:</i> 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
<i>Operational audit:</i> 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

organizations have prescribed policies, contractual arrangements, and legal requirements that may require compliance auditing. Compliance audits for government-funded programs are often done by public accounting firms and are discussed in more detail in Chapter 19.

Results of compliance audits performed for private companies are typically reported to management, rather than outside users, because management is the primary group concerned with prescribed procedures and regulations. As a result, internal auditors, who are employed by the organization, often perform compliance audits. When an organization such as the CRA wants to determine whether individuals or organizations are complying with its requirements, the auditor is also employed by the organization (the CRA) issuing the requirements.

An **operational audit** or a performance audit evaluates the efficiency, effectiveness, and economy 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 examination of evidence is not limited to accounting, but can include evaluation of the organizational structure, computer operations, production methods, marketing, or any other area in which the audit team is qualified. As a result, many operational audits require a multidisciplinary specialist team that clearly understands the organizational and operational facets under audit. Operational and compliance audits are the main types of audits conducted by government and internal auditors; however, public accountants can also do these types of engagements.

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

TYPES OF AUDITORS

Throughout our previous discussion, we have highlighted three common types of assurance engagements. Here, we provide an overview of five types of auditors—internal auditors, government auditors, Canada Revenue Agency auditors, forensic accountants and fraud auditors, and public accountants. There are other specialist auditors, which we will refer to throughout the text, who play an important role in the financial statement audit, such as the tax expert who audits the tax provision, and the information systems specialist who assesses the information systems controls.

Internal Auditors

Internal auditors work for individual companies, banks, hospitals, universities, and governments. According to the Definition of Internal Auditing in The IIA’s International Professional Practices Framework (IPPF), *internal auditing* is “an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.”¹

As the IIA definition highlights, internal auditors provide a variety of assurance services, such as financial and internal control audits, operational audits, compliance audits, system security audits, and forensic and fraud investigations. These types of audits add value and can improve organizational operations, as well as help reduce fraud, waste, and abuse in organizations. Internal auditors also perform consulting activities such as assistance in evaluating new systems prior to implementation and in assessing risks within the organization.

Many internal auditors of public companies provide assurance to management or boards of directors that internal controls are designed adequately and operating effectively. These engagements are in response to the regulatory requirements. National Instrument 52–109 (Certification of Disclosure in Issuers’ Annual and Interim Filings) in Canada and Section 404 of the Sarbanes-Oxley Act (usually referred to as SOX) in the United States (which applies to Canadian subsidiaries of U.S. companies and Canadian companies listed in the United States) require public companies to report management’s assessment of the effectiveness of internal control over financial reporting.

To effectively perform assurance engagements, an internal auditor must be independent of the line functions in an organization but will not be completely independent of the entity as long as an employer–employee relationship exists. In order to maintain independence, internal auditors typically report directly to the **audit committee** of the board of directors and senior management. While internal auditors provide management with valuable information for making decisions, it is unlikely that users from outside the entity will want to rely on information verified by internal auditors because of their lack of independence (explained further in Chapter 3). This lack of independence is the major difference between internal auditors and external auditors.

Audit committee—a committee of the board of directors that is responsible for auditor oversight. It is an objective and independent liaison between auditors, management, and the board of directors.

Internal auditors’ responsibilities vary considerably, depending upon the employer. For example, management of one company may decide that internal auditors should be extensively involved in systems development, whereas others may decide that their work should focus primarily on financial controls and fraud audits. Internal audit staff size can range from one or two to hundreds of employees, each of whom has diverse responsibilities, including many outside the accounting area.

Many internal auditors are members of the Institute of Internal Auditors (IIA), which establishes standards for ethics and for the practice of internal auditing. The IIA issues a highly regarded designation, Certified Internal Auditor (CIA), to auditors who have completed the necessary examination and experience requirements.

Government Auditors

The Government of Canada, various provincial governments, and several large Canadian municipalities (i.e., Calgary, Edmonton, Winnipeg, Toronto, Ottawa, Halifax, and Montreal) all have an auditor general who is responsible for auditing the ministries, departments, and agencies that report to that government. These government auditors may be appointed by a bipartisan legislative committee or by the government in that jurisdiction. They report to their respective legislatures and are responsible to the body appointing them.

¹ Institute of Internal Auditors, “About internal auditing,” accessed December 30, 2019, at <https://global.theiia.org/about/about-internal-auditing/pages/about-internal-auditing.aspx>.

The primary responsibility of the government audit staff employed at the offices of auditors general is to perform the audit function for government. The extent and scope of these audits are determined by legislation in the various jurisdictions. For example, the Auditor General of Canada is required to perform the following audits:

1. Internal audits into financial matters or compliance with regulations, and whether or not the operations are conducted in an efficient, effective, and economic manner
2. External audits of the financial statements
3. Special examinations of efficiency, effectiveness, and economy (every five years)

In some ways, these government auditors are much like external auditors. They are organizationally independent of the government entities they audit, and the Auditor General reports directly to the legislature. Further, most of the financial information prepared by government agencies and, in some cases, by Crown corporations is audited by these government auditors before the information is submitted to the various legislatures. Because the authority for expenditures and receipts of government agencies is defined by legislation, there is considerable emphasis on compliance in these audits. In many provinces, experience as a government auditor fulfills the experience requirement for the CPA designation.

In Canada, auditors general often conduct **performance audits**, sometimes called value-for-money audits, because they help determine whether value is received for the money spent. The purpose of these audits is to determine whether the organization or program being audited is achieving its objectives effectively, economically, and efficiently. The professional standards for these audits are published in the *CPA Canada Assurance Handbook*. The audit reports are publicly available and, each year, when the Auditor General's annual report is released, the findings generate considerable media attention as well as political controversy.

Performance audits—public sector audits, also referred to as value-for-money audits, that encompass economy, efficiency, and effectiveness.

Canada Revenue Agency Auditors

The Canada Revenue Agency is responsible for the enforcement of the federal tax laws as they have been defined by Parliament and interpreted by the courts. A major responsibility of this agency is to audit the returns of taxpayers to determine whether they have complied with the tax laws. These audits are solely compliance audits, and the auditors who perform them are referred to as Canada Revenue Agency auditors.

It might seem that the audit of returns for compliance with the federal tax laws would be a simple and straightforward problem. However, tax laws are highly complicated, and there are hundreds of volumes of court interpretations. The tax returns being audited vary from the simple returns of individuals who work for only one employer and take the standard tax deductions to the highly complex returns of multinational corporations. Taxation problems could involve individual taxpayers, sales tax, goods and services tax, corporate taxes, or trusts, and an auditor involved in any of these areas must have applicable expertise to conduct the audit.

Forensic Accountants and Fraud Auditors

Forensic accounting and fraud auditing are one of the fastest growing areas within the audit world, mainly because of the huge growth in white-collar and occupational fraud. Public accounting firms, companies, police forces, regulators, and law firms often hire these auditors to investigate financial statement fraud, asset misappropriations, money laundering, bribery, theft of information via computer hacking, and a long list of other fraudulent activities. Fraud auditors and forensic accountants may also assist in the financial statement audit. Canadian assurance and auditing standards require a fraud risk assessment as part of the financial statement audit, which is often performed by a fraud auditor or forensic accountant.

Forensic accountants combine their accounting knowledge with investigative skills in various litigation support and investigative accounting settings. The day-to-day

work of forensic accountants and fraud auditors involves interviewing key people, studying accounts, and, increasingly, examining electronic documents, writing investigation reports, testifying at trials, and understanding factors that motivate individuals to commit fraud. A characteristic that distinguishes fraud auditors and forensic accountants from other auditors is their persistence and doggedness in following up suspicions—what is referred to as an “investigative mindset.”

Forensic and fraud auditors may be specialists in external auditing, internal auditing, information systems, private investigation, tax accounting, or other disciplines. They may also have specialist designations such as the CPA-CFF (Certified in Financial Forensics) or the CFE (Certified Fraud Examiner) offered by the Association of Certified Fraud Examiners.

Public Accountants

Public accountants provide accounting services to the public. Of those services, which include assurance services as well as accounting and tax advice, the most well-known service is the financial statement audit. As we have highlighted, there are various types of auditors and assurance engagements; however, in the case of public accountants, when the term “audit” is used, it is in reference to the financial statement audit. Only public accounting firms can conduct financial statement audits (reasonable assurance) or reviews (limited assurance), and only Canadian CPAs with a public accountant’s licence can sign an assurance report related to financial statements. An audit required by law, as in the case of public companies and not-for-profit organizations that meet certain revenue thresholds, is referred to as a *statutory audit*.

Because of the widespread use of audited financial statements in the Canadian economy, as well as businesses’ and other users’ familiarity with these statements, it is common to use the terms “external auditor,” “independent auditor,” “public accountant,” and “licensed public accountant” synonymously. We will refer to these auditors as public accountants, or PAs. In order to be able to practise public accounting, a PA must be a member in good standing in one of the provincial CPA institutes, meet the qualifications per the provincial public accounting act for performing an audit or review engagement, and be independent. Public accountants are required to perform their work in accordance with their professional standards, which are set out in the *CPA Canada Assurance Handbook*.

CONCEPT CHECK

- C1-4** Describe and explain the differences and similarities between financial statement, compliance, and operational audits.
- C1-5** Describe and explain the differences and similarities among the various types of auditors.

LO 5 Distinguish between accounting and financial statement auditing.

ACCOUNTING VS. AUDITING

Many financial statement users and members of the general public confuse auditing and accounting. The confusion occurs because the financial statement audit is concerned with accounting information which requires the auditor to have considerable expertise in accounting standards. 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 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 other stakeholders can use to make decisions. Accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting

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

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.

Like accountants, auditors must understand the relevant accounting principles and rules (the accounting standards). However, auditors are not responsible for recording the financial information. Because financial statements are prepared using many judgmental evaluations or estimates, 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 of receivables. Therefore, when auditing accounting data, the auditor is concerned as to whether recorded information reasonably reflects the economic events that occurred during the accounting period within specified dollar ranges (materiality).

In addition to understanding accounting, the financial statement 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.

ASSURANCE AND NONASSURANCE SERVICES OFFERED BY PUBLIC ACCOUNTANTS

Regardless of the subject matter or criteria, companies often seek out public accountants to provide independent assurance on various types of information, due to their independence, competence, and rigorous professional standards. While assurance over historical financial statement information is the sole domain of public accountants, in the case of other types of assurance services, PAs often compete with a variety of other professionals.

Assurance Engagements Related to Historical Financial Information

As previously mentioned, PAs can provide a variety of assurance engagements, with different levels of assurance, and for a wide variety of information. Audits, reviews, and audits of financial information other than financial statements are common assurance engagements related to financial information.

Audit of Historical Financial Statements The most well-known example of assurance services is the financial statement audit. As already highlighted, in the case of public accounting the term “audit” refers to the financial statement audit. Throughout the textbook, when we refer to audit, it is in the context of the financial statement audit. The public accountant provides reasonable assurance that the financial statements are in accordance with the applicable accounting framework.

Publicly traded companies in Canada are required to have audits of their financial statements. Auditor reports can be found in the public company's annual report, and many companies' audited financial statements can be accessed via the internet from the System for Electronic Document Analysis and Retrieval (SEDAR) at www.sedar.com. Public companies also post copies of financial statements to their corporate websites (check the investor relations tab for any public company). Although not required by the Canada Business Corporations Act, many privately held companies also have annual financial statement audits. While the most popular reason for the annual audit is to obtain financing from banks and other institutions, private companies who have plans to go public or ones with an inactive minority shareholder often decide to have an audit as well. Government and not-for-profit organizations often have financial statement audits due to regulatory requirements, as well as to meet the requirements of lenders or funding sources.

LO 6 Describe assurance and nonassurance services provided by public accountants and distinguish the financial statement audit from other assurance services.

Review of Historical Financial Statements In the case of smaller, nonpublic companies, users are often satisfied with a review engagement, which has a lower level of assurance and lower cost than an audit. As in the case of an audit, management asserts that the financial statements are fairly stated in conformity with an applicable financial reporting framework. However, a review engagement provides only limited (or a moderate level of) assurance, rather than high assurance, as in the case of an audit engagement. Although cost saving is a major consideration, the underlying reason why a user would be amenable to limited assurance is based upon the level of information risk (usually referred to as their assurance needs). Review engagements are discussed in more detail in Chapter 19.

Audit of Financial Information Other Than Financial Statements These engagements are audits of specific income statement or balance sheet accounts (e.g., sales, receivables, inventory) or audits of a single financial statement (e.g., balance sheet or operating statement). For example, an auditor might provide an opinion on the sales at a Shoppers Drug Mart in a Saskatoon shopping mall because the store's rent is based on sales and the owner of the mall requires an audit opinion.

Assurance Engagements for Non Financial Information

Assurance engagements for nonfinancial information include both attestation and direct reporting engagements. (We will discuss the difference between an attest and direct engagement in Chapter 19.) The *CPA Canada Assurance Handbook* has specific standards for the following assurance engagements: effectiveness of internal control over financial reporting, attestation services on service organizations, reports of compliance with agreements and regulations, and greenhouse gas emissions. For all other

STILL CONFUSED? READ THIS.

Audits vs Reviews—What's the Difference?

You and Mitch had just finished talking to Fran, the audit senior, about the upcoming audit of Hillsburg Hardware. After she left, you both were confused about the difference between audits and reviews. Because you had already asked her lots of questions about audits and assurance, Mitch volunteered to talk to the audit manager, Leslie Nagan.

MB: Fran mentioned to me that Hillsburg is considering purchasing a paint manufacturing company. However, she said that the paint company's financial statements are not audited, but are reviewed. I don't understand. Why does Hillsburg have an audit, whereas the paint company has a review—both are private companies in similar industries?

LN: Good question. It all depends on the level of assurance required by the users of financial statements. To suit our clients' needs, BKK offers two kinds of assurance services — audits, which provide reasonable assurance, and reviews, which provide limited assurance. The difference between an audit and a review is in the type and extent of work that we perform during each engagement. During a review we typically do *not* ask management for any documents such as sale agreements or bank statements. Our work primarily consists of speaking with management and asking questions and then applying analytical procedures to check if what management tell us is reflected in the financial statements. Whereas, during an audit, in addition to speaking with management, we also obtain and check documents and records.

That's why an audit takes more time to complete and costs more than a review. It also provides a high level of assurance—what we call reasonable assurance. But reasonable assurance, which costs more, is not always necessary. In many situations, users of financial statements may find that a review is sufficient, as is the case with the paint company. Think of it this way. Let's say that you have an old car and are planning to go on a long road trip to British Columbia. Because your car is old, you are worried that it might break down during the long trip. So, you decide to get your car inspected by a car mechanic. The mechanic can do a quick visual inspection of your engine and brakes. This quick inspection is similar to a review engagement. As long as the mechanic doesn't observe that there is anything wrong with your car, the inspection gives you some level of comfort (assurance) about the condition of your car.

If you are still worried that your car may not survive the long trip, you can ask your mechanic for a more extensive inspection—this is like an audit. This inspection will cost you more and take longer because the mechanic will perform more work (e.g., take the wheels off to get better access to inspect the brakes, take out and check the condition of your sparkplugs, test the battery, check engine fluids, tension of belts, etc.). Certainly, this more extensive inspection will cost you more, but it will give you more comfort (assurance) that your car is ready for the trip. That's similar to the higher level of assurance that the users of Hillsburg's financial statements want.

nonfinancial information, such as Irving Tissue Corporation’s “MAJESTA Tree Planting Promise,” there are two umbrella standards, one for attest engagements and one for direct engagements.

Audit of Effectiveness of Internal Control Over Financial Reporting As mentioned in the description of internal audits, managers of public companies are required to report on the effectiveness of internal controls. In addition to this requirement, the Sarbanes-Oxley Act also compels auditors to evaluate management’s assessment of internal controls, which is an attestation to the effectiveness of internal control over financial reporting (there is no similar audit requirement under Canadian legislation). This evaluation, which is integrated with the audit of the financial statements, increases user confidence about future financial reporting because effective internal controls reduce the likelihood of future misstatements in the financial statements.

This type of report is discussed further in Chapters 8 and 19.

Audit of Controls of Service Organizations Many companies outsource some or all of their information technology (IT) needs to an independent computer service organization rather than maintain an internal IT function. As part of the financial statement audit, the PA is required to obtain an understanding of the client’s internal controls over financial reporting. However, this is difficult to do if the client is using a service organization. In those instances, the service centre engages a public accounting firm to obtain an understanding and test internal controls at the service organization and to issue an attestation report for the use of all customers and their independent auditors.

Assurance Engagements on Compliance With an Agreement or Regulations We have already discussed compliance audits, which are a popular assurance service provided by public accountants. These types of engagements are opinions on compliance with an agreement or regulations. For example, an auditor may provide an opinion on the company’s compliance with specific terms of its bank loan agreement, such as the current ratio as defined in the agreement.

Assurance Engagements on Greenhouse Gas Statements Many companies are required to provide information on greenhouse gas (GHG) emissions in their financial statements as well as separate reports to various provincial and federal regulators. As we have already seen in the opening vignette, companies such as UPS engage public accountants to attest that their statement of GHG emissions is in accordance with the relevant criteria, Greenhouse Gas Protocol Corporate Accounting and Reporting Standard. Given the complexity of the subject matter, multidisciplinary teams, which would include subject matter experts (such as engineers and scientists) and assurance experts (the PAs), would perform these engagements.

Assurance Engagements for Other Non-financial Information There are almost no limits on what other nonfinancial information a public accountant can provide assurance services for. For instance, in Auditing in Action 1-3, we refer to PricewaterhouseCoopers, which since 1935 has attested to the ballot accuracy, secrecy, and integrity of the voting process of the Academy Awards, now called The Oscars. And, as highlighted in the opening vignette and Auditing in Action 1-4, a growing area of other assurance services for large public accounting firms is assurance over sustainability statements and reports. And there are many more types of assurance services being currently provided—one recent survey of large American CPA firms identified more than 200 different assurance services being performed.

Assurance services related to other nonfinancial information are not the sole domain of public accounting firms. For instance, companies such as Loblaw and Apple regularly use assurance providers, such as Bureau Veritas, to get assurance that their suppliers comply with health and safety regulations, child labour guidelines, and many other employee welfare issues. Among the variety of service providers that offer assurance services for various types of nonfinancial information, some adhere to strict accreditation standards that translate into common practices among their peers, while