Fourth Canadian Edition

AUDITING & ASSURANCE SERVICES

A SYSTEMATIC APPROACH

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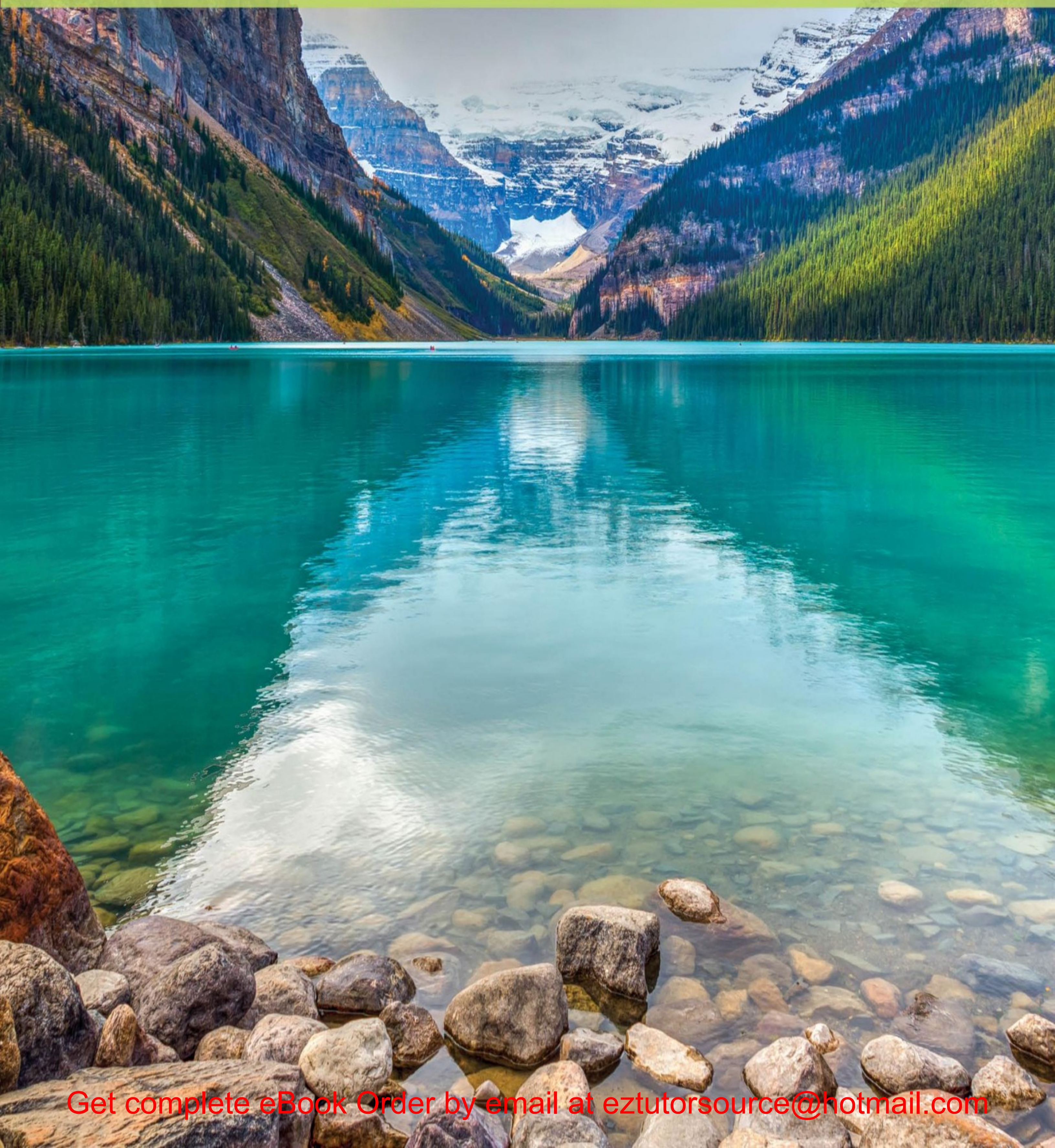

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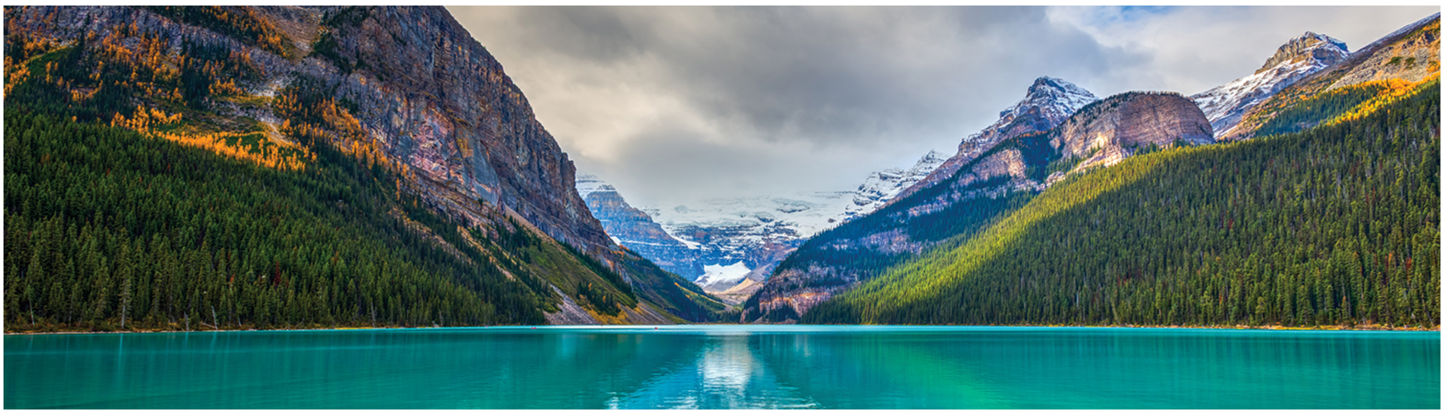
FOURTH CANADIAN EDITION



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PART ONE Introduction to Assurance and Financial Statement Auditing

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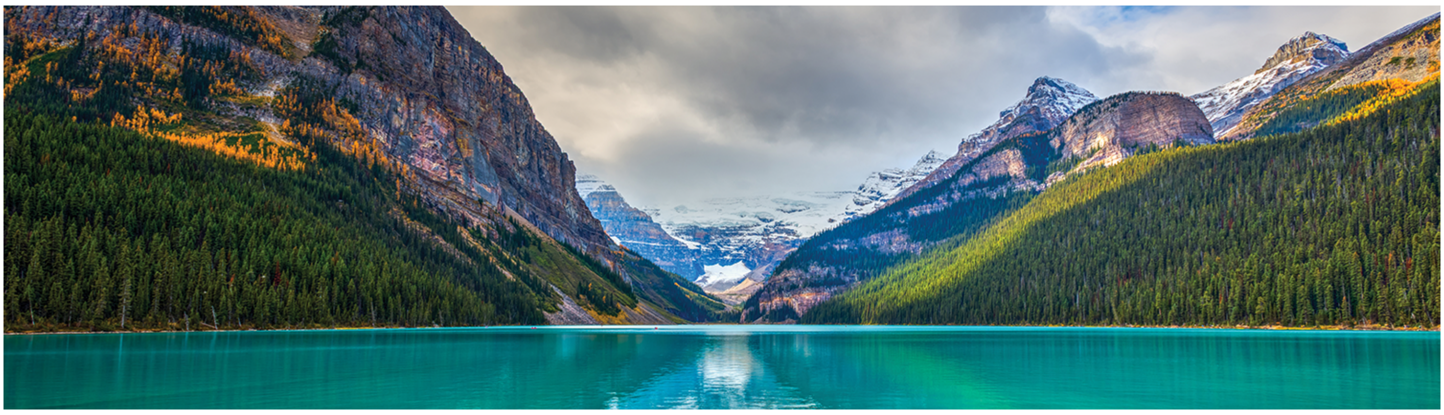

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An Introduction to Assurance and Financial Statement Auditing

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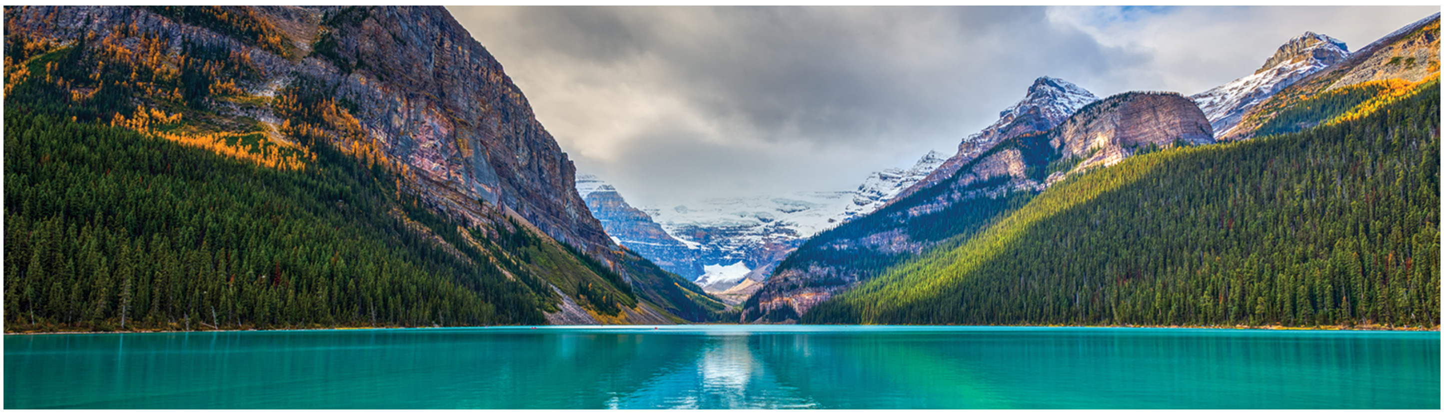

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LEARNING OBJECTIVES

Upon completion of this chapter you will

1. 1-1 Understand why studying auditing can be valuable to you whether or not you plan to become an auditor, and why it is different from studying accounting.
2. 1-2 Understand the demand for auditing and be able to explain the desired characteristics of auditors and audit services through an analogy to a house inspector and a house inspection service.
3. 1-3 Understand that auditing is a business.
4. 1-4 Understand the relationships among auditing, attestation, and assurance services.
5. 1-5 Know the basic definition of a financial statement audit.
6. 1-6 Understand three fundamental concepts that underlie financial statement auditing.
7. 1-7 Be able to explain why on most audit engagements an auditor tests only a sample of transactions that occurred.
8. 1-8 Be able to describe the basic financial statement auditing process and the phases in which an audit is carried out.
9. 1-9 Know what an audit report is and understand the nature of an unqualified report.
10. 1-10 Understand that the way audits are done is changing in exciting ways due to the application of technology, and audit data analytics in particular.
11. 1-11 Understand why auditing demands logic, reasoning, and resourcefulness.

RELEVANT ACCOUNTING AND AUDITING PRONOUNCEMENTS

CAS 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards
CAS 210, Agreeing the Terms of Audit Engagements
CAS 220, Quality Management for an Audit of Financial Statements
CAS 230, Audit Documentation
CAS 300, Planning an Audit of Financial Statements
CAS 315, Identifying and Assessing the Risks of Material Misstatement
CAS 320, Materiality in Planning and Performing an Audit
CAS 450, Evaluation of Misstatements Identified During the Audit
CAS 500, Audit Evidence
CAS 700, Forming an Opinion and Reporting on Financial Statements
CAS 705, Modifications to the Opinion in the Independent Auditor's Report
CAS 706, Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

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We welcome you to the world of auditing, and we invite you to invest your best efforts to learn the extremely practical and useful concepts that underlie this respected profession! These concepts will be valuable to you regardless of what you plan to do in your future career. You will learn in this chapter that auditing consists of a set of practical conceptual tools that help accounting professionals to find, organize, and evaluate evidence about the assertions of another party. The demand for capable accountants and auditors of high integrity has never been greater. Opportunities for auditors are plentiful and rewarding and can lead to attractive career opportunities. Those who practise as auditors often later go into financial management, becoming controllers, chief financial officers (CFOs), and even chief executive officers (CEOs). But even those who do not plan to become an auditor can benefit greatly from an understanding of financial statement auditing and its underlying concepts. Learning these tools is valuable to any business decision maker.

This is a particularly exciting time to learn about auditing and to be an auditor—the profession is in the early stages of a sea change in the way audits are carried out. Data analytics and other advanced technologies, including applications of artificial intelligence, are rapidly being integrated into the audit process. These developments are dramatically changing the work auditors do. These changes will place a premium not only on auditors' ability to use technology but also on their ability to generate penetrating insights by exercising professional judgement. Having a solid understanding of fundamental business, accounting, and auditing concepts will become even more important in a world of advancing technology.

We live in a time when the amount of information available for decision makers via electronic databases, the Internet, and other sources is rapidly expanding, and there is a great need for the information to be reliable, credible, relevant, and timely. High-quality information is necessary if managers, investors, creditors, and regulatory agencies are to make informed decisions. Auditing and assurance services play an important role in ensuring the reliability, credibility, and relevance of business information.

The following examples present situations that illustrate how auditing can add value by increasing the reliability and credibility of an entity's financial statements:

> Aliyah Menendez, a local community activist, has been operating a not-for-profit centre that provides assistance to abused women and their children. She has financed most of her operations from private contributions. Ms. Menendez applied to the Provincial Health Authority requesting a large grant to expand her two shelters to accommodate more women. In completing the grant application, Ms. Menendez discovered that the province's laws for government grants require that recipients be audited to ensure that existing funds are being used appropriately. Ms. Menendez hired a CPA to audit the centre's financial statements. Based on the centre's activities, the intended use of the funds, and the auditor's clean report, the grant was approved.
>
> Conway Computer Company is a wholesaler of computer products. The company was started by George and Jimmy Steinbuker five years ago. Two years ago, a venture capital firm acquired 40 percent of the company and thus provided capital for expansion. Conway Computer's revenues and profits increased by 25 percent in each of the last two years, and the Steinbuker brothers and the venture capital firm decided to take the company public through a share sale. However, they knew that the company's financial statements needed to be audited by a reputable public accounting firm before a registration statement could be filed with the Ontario Securities Commission and in order for investors to trust the share offering. The company hired a major public accounting firm to perform its audits and the company successfully sold shares to the public.

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These situations show the importance of auditing to both private and public enterprise. By adding an audit to each situation, the users of the financial statements have additional assurance that the financial statements report honestly and accurately, and they will be more willing to rely on those statements. Auditors can also provide valuable assurance for operating information, information systems reliability and security, and the effectiveness of an entity's internal controls. Consider the following example:

> EarthWear Clothiers is a successful mail-order retailer of high-quality clothing for outdoor sports. Over the last few years the company has expanded sales through its Internet site. EarthWear's common shares are listed and traded on the TSX. EarthWear is considering expanding into the United States and being listed on a U.S. exchange. Securities laws in the United States require company officials to certify that they have properly designed, implemented, and tested internal control over their accounting and reporting information systems. EarthWear's public accounting firm, Willis & Adams, would examine the design and documentation of EarthWear's internal controls on an annual basis and conducts independent tests to verify that EarthWear's controls are operating effectively. Willis & Adams would issue a report to the public expressing its opinion as to whether EarthWear's internal controls are well designed and operating effectively.

Most readers of an introductory auditing text initially have little understanding of what auditing and assurance services entail. Thus, we start by helping you understand in general terms why there is a demand for auditing and assurance services. We then compare auditing to other well-known forms of assurance to provide an understanding of the economic role auditing plays. Finally, we define auditing, attestation, and assurance services and give you an overview of the financial statement auditing process.

LO 1-1 Tips for Learning Auditing

You will find that the study of auditing is different from any of the accounting courses you have taken in college or university, and for good reason. Most accounting courses focus on learning the rules, techniques, and computations required to prepare and analyze financial information. Auditing, on the other hand, focuses on learning the analytical and logical skills necessary to evaluate the relevance and reliability of financial information as well as the adequacy of the systems and processes responsible for recording and summarizing that information. This implies that you know all of the accounting standards to which you are applying auditing techniques, be they International Financial Reporting Standards (IFRS), Public Sector Accounting Standards (PSAS), or Not-for-Profit Standards (NPOS). This is simply due to the nature of auditing. Thus, we will periodically prompt you to "stop and think" about the concepts being discussed throughout the book. Seeking to thoroughly understand and apply principles as you read them will greatly improve your ability to audit.

Learning auditing essentially helps you understand how to gather and assess evidence so you can evaluate assertions (or claims) made by others. This text is filled with the tools and techniques used by financial statement auditors in practice. You will find that the "tool kit" used by auditors consists of a coherent, logical framework, together with techniques useful for analyzing financial data and gathering evidence about others' assertions. Acquiring this conceptual tool kit can be valuable in a variety of settings, including practising as an auditor, running a small business, providing consulting services, and even making executive business decisions. An important implication is that learning this framework makes the study of auditing valuable to you as a future accountant or business decision maker, whether or not you plan to become a financial statement auditor.

Many examples in auditing are taken from Canada's closest neighbour, the United States. The U.S. is Canada's largest trading partner, the U.S. dollar is the world's reserve currency, and the U.S. has the broadest and deepest financial markets in the world. Many Canadian companies have U.S. subsidiaries (and vice versa), and Canadian companies are often listed on a U.S. exchange. Fortunately, auditing concepts are similar regardless of the country and concepts demonstrated in one country can provide a useful example anywhere.

One difference between Canada and the United States is that in Canada, securities commissions responsible for administering and enforcing securities legislation are under provincial jurisdiction. For example, a company based in Ontario will be regulated by the Ontario Securities Commission and one based in British Columbia will be regulated by the British Columbia Securities Commission. There is a passport system in Canada that gives a market participant automatic access to capital markets in other jurisdictions by obtaining a decision only from its principal (home) regulator and complying with a harmonized set of laws. In the United States, on the other hand, all companies, regardless of what state they are based in or the exchange on which their shares are traded (e.g., New York, NASDAQ), are regulated by a single national agency, the Securities and Exchange Commission (SEC).

Information on listed companies in Canada can be found at www.sedar.com and information on listed companies in the United States can be found at www.edgar.com.

While the concepts and techniques you will learn in this book will be useful to you regardless of your career path, our experience is that students frequently fall into the trap of trying to understand auditing in terms of memorized lists of rules, tools, and techniques. The study of auditing and the related concepts and techniques will make a lot more sense if you build your understanding of why audits are needed, if you understand the necessary characteristics of audits and auditors, and if you focus on what an auditor does, and *why*. Don't fall into the trap of attempting to study auditing through rote memorization! Instead, pause frequently to be sure you understand both "what?" and "why?" as you study the concepts and techniques of auditing, as well as "how" auditing is carried out.

As you saw in the introduction to this chapter, reliable information is important for managers, investors, creditors, and regulatory agencies to make informed decisions. Auditing helps ensure that information is reliable, credible, and relevant. In fact, the assurance provided by auditing is vital to the proper functioning of our economic system!

LO 1-2 The Demand for Auditing and Assurance

In view of the fact that many of the largest companies spend millions of dollars each year for their annual audit, it is worth asking why an entity would decide to spend so much money on an audit?[1] Some might answer that audits are required by law. While true in certain circumstances, this answer is far too simplistic. Audits are often utilized in situations where they are not required by law, and audits were in demand long before securities laws required them. In fact, evidence shows that some forms of accounting and auditing existed in Greece as early as 500 BC.[2] However, the development of the corporate form of business and the expanding world economy over the last 200 years have given rise to an explosion in the demand for the assurance provided by auditors. In 1926, several years prior to the Securities Acts of 1933 and 1934, which required audits for publicly traded companies in the United States, 82 percent of the companies on the New York Stock Exchange were audited by independent auditors.[3]

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Principals and Agents

The demand for auditing can be understood as the need for accountability when business owners hire others to manage their businesses, as is typical in modern corporations. Until the late 18th and early 19th centuries, most organizations were relatively small and were owned and operated as sole proprietorships or partnerships. Because businesses were generally run by their owners and borrowing was limited, accountability to outside parties often was minimal. The birth of modern accounting and auditing occurred during the industrial revolution, when companies became larger and needed to raise capital to finance expansion.[4] Over time, capital markets developed, enabling companies to raise the investment capital necessary to expand to new markets, finance expensive research and development, and fund the buildings, technology, and equipment needed to deliver products to market. A capital market allows a public company to sell small pieces of ownership (i.e., shares) or to borrow money in the form of thousands of small loans (i.e., bonds) so that vast amounts of capital can be raised from a wide variety of investors and creditors. A *public company* is a company that sells its shares or bonds to the public, giving the public a valid interest in the proper use of the company's resources. Thus, the growth of the modern corporation led to diverse groups of owners who are not directly involved in running the business (shareholders) and the use of professional managers hired by the owners to run the corporation on a day-to-day basis. In this setting, the managers serve as *agents* for the owners (who are sometimes referred to as *principals*) and fulfill a *stewardship* function by managing the corporation's assets.

Accounting and auditing play important roles in this principal–agent relationship. We first explain the roles of accounting and auditing from a conceptual perspective. Then we'll use an analogy involving a house inspector to illustrate the concepts. First, it is important to understand that the relationship between an owner and manager often results in information asymmetry between the two parties. *Information asymmetry* means that the manager generally has more information about the "true" financial position and results of operations of the entity than does the absentee owner.

Stop and Think: What negative consequences could information asymmetry have for the absentee owner? How do the perspectives and motives of the manager and absentee owner differ?

Because their goals may not coincide, there is a natural *conflict of interest* between the manager and the absentee owner. If both parties seek to maximize their self-interest, the manager may not always act in the best interests of the owner. For example, the risk exists that a manager may follow the example of Tyco Inc.'s former CEO Dennis Kozlowski, who spent Tyco funds on excessive personal benefits such as $6,000 shower curtains, or Andrew Fastow, the former CFO of Enron, who pleaded guilty to manipulating the reported earnings of Enron in order to inflate the price of the company's shares so that he could earn larger bonuses and sell his share holdings at artificially high prices. The owner can attempt to protect themself against the possibility of improper use of resources by reducing the manager's compensation by the amount of company resources that the owner expects the manager to consume. But rather than accept reduced compensation, the manager may agree to some type of monitoring provisions in their employment contract, providing assurance to the owner that they will not misuse resources. For example, the two parties may agree that the manager will periodically report on how well they have managed the owner's assets. Of course, a set of criteria is needed to govern the form and content of the manager's reports. In other words, the reporting of this financial information to the owner must follow some set of agreed-upon principles in holding the manager accountable. As you can see, one primary role of accounting information is to hold the manager accountable to the owner—hence the word *accounting*.

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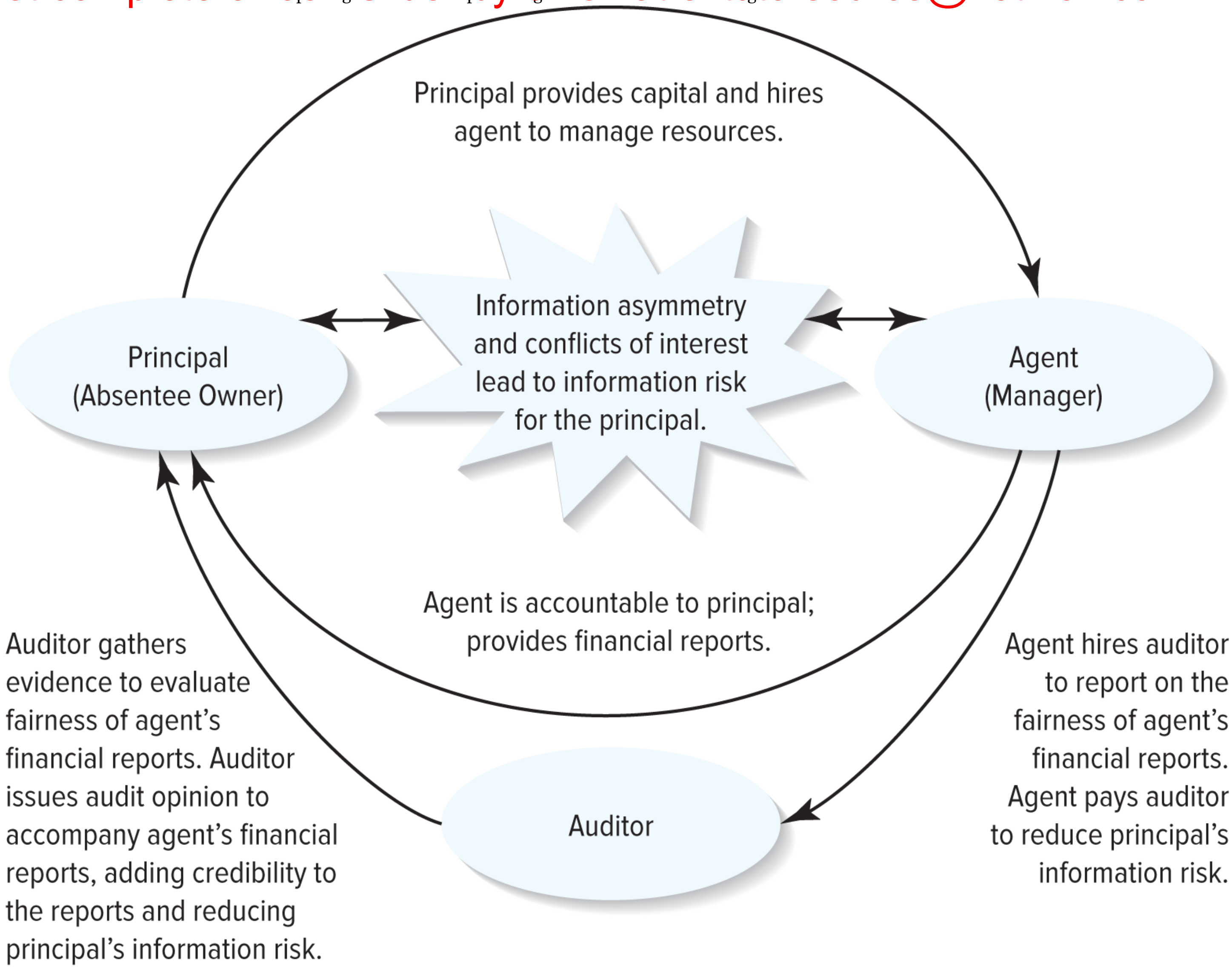
The Role of Auditing

Of course, reporting in accordance with an agreed-upon set of accounting principles does not by itself solve the problem. Because the manager is responsible for reporting on the results of their own actions, which the absentee owner cannot directly observe, the manager is in a position to manipulate the reports. Again, the owner adjusts for this possibility by assuming that the manager *will* manipulate the reports to their benefit and by reducing the manager's compensation accordingly. It is at this point that the demand for auditing arises. If the manager is honest, it may very well be in the manager's self-interest to hire an auditor to monitor and independently report to the owner on their activities. The owner likely will be willing to invest more in the business and to pay the manager more if the manager can be held accountable for how they use the owner's invested resources. As the amount of capital involved and the number of potential owners increase, the potential impact of accountability also increases. The auditor's role is to determine whether the reports prepared by the manager conform to the contract's provisions. Thus, the auditor's verification of the financial information adds credibility to the report and reduces *information risk*, or the risk that information circulated by a company's management will be false or misleading. Reducing information risk potentially benefits both the owner and the manager. Figure 1–1 provides an overview of this agency relationship.

FIGURE 1–1 Overview of the Principal–Agent Relationship Leading to the Demand for Auditing



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While the setting we've outlined is very simple, understanding the basics of the owner–manager relationship is helpful in understanding the demand for auditing. The principal–agent model is a powerful conceptual tool that can be extrapolated to much more complex employment and other contractual arrangements. For example, how can a lender prevent management from taking the borrowed funds and using them inappropriately? One way is to place restrictive covenants in the debt agreement with which the entity and its management must comply. Again, this arrangement gives rise to a demand for the auditing of information reported by management to the lender in terms of whether the debt covenants are being met.

Practice INSIGHT

At the heart of a capital-market economy is the flow of reliable information, which investors, creditors, and regulators use to make informed decisions. In the United States, U.S. Chief Justice Warren Burger gave his view of the significance of the audit function in a 1984 Supreme Court decision:

> By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors and stockholders, as well as to the investing public.

More than 30 years later, the message is the same—users of financial statements rely on the external auditor to act with honour and integrity in protecting the public interest.

In summary, auditing is demanded because it plays a valuable role in monitoring the contractual relationships between the entity and its shareholders, managers, employees, and debt holders. Chartered Professional Accountants have been charged with providing audit services because of their traditional reputation of competence, independence, objectivity, and concern for the public interest. As a result, they are able to add credibility to information produced and reported by management to outside parties. The role of the Chartered Professional Accountant is discussed in more detail in Chapter 2.

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An Assurance Analogy: The Case of the House Inspector

Before we discuss financial statement auditors further, let's illustrate the concepts we've just covered using an analogy: buying a home. In the purchase of an existing house, *information asymmetry* usually is present because the seller typically has more information about the house than does the buyer. There is also a natural *conflict of interest* between the buyer and the seller. Sellers generally prefer a higher selling price and may be motivated to overstate the positive characteristics and understate or remain silent about the negative characteristics of the property they have for sale. In other words, there is *information risk* to the buyer.

Seller Assertions, Information Asymmetry, and Inspector Characteristics

To support the asking price, sellers typically make *assertions* about their property. For instance, the seller of an older home might declare that the roof doesn't leak, that the foundation is sound, that there is no rot or pest damage, and that the plumbing and electrical systems are in good working order. Fortunately, many sellers are honest and forthcoming, but this is not always the case. The problem is that the buyer often does not know if they are dealing with an honest seller or if the seller has the necessary expertise to evaluate all the structural or mechanical aspects of the property. Lacking the necessary expertise to validate the seller's assertions, the buyer can logically reduce information risk by hiring a house inspector.

Stop and Think: Imagine for a moment that you are buying a house and are wisely considering hiring an inspector. Before reading on, test your intuition—what characteristics would you like your inspector to possess?

Desired Characteristics of the House Inspection Service

Now that you have identified some of the characteristics of a good inspector, which likely include competence, honesty, and objectivity, consider the key characteristics of the service they will provide. Are some of the seller's assertions more important than others? For instance, you are probably not equally concerned with the assertions that there is no structural rot and that the lightbulbs in the master bathroom are working. Depending on what you are willing to pay, the inspection could theoretically range from the extremes of simply driving past the house to taking the home entirely apart, board by board, looking for the smallest problems. How thorough do you want the inspector to be? Do you want the inspector to issue a "pass-fail" grade based on a quick walk-through or would you like more details, such as careful examination of the furnace and air conditioner? As you can see, there are many factors to take into account in deciding on the nature and extent of the assurance service you want to buy. In Table 1–1 we have listed what we think are desirable characteristics of a house inspector and of the service provided by an inspector. Pause for a moment to compare your thinking with ours.

TABLE 1–1Important Characteristics of House Inspectors and Inspections

Desirable Characteristics of House *Inspectors*

- Competent—they possess the required training, expertise, and experience to evaluate the property for sale. Competency will also relate to the ability to use the tools, such as a voltage indicator or carbon monoxide analyzer, that the inspector would be expected to possess.
- Objective—they have no reason to side with the seller; they are independent of the seller's influence.
- Honest—they will conduct themselves with integrity, and they will share all of their findings with the buyer.
- Skeptical—they will not simply take the seller's assertions at face value; they will conduct their own analysis and testing.
- Responsible and/or liable—they should stand behind their assessment with a guarantee and/or be subject to litigation if they fail to act with due care.

Desirable Characteristics of a House Inspection *Service*

- Timely—the results of the service are reported in time to benefit the decision maker.

- Reasonably priced—the costs of the services must not exceed the benefits. For this to occur, the service provider will likely need to focus attention on the most important and risky assertions and likely cannot provide absolute assurance, even with respect to important seller assertions.
- Complete—the service addresses all of the most important and risky assertions made by the seller.
- Effective—the service provides some degree of certainty that it will uncover significant risks or problems.
- Systematic and reliable—the service is based on a systematic process, and the conclusions are based on reliable evidence. In other words, another comparable inspector would likely find similar issues and come to similar conclusions.
- Informative—the service provides a sense for how likely mechanical or structural failure is in the near future and provides an estimate of the cost to repair known defects or failures.

The concepts contained in Table 1–1 are in fact fundamental to most forms of inspection (including financial statement audits). Certainly home inspections and other assurance services must focus on the assertions that are most important, and they must be conducted in a timely and cost-effective manner. Some assertions are more important than others because of their potential risk or cost. For example, a house inspector should recognize the signs that indicate an increased risk of a leaky roof. If those signs are present, they should investigate further, because damage caused by a leaky roof can be very expensive to repair. At the same time, just because the seller asserts that they recently lubricated all the door and window hinges doesn't mean it would be wise to pay the inspector to validate this assertion.

Stop and Think: How might a house inspection be similar to a financial statement audit?

Relating the House Inspection Analogy to Financial Statement Auditing

Now that we have discussed some of the basic characteristics of house inspectors and their services, let's consider how these relate to financial statement auditors. As noted previously, the demand for the assurance provided by a house inspector comes from information asymmetry and conflicts of interest between the buyer and the seller. Information asymmetry and conflicts of interest also exist between managers of companies and potential investors. For example, if managers are overly optimistic or if they wish to inflate their bonus compensation, they may unintentionally or intentionally overstate the company's earnings and assets (e.g., by understating the allowance for doubtful accounts or by claiming to have more cash than they really have). One important difference between our house inspector example and financial statement auditing is that the buyer of a home typically hires the inspector. In other words, the buyer identifies and hires the inspector rather than hiring someone that the seller recommends—presumably because by hiring an inspector directly, they increase the likelihood that the inspector will be objective and independent.

However, as was discussed previously, the companies selling shares or bonds to the public typically hire and pay the auditor, rather than the other way around. To raise capital in the marketplace, companies often sell many small parcels of shares and bonds to a large number of investors. Suppose a financial statement audit of a given company would cost $500,000. Under such circumstances, it obviously doesn't make sense for each individual investor to pay for an audit. Instead, the company hires and pays for the auditor because a reputable independent auditor's opinion can provide assurance to thousands of potential investors. In addition, recall from our previous discussion that the initial demand for auditing comes not from the principal but from the agent. By purchasing the assurance provided by an audit, the company can sell its shares and bonds to prospective owners and creditors at more favorable prices, significantly reducing the cost of capital. In fact, studies indicate that audits save companies billions of dollars in costs of obtaining capital—for example, by getting lower interest rates on loans and selling shares at higher prices.

Given that the seller of shares and bonds typically hires the auditor, consider just how crucial a strong reputation is to an independent auditor. Four large, international accounting firms dominate the audits of large publicly traded companies, auditing approximately 98 percent of all Canadian reporting issuers by market capitalization. One reason these firms dominate the audits of large companies is because they have well-known names and strong reputations. Entities who buy assurance from these firms know that potential investors and creditors will recognize the auditing firm's name and reputation and feel assured that they therefore face reduced information risk.

The fact that the entity being audited typically hires and pays the auditor also highlights just how important auditor objectivity and independence are to the investing public. In fact, Arthur Andersen, the once highly regarded member of the former "Big 5" international accounting firms, failed in 2002 at least in part because the firm lost its reputation as a high-quality, objective auditor whose opinion could be relied upon by investors and creditors. Later in the book we will discuss some changes enacted over the past several years to strengthen the independence of financial statement auditors, including prohibiting auditors from providing many kinds of consulting services to their public audit clients.

Management Assertions and Financial Statements

We've seen that home sellers make a number of different assertions about which a home buyer might want independent assurance. What assertions does a company that is selling its shares or bonds make? Some of the most important assertions entities make to investors are implicit in the entities' financial statements. Immediately after this chapter you will find a set of financial statements for EarthWear, a hypothetical seller of high-quality outdoor clothing. We'll use EarthWear examples and exercises throughout the book to illustrate important audit concepts and techniques. Let's consider what assertions EarthWear makes to potential investors when it publishes its financial statements. For example, EarthWear lists the asset account "Cash" on its balance sheet and indicates that the account's year-end balance was $48.9 million.

Stop and Think: Consider for a moment what assertions the company is making about cash.

An obvious answer is that EarthWear's management is asserting that the cash is really there—that it "exists." They are also implicitly asserting that all the cash that the company owns is included in the records—in other words, the financial records are "complete" with respect to the company's cash. Finally, management is asserting that the cash amount is fairly and accurately recorded, and that no other parties have valid claims to the cash. Such assertions are implicit for each account in the financial statements.

Financial statement assertions are management's expressed or implied claims about information reflected in the financial statements. Assertions are central to auditing because they are the focus of the auditor's evidence collection efforts. In other words, much of what auditors do revolves around collecting and evaluating evidence about management's financial statement assertions.

One of the main tasks of the auditor is to collect sufficient appropriate evidence that management's assertions regarding the financial statements are correct. If you were to audit EarthWear, how would you go about collecting evidence for the cash account? The process is really quite logical and understandable. First, you would carefully consider the most important assertions the company is making about the account, and then you would decide what evidence you would need to substantiate the truthfulness of each important assertion. For example, to ensure the cash exists, you might examine bank statements or send a letter to the bank requesting confirmation of the balance. To ensure the cash hasn't been pledged or restricted, you might review the minutes of key management meetings to look for discussions or agreements on this issue.

We will discuss management assertions in greater depth in Chapter 5, but for now take a look at Table 1–2, which lists all of the management assertions that auditors focus on in an audit. This presentation divides management assertions into two aspects of information reflected in the financial statements: transactions and related disclosures, and account balances and related disclosures. For example, EarthWear's management asserts, among other things, that transactions relating to inventory actually *occurred*, that they are *complete* (i.e., no valid transactions were left out), that they are *classified* properly (e.g., as an asset rather than an expense), and that they are recorded *accurately* and in the *correct period*. Similarly, management asserts that the inventory represented in the inventory account balance *exists*, that the entity *owns* the inventory, that the balance is *complete*, and that the inventory is properly *valued*. Understanding the assertions in terms of transactions and account balances helps the auditor focus on the different types of audit procedures needed to test management's assertions in these two categories. Chapter 5 discusses the types of procedures available to the auditor in more detail.

TABLE 1–2Summary of Management Assertions by Category

Assertions about classes of transactions and events (and related disclosures) for the period under audit:

- **Occurrence:** Transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.
- **Completeness:** All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Authorization:** All transactions and events have been properly authorized.
- **Accuracy:** Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.
- **Cutoff:** Transactions and events have been recorded in the correct accounting period.
- **Classification:** Transactions and events have been recorded in the proper accounts.
- **Presentation:** Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Assertions about account balances (and related disclosures) at the period end:

- **Existence:** Assets, liabilities, and equity interests exist.
- **Rights and obligations:** The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- **Completeness:** All assets, liabilities, and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.
- **Accuracy, valuation, and allocation:** Assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.
- **Classification:** Assets, liabilities, and equity interests have been recorded in the proper accounts.
- **Presentation:** Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

*International and AICPA auditing standards consider Authorization to be a subset of the Occurrence assertion and thus do not list it separately. We list Authorization as a separate assertion about classes of transactions and events for instructional clarity.

Once you have finished auditing the important assertions relating to each account included in the company's financial statements, you will need to report your findings to the company's shareholders and to the investing public because EarthWear is publicly traded.

Now, instead of EarthWear's auditor, imagine you are a prospective investor in EarthWear. As an investor, would the reputation of the company's auditor matter to you? Would you want to know that the audit firm used an appropriate, well-recognized audit approach to gather sufficient, appropriate evidence? What form of report would you expect? What if the lead partner on the audit were a close relative of EarthWear's president? Considering these questions makes it easy to see that the desired characteristics of auditors and audit services are similar to those relating to house inspectors and house inspection services.

We hope the analogy of house inspectors and auditors as assurance providers has helped you understand the basic intuition behind the necessary characteristics of auditors and auditing and why auditing is in demand, even when it is not required by law. As you study this book, we encourage you to keep in mind how the concepts you are learning relate to important characteristics of auditors and the services they offer. Keep the big picture in mind!

LO 1-3 Assurance Services as a Business

Auditing is a business like any other: the firm needs to bring in clients, provide services to those clients, obtain payment for those services, and do it all in a cost-effective manner.

According to the Carnegie Institute of Technology, "85% of your financial success is due to your personality and ability to communicate, negotiate and lead. Shockingly, only 15% is due to technical knowledge."[5]

If you work for a firm that does audits, your time will be spent: talking to organizations who may be seeking auditing services, making presentations to committees on the services your firm can provide, meeting with audit team members to understand their capabilities as this will influence the services you can provide, speaking with personnel in your clients' offices, talking with auditors in the firm's offices in other geographic locations about work that needs to take place elsewhere, conversing with auditors who are currently working on audits, and making presentations to committees on the basis of the results of your firm's work.

If you work for an organization that hires auditors, your time will be spent: discussing the assurance needs of your organization, seeking out and then evaluating the capabilities of a potential audit firm, accurately contracting for the services to be provided, having your staff speak to and prepare working paper for auditors, making payment for services rendered, and understanding the final assurance report delivered.

Whether you work for a firm that provides audit services or for an organization that needs assurance work done, your ability to communicate both verbally and in writing, to negotiate, and to lead will be critical to your success.

One way to start with this part of your professional training would be to join the local chamber of commerce or other business networking group in your area. You might also consider sitting on the board of a local charity, as other board members will likely be good contacts. You might also join an organization related to a subject that interests you; for example, if you run to stay in shape, you might think about joining a local running club. Finally, you might consider joining a service organization such as the local community association or Rotary Club; but be aware that such organizations are focused on providing service, and business opportunities may be several years down the road.

Another idea relates to making presentations. Most people are nervous when they try to talk in front of others. One way to get over such nervousness is to practise by joining some such organization as Toastmasters, which has chapters virtually everywhere. Check the Internet for a group located conveniently near you.

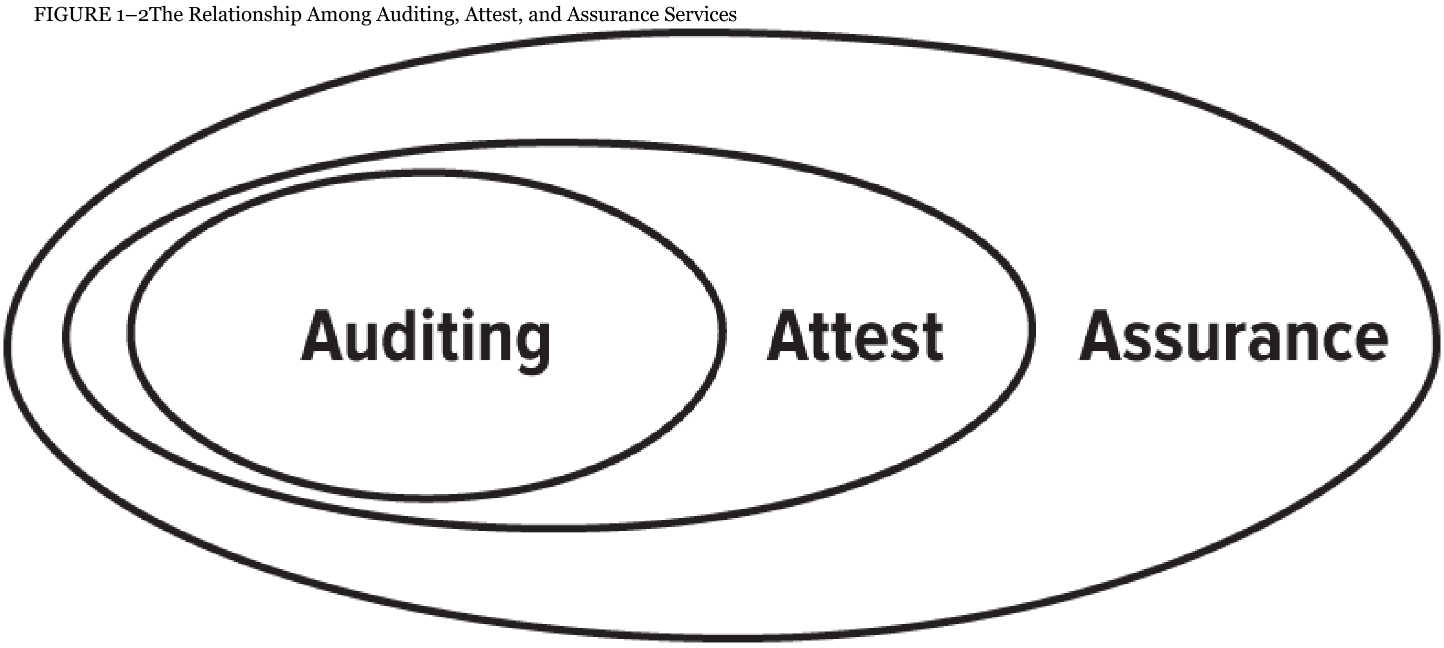
Before you can communicate, negotiate, or lead, you need to understand the subject matter about which you are communicating, negotiating, or leading. This textbook is about the technical knowledge you will need to successfully understand the audit process, but be aware that this is only the start of your journey.

LO 1-4 Auditing, Attest, and Assurance Services Defined

Accounting professionals can perform various services that provide assurance about the reliability and relevance of information given by one party to another. The broadest category of such services is simply called assurance services. Attest services are a subset of assurance services, and auditing is a type of attest service. Many times these terms are used interchangeably because they are related, and at a general level, they encompass the same process: *the evaluation of evidence to determine whether information has been recorded and presented in accordance with a predetermined set of criteria, together with the issuance of a report that indicates the degree of correspondence.*

Figure 1–2 illustrates the concept that attest services are a subset of the broader category of assurance services, and, in turn, auditing services are a specialized type of attest service. We'll discuss each category in turn, from narrowest to broadest.

FIGURE 1–2The Relationship Among Auditing, Attest, and Assurance Services



LO 1-5 Audit Services

Consider the following formal definition of *auditing*:

> **Auditing** is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.[6]

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Let's discuss this definition in plain English. The phrase "systematic process" implies that there should be a well-planned and thorough approach for conducting an audit. This approach involves "objectively obtaining and evaluating evidence." In other words, the auditor must *search for* audit evidence and objectively *evaluate* the relevance and validity of the evidence they find. The type, quantity, and reliability of evidence will vary between audits, but the process of obtaining and evaluating evidence makes up most of the auditor's activities on any audit.

As our analogy between house inspection and auditing illustrates, the evidence gathered by the auditor must relate to relevant assertions, which in auditing pertain to economic actions and events. The auditor compares the evidence gathered to management's financial statement assertions in order to assess "the degree of correspondence between those assertions and established criteria." While different types of "criteria" might be available in various settings, generally accepted accounting principles usually serve as the basis for evaluating management's assertions in the context of a financial statement audit.

The last key phrase in the definition, "communicating the results to interested users," relates to the report the auditor provides to the intended users of the reported information. The communication will vary depending on the type and purpose of the audit, and the nature of the auditor's findings. In the case of financial statement audits, very specific types of reports are prescribed by auditing standards to communicate the auditor's findings. We will show you what an audit report relating to a public company's financial statements looks like later in this chapter.

Attest Services

Auditors have a reputation for independence and objectivity. As a result, various parties frequently request that auditors attest to information beyond historical financial information. However, professional standards did not allow for such services until the profession established a separate set of attestation standards in 1986. These standards provide the following definition for *attest services*:

> **Attest services** occur when a practitioner is engaged to issue . . . a report on subject matter, or an assertion about subject matter, that is the responsibility of another party.

Notice that this definition is broader than the one previously discussed for auditing because it is not limited to economic events or actions. The subject matter of attest services can take many forms, including prospective information, analyses, systems and processes, and even the specific actions of specified parties. Note that financial statement auditing is a particular, specialized form of an attest service.

Assurance Services

In the late 1990s, the accounting profession expanded the potential breadth of auditors' activities beyond auditing and attest services to include a broader set of *assurance services*. Extending auditors' activities to assurance services allows reporting not only on the reliability and credibility of information but also on the *relevance* and *timeliness* of that information. Assurance services are defined as follows:

> **Assurance services** are independent professional services that improve the quality of information, or its context, for decision makers.

This definition captures some important concepts. First, the definition focuses on *decision making*. Making good decisions requires quality information, which, in the context of the broad set of assurances services, can be financial or nonfinancial. Second, it relates to improving the *quality of information* or its context. An assurance service engagement can improve quality through increasing confidence in the information's reliability and relevance. Context can be improved by clarifying the format and background with which the information is presented. Third, the definition includes "*independence*," which relates to the objectivity of the service provider. Last, the definition includes the phrase "*professional services*," which implies the application of professional judgment and due care by the provider. To summarize, assurance services can include almost any service provided by accounting professionals that involves capturing information, improving its quality, or enhancing its usefulness for decision makers.

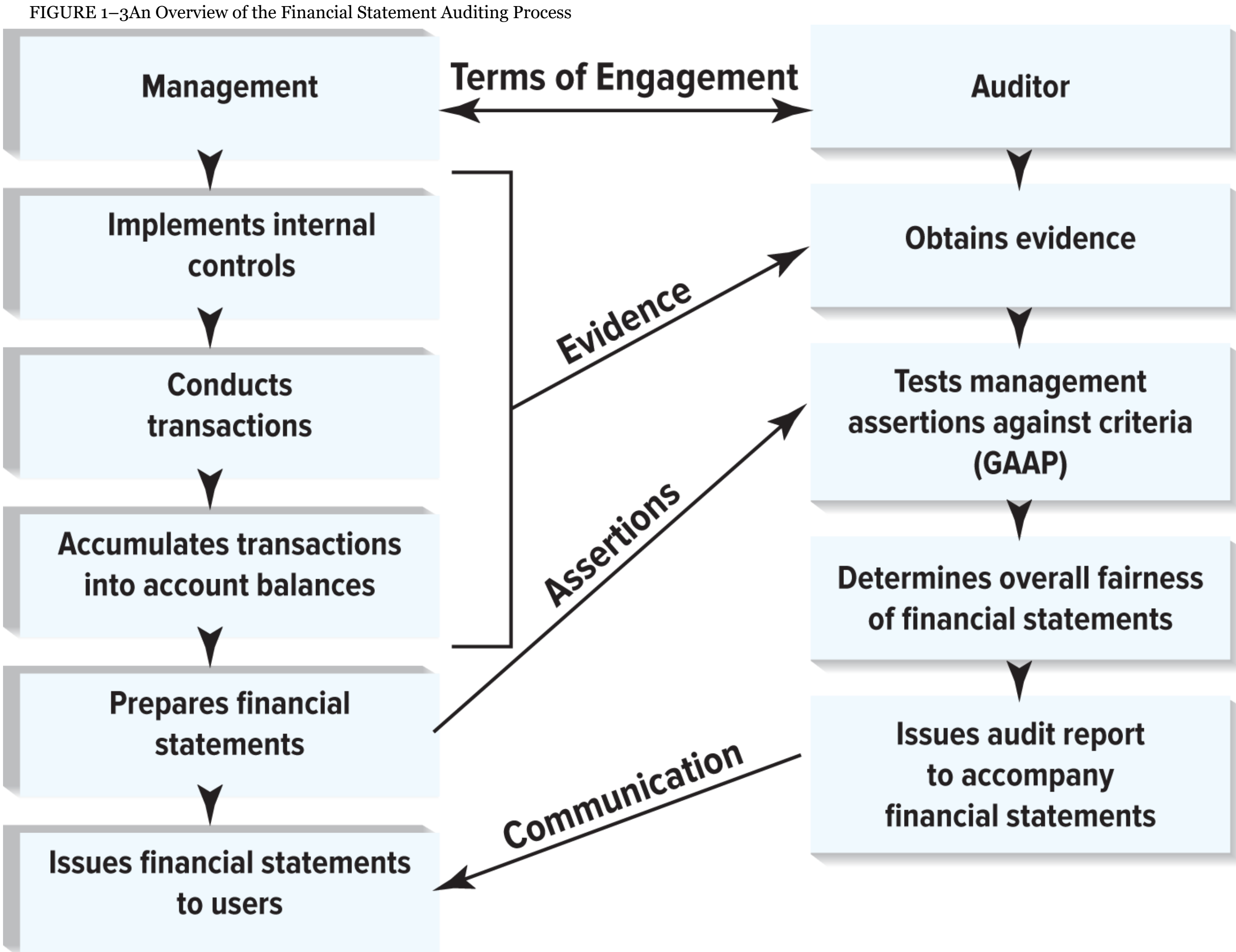
This text focuses primarily on financial statement auditing because it represents the major type of assurance service offered by most public accounting firms. In addition, in many instances, the approach, concepts, methods, and techniques used for financial statement audits also apply to other attest and assurance service engagements. While this text focuses primarily on financial statement auditing, Chapters 2 and 21 describe various examples of audit, attest, and assurance services commonly offered by different kinds of auditors, including *internal auditors* who are often directly employed by the company for which they provide services.

LO 1-6 Fundamental Concepts in Conducting a Financial Statement Audit

Figure 1–3 presents a simplified overview of the process for conducting a financial statement audit from start to finish. Take a moment to think through the steps in this figure. The auditor gathers evidence about the business transactions that have occurred and about the account balances into which the transactions have been accumulated. The auditor uses this evidence to compare the assertions contained in the financial statements to the criteria used by management in preparing them (i.e., GAAP). The auditor's report communicates to the user the degree of correspondence between the assertions and the criteria. Be sure you understand Figure 1–3 before you continue reading! Taking a moment to think through these concepts will help you make sense of the three fundamental concepts underlying a financial statement audit, which we will explain next.

The conceptual and procedural details of a financial statement audit build on three fundamental concepts: materiality, audit risk, and evidence relating to management's financial statement assertions. The auditor's assessments of materiality and audit risk influence the nature, timing, and extent of the audit evidence to be gathered. This section briefly discusses the concepts of materiality, audit risk, and audit evidence. Chapters 3 through 5 cover each of these concepts in greater depth, but your study of those chapters will be easier and more effective if you take the time now to understand the concepts of materiality, audit risk, and audit evidence at a general level.

FIGURE 1–3An Overview of the Financial Statement Auditing Process



Materiality

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Materiality refers to the amount by which a set of financial statements could be misstated without affecting the judgement of a reasonable person. For example, suppose a company's earnings per share (EPS) is $4.50 but due to an unintentional error the company mistakenly reports EPS of $4.52. This very small difference is unlikely to affect an investor's decisions in any significant way. Thus, the auditor will likely consider the difference to be *immaterial*.

One of the auditor's first tasks in planning an audit is to make a judgement about just how big a misstatement would have to be before it would significantly affect users' judgements. The concept of materiality is important because it simply is not practical or cost-beneficial for auditors to ensure that financial statements are completely free of any small misstatements.

The Canadian Auditing Standard 320 has the following definition of materiality:

> Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.[7]

The focus of this definition is on the users of the financial statements. In planning the engagement, the auditor assesses the magnitude of a misstatement that may affect users' decisions. This materiality assessment helps the auditor determine the nature, timing, and extent of audit procedures used to collect audit evidence. Let's relate the concept of materiality to our house inspector analogy—we would not be willing to pay a house inspector to validate the remaining life on lightbulbs or thoroughly test every cabinet hinge. These items are not material to the buyer's decision.

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While other factors must be considered in determining materiality, a common rule of thumb is that total (aggregated) misstatements of more than about 5 percent of income before tax would cause the financial statements to be materially misstated. Suppose the auditor decides that the financial statements of a client with $8 million in pre-tax income would be materially misstated if total misstatements exceed 5 percent of income, or $400,000. The auditor would design audit procedures precise enough that they would be very likely to detect misstatements that, either by themselves or in combination with other misstatements, might exceed the materiality threshold of $400,000. When testing is complete for all accounts, the auditor will evaluate the audit results and ask the company to adjust its financial records for identified misstatements. The auditor will issue a clean audit opinion if the auditor's estimate of remaining, unadjusted misstatements in all the accounts add up to less than overall materiality of $400,000. This is why the wording of the standard auditor's report indicates that the financial statements "present fairly *in all material respects* . . ." As we will explain next, in connection with the concept of audit risk, there can be no guarantee that the auditor will uncover *all* material misstatements. In fact as we discuss next, the auditor provides no assurance that *immaterial* misstatements, and only reasonable assurance that material misstatements, will be detected.

Audit Risk

The second major concept involved in auditing is *audit risk*, which is the risk that the auditor may mistakenly give a "clean" opinion on financial statements that are materially misstated.

> **Audit risk** is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.[8]

Auditing standards make it clear that an audit provides *reasonable assurance* that the financial statements do not contain material misstatements. The phrase "reasonable assurance" implies that even when the auditor does a good job, there is some risk that a material misstatement could be present in the financial statements and the auditor will fail to detect it. The auditor plans and conducts the audit to achieve an acceptably low level of audit risk. The auditor controls the level of audit risk through the effectiveness and extent of the audit work conducted. The more effective and extensive the audit work (and thus the type and amount of audit evidence collected), the lower the risk that a misstatement will go undetected and that the auditor will issue an inappropriate report. But it is important to understand that the concept of reasonable assurance means that an auditor could conduct an audit completely in accordance with professional auditing standards and fail to detect material misstatements. A house inspector cannot absolutely guarantee the absence of any significant problems without inordinate cost. Similarly, due to cost constraints and the sheer impossibility of investigating every item reflected in an entity's financial statements, the risk that an auditor will mistakenly issue a clean opinion on materially misstated financial statements should be low, but it cannot be driven to zero at reasonable cost. Even careful and competent auditors can only offer reasonable, rather than absolute, assurance.

Audit Evidence Regarding Management Assertions

The third major concept involved in auditing is *evidence regarding management's assertions*, or, more simply, *audit evidence*. Most of the auditor's work in arriving at an opinion on the financial statements consists of obtaining and evaluating audit evidence relating to management's assertions. Audit evidence consists of the underlying accounting data and any additional information available to the auditor, whether originating from the client or externally.

As illustrated earlier in our discussion about EarthWear, management's assertions are used as a framework to guide the collection of audit evidence. The assertions, in conjunction with the assessment of materiality and audit risk, are used by the auditor to determine the nature, timing, and extent of evidence to be gathered. Once the auditor has obtained sufficient appropriate evidence that the management assertions can be relied upon for each significant account and disclosure, the auditor has reasonable assurance that the financial statements are fairly presented. Note the two key descriptors of audit evidence: *sufficient* and *appropriate*.

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The *sufficiency* of audit evidence simply refers to the quantity of evidence the auditor obtains—does the auditor have enough evidence to justify a conclusion as to whether management's assertions are fairly stated? The *appropriateness* of audit evidence refers to whether the evidence is relevant and reliable. *Relevance* refers to whether the evidence relates to the specific management assertion being tested. *Reliability* refers to whether the evidence can be relied upon to signal the true state of the account balance or assertion being examined. Using the house inspection example, inspecting the foundation of a house may not give us *relevant* evidence about whether the roof leaks. Likewise, evidence about the roof that is obtained by standing on the ground and looking up likely would not be as *reliable* as evidence obtained by climbing up on the roof or by inspecting the attic space. Technology can affect both the nature and the costs of evidence gathering. For example, a home inspector can use a thermal camera to detect insulation deficiencies and air leakages that might otherwise not be easily spotted.

While the auditor has a professional responsibility to obtain "sufficient appropriate evidence," the auditor seldom has the luxury of obtaining completely convincing evidence about the true state of a particular management assertion. In most situations, the auditor is able to obtain only persuasive evidence that the assertion is fairly stated.

LO 1-7 Sampling: Inferences Based on Limited Observations

You might ask why the auditor relies on concepts such as materiality and audit risk in designing an audit. Why not test all account balances and all transactions that occurred during the period so that audit risk can be driven to zero, even for immaterial misstatements? The main reason is the cost and infeasibility of such an audit. In a very small business, the auditor might be able to examine all transactions that occurred during the period and all the accounts that exist at the end of the period and still issue the audit report in a reasonable amount of time. However, it is unlikely that the owner of the business could afford to pay for such an extensive audit. For a large organization, the sheer volume of transactions, which might well reach into the millions, prevents the auditor from examining every transaction. Similarly, ending account balances can reflect millions of individual items (e.g., individual inventory items making up the ending inventory account). Thus, just as with a house inspection, there is a trade-off between the exactness or precision of the audit and its cost.

To deal with the problem of not being able to examine every transaction and account, the auditor selects a subset of transactions and accounts to examine. Many times the auditor, based on previous audits, understanding of the client's internal control system, and knowledge of the client's industry, is aware of items in an account balance that are more likely to contain misstatements. For example, the auditor's prior knowledge may indicate that individual accounts receivable involving certain types of customers are more likely to contain misstatements. The auditor can use this knowledge to specifically select those particular accounts receivable for examination. When the auditor has no special knowledge about which particular transactions or items may be misstated, they use random sampling procedures that increase the likelihood of obtaining a sample that is *representative* of the population of transactions or account items. In such cases, the auditor uses the laws of probability to make inferences about potential misstatements based on examining a sample of transactions or items.

The size of the subset of items the auditor examines is primarily a function of materiality and the desired level of assurance for the account or assertion being examined. There is an *inverse* relation between sample size and materiality, and a *direct* relation between sample size and desired level of assurance. For example, if an auditor assesses a small materiality amount for an account, a larger sample will be needed than if materiality were a larger amount. This occurs because the auditor must gather more evidence (a larger sample) to have a reasonable likelihood of detecting smaller errors. You can think of materiality as the "fineness of the auditor's filter." A lower materiality amount requires the auditor to use a finer filter in order to detect smaller errors, and it takes more work to create a finer filter. Similarly, as the desired level of assurance increases for a given materiality amount, the sample size necessary to test an assertion becomes greater.

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As you will see in later chapters, auditors' increasing use of data analytics will sometimes allow for the testing of entire populations, eliminating the need for sampling. This is especially the case where the auditor's testing is entirely focused on electronic records that can be accessed, prepared, and evaluated with the use of specialized audit software. However, in cases where the auditor's testing needs to tie auditee records to information from outside parties or to physical items, such as inventory, sampling will continue to be widely used.

LO 1-8 The Audit Process

Now that we have explained some of the fundamental concepts of auditing, let's summarize the logical thought processes underlying a financial statement audit and then walk through the major phases of an audit. Be sure and take some time here—a thorough understanding of this section will be a great help to you in understanding subsequent chapters!

Overview of the Financial Statement Auditing Process

Consider the auditor's task from a logical perspective. The end product of an auditor's work is an opinion indicating whether or not the client's financial statements are free of material misstatement. What might an auditor do to obtain the information needed to develop and support that opinion? The auditor must first obtain a thorough understanding of the client, its business and industry, and its information system. The auditor must understand the risks (e.g., that revenue is accurate, or that expenses are complete) the client faces, how it deals with those risks, and what remaining risks are most likely to result in a material misstatement in the financial statements. Armed with this understanding, the auditor plans procedures that will produce evidence helpful in developing and supporting the opinion on the financial statements.

To understand this process, consider what financial statements are made of. From your financial accounting courses, you know that accounting systems capture, record, and summarize individual transactions. Entities must design and implement controls to ensure that those transactions are initiated, captured, recorded, and summarized appropriately. These individual transactions are grouped and summarized into various account balances, and finally, financial statements are formed by organizing meaningful collections of those account balances (e.g., current liabilities). We have just identified three stages in the accounting process that take place in the preparation of financial statements: *internal controls* are implemented to ensure that the client's information system appropriately captures and records *individual transactions,* which are then collected into ending *account balances*. This summary might seem like an oversimplification, but it will help you understand the stages of a client's accounting process on which auditors focus to collect evidence.

Keep in mind that the auditor's job ultimately is to express an opinion on *whether the financial statements are fairly stated*. It makes sense, then, that the auditor can design procedures to collect *direct* information about the ending account balances that make up the financial statements. For example, an auditor might confirm the ending balance of the cash account by contacting the client's bank, or the auditor might verify the ending balance of the inventory account by physically examining individual inventory items that make up the ending balance. But remember—account balances are made up of *transactions* that occurred over the past year (or earlier). If the auditor designs procedures to test whether the transactions were captured and handled properly, the auditor can obtain *indirect* information about whether the ending account balances are likely to be fairly stated. This information is clearly one step removed from the ending account balances themselves. But we can even back up one more step. If the auditor designs procedures to test whether the entity's *internal control* over financial transactions is effective, the auditor can obtain additional indirect information regarding whether the account balances are fairly stated.

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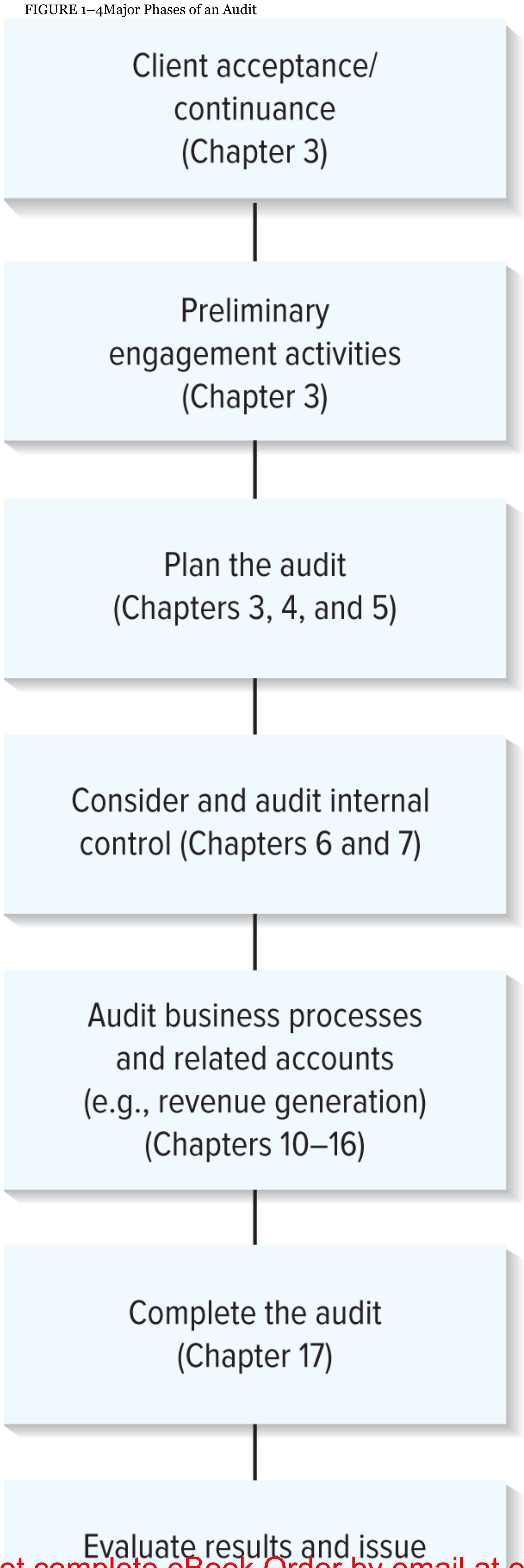
Carefully think through the logic in this last step: if controls are effective, then the transactions will probably be captured and summarized properly, which means in turn that the account balances are likely to be free of material misstatement. Thus, information about internal control is even more indirect than information about transactions, but it is useful information nonetheless! In fact, while it is indirect, evidence about internal control is often a relatively cost-effective form of audit evidence.

To summarize, the auditor can collect evidence in each of three different stages in a client's accounting system to help determine whether the financial statements are fairly stated: (1) the *internal control* put in place by the client to ensure proper handling of transactions (e.g., evaluate and test the controls); (2) the *transactions* that affect each account balance (e.g., examine a sample of the transactions that happened during the period); and (3) the ending *account balances* themselves (e.g., examine a sample of the items that make up an ending account balance at year-end). Instead of sampling, an auditor may choose to use specialized data analytic software to examine all transactions that affect some account balances. Evidence that relates directly to ending account balances is usually the highest quality, but also the costliest, evidence. Thus, an auditor will usually rely on a combination of evidence from all three stages in forming an audit opinion regarding the fairness of the financial statements. On which of these three areas it is best to focus depends on the circumstances, and this is generally left to the auditor's discretion. Chapters 3 and 5 address the types of procedures and types of evidence available to the auditor in more detail.

Major Phases of the Audit

The audit process can be broken down into a number of audit phases (see Figure 1–4). While the figure suggests that these phases are sequential, they are actually quite iterative and interrelated in nature. Phases often include audit procedures designed for one purpose that provide evidence for other purposes, and sometimes audit procedures accomplish purposes in more than one phase. Figure 1–4 shows the specific chapters where each of these phases is discussed in detail.

FIGURE 1–4 Major Phases of an Audit



audit report (Chapters 1 and 18)

Client Acceptance/Continuance

Professional standards require that public accounting firms establish policies and procedures for deciding whether to accept new clients and to retain current clients. There is much less risk associated with clients that the firm has previously audited; however, circumstances in the client's profile may have changed, so continuing to audit a client needs to be evaluated each year. The purpose of such policies is to minimize the likelihood that an auditor will be associated with new or continuing clients that lack integrity (e.g., a criminal organization). If an auditor is associated with a client that lacks integrity, the risk increases that material misstatements may exist and not be detected by the auditor. For a prospective new client, the auditor is required to confer with the predecessor auditor and the auditor frequently conducts background checks on top management. The knowledge that the auditor gathers during the acceptance/continuance process provides valuable understanding of the entity and its environment, thus helping the auditor assess risk and plan the audit.

Preliminary Engagement Activities

There are generally three preliminary engagement activities: (1) determine the audit engagement team requirements; (2) ensure the independence of the audit firm and audit team; and (3) establish an understanding with the client regarding the services to be performed and the other terms of the engagement.

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Once the decision has been made to accept an audit engagement, the auditor begins preliminary engagement activities by updating the understanding of the entity and its environment. This understanding includes the nature of the entity and the industry in which it operates, how it measures its own performance, the nature of its information system, and the quality of its internal control. The auditor's understanding of the entity and its environment helps in assessing the risk of material misstatement and in setting the scope of the audit.

The engagement partner or manager forms an audit team composed of members who have the appropriate audit and industry experience for the engagement, determines whether specialists (e.g., tax specialists) are needed, and makes sure that the audit firm and individual team members are free from prohibited relationships that might threaten the auditor's objectivity.

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Finally, the auditor establishes an understanding with the client regarding the services to be performed and the terms of the engagement, including such considerations as timing of the audit and expected audit fees. Chapter 3 addresses the preliminary engagement activities of the audit process in more detail.

Plan the Audit

Proper planning is important to ensure that the audit is conducted in an effective and efficient manner. In order to plan the audit properly, the audit team must make a preliminary assessment of the client's business risks and determine materiality. The audit team relies on these judgments to then assess risk relating to the likelihood of material misstatements in the financial statements. Audit planning should take into account the auditor's understanding of the entity's internal control system (discussed next). This assessment of internal control may be in greater depth if the client is a public company on a U.S. exchange, because for U.S. public companies the auditor is required to report on both the company's internal control over financial reporting and the company's financial statements. The outcome of the auditor's planning process is a written audit plan that sets forth the nature, extent, and timing of the audit procedures to be performed. You will learn about the issues that are involved in this phase of the audit in Chapters 3, 4, and 5.

Consider and Audit Internal Control

A company's system of internal control is put in place by the company's board of directors and management to help the company achieve reliable financial reporting, effective and efficient operations, and consistent compliance with applicable laws and regulations. The quality of a company's internal control over financial reporting is of direct relevance to auditors. As part of obtaining an understanding of the entity and its environment, the auditor obtains an understanding of internal control to help the auditor assess risk and identify areas where financial statements might be misstated. Chapter 6 covers the role of internal control in a financial statement audit, and Chapter 7 specifically addresses the audit of internal control for U.S.-listed public companies. Later chapters apply the process of considering and auditing internal control in the context of various business processes.

Audit Business Processes and Related Accounts

Auditors usually organize audits by grouping financial statement accounts according to the business processes that primarily affect those accounts. For example, sales revenue and accounts receivable are both part of a company's sales and collection process and are audited together. The auditor applies audit procedures to the accounts in order to obtain audit evidence about management's assertions relating to each account and reduce the risk of undetected material misstatement to an appropriately low level. On most engagements, actually conducting the planned audit tests comprises most of the time spent on a financial statement audit or an audit of internal control over financial reporting. For public company clients, the audit of internal control is done in an integrated way with the financial statement audit. This topic is addressed in Chapter 7 and throughout the book where appropriate.

Complete the Audit

The auditor must obtain sufficient appropriate evidence in order to reach and justify a conclusion on the fairness of the financial statements. After the auditor has finished gathering reliable evidence relating to management's financial statement assertions, the auditor assesses the sufficiency of the evidence and obtains additional evidence where deemed necessary. In this phase, the auditor also addresses a number of issues, including the possibility of undisclosed contingent liabilities, such as lawsuits, and searches for any events subsequent to the balance sheet date that may impact the financial statements. Chapter 17 discusses the completion phase of the audit in detail.

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LO 1-9 Evaluate Results and Issue Audit Report

The final phase in the audit process is to evaluate results and choose the appropriate audit report to issue. The auditor's report, also known as the audit opinion, is the main product or output of the audit. Just as the report of a house inspector communicates the inspector's findings to a prospective buyer, the audit report communicates the auditor's findings to the users of the financial statements.

After completion of the audit work, the auditor determines if the preliminary assessments of risks were appropriate in light of the evidence collected and whether sufficient evidence was obtained. The auditor then aggregates the total known and estimated uncorrected misstatements and determines whether they cause the financial statements to be materially misstated. If the uncorrected misstatements are judged to be material, the auditor will request that the client correct the misstatements. If the client refuses, the auditor issues an opinion that clearly indicates that the financial statements are materially misstated and explains the nature of the misstatement. If the uncorrected misstatements are insignificant enough that they do not cause the financial statements to be materially misstated, or if the client is willing to correct the misstatements, the auditor issues an unqualified (i.e., "clean") report.

The Unqualified/Unmodified Audit Report

The unqualified audit report is by far the most common type of report issued.[9] In this context, *unqualified* means that, because the financial statements are free of material misstatements, the auditor does not find it necessary to *qualify* (i.e., specify any exceptions to) the audit opinion. This is a point that students often get confused about, so please pause for a moment here and make sure you understand that an unqualified audit opinion is an opinion that the financial statements are free of material misstatement. In other words, an unqualified opinion is a "clean" opinion. While it is fairly common for the auditor to find misstatements needing correction, audit clients are almost always willing to make the adjustments necessary to receive a clean opinion. Exhibit 1–1 presents an audit report issued on EarthWear Clothier's financial statements. This report covers financial statements that include balance sheets for two years and statements of income, shareholders' equity, and cash flows for three years. The audit report presented in Exhibit 1–1 is the standard type of unqualified audit opinion issued for publicly traded companies.

EXHIBIT 1–1 The Auditor's Standard Unqualified Report–Comparative Financial Statements (with explanatory paragraph)

Independent Auditor's Report

To the shareholders and the board of directors of EarthWear Company

Opinion on the Financial Statements

We have audited the consolidated financial statements of EarthWear Clothiers (the "Company") which comprise the consolidated statements of financial position as of December 31, 2025 and 2024, and the related consolidated statements of income and comprehensive income, shareholders' equity, and cash flows for each of the years ended December 31, 2025 and December 31, 2024, and notes to the consolidated financial statements, including a summary of significant accounting policies (collectively referred to as the "financial statements").

In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2025 and 2024, and its financial performance and its cash flows for each of the years ended December 31, 2025 and December 31, 2024, in accordance with International Financial Reporting Standards as issued by the International Accounting Standards Board ("IFRS").

Basis for Opinion

We conducted our audit in accordance with Canadian generally accepted auditing standards ("Canadian GAAS"). Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Statements* section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in Canada, and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Emphasis of Matter

We draw attention to Note 23 of the financial statements, which describes the effects of a fire at the Company's distribution facility. Our opinion is not modified in respect of this matter.

Key Audit Matters

The key audit matter communicated below is a matter arising from the current period audit of the financial statements that was communicated or required to be communicated to the audit committee and that: (1) relates to accounts or disclosures that are material to the financial statements and (2) involved especially challenging, subjective, or complex audit judgements. The communication of key audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the key audit matter below, providing separate opinions on the key audit matter or on the accounts or disclosures to which it relates.

Key Audit Matter	**Auditor Response**
IT systems and controls We place a high level of reliance on the Company's IT systems and key internal controls. As a result, a significant proportion of our audit effort was conducted in this area at local, regional, and international levels and at the company's shared service centres. Our focus was on understanding and validating the impacts of key changes being made to the control environment. As indicated in EarthWear's financial statement disclosures, the Company has continued to devote considerable resources to the development of key business and related IT controls to ensure a robust system of internal control.	We conducted detailed end-to-end walkthroughs of the finance processes, utilizing our understanding from the prior year to reassess the design effectiveness of the key internal controls and to identify changes. We then conducted testing of the operating effectiveness of these controls to obtain evidence that they operated throughout the year. In response to the changes and control enhancements made during the year, we performed the following: • reviewed the design of the standard controls to ensure they mitigated the relevant financial reporting risks and tested samples from the periods immediately prior to and post-implementation; • where systems changed during the year, tested IT general controls and data migration processes; • tested the enhanced user access management controls; and • tested controls and performed additional substantive procedures of key general ledger account reconciliations and manual journals.

Responsibilities of Management and Those Charged with Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRS, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going-concern basis of accounting, unless management intends to either liquidate the Company or cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with Canadian GAAS will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

As part of an audit in accordance with Canadian GAAS, we exercise professional judgement and maintain professional skepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.
- Conclude on the appropriateness of management's use of the going-concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Company to express an opinion on the financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

The engagement partner on the audit resulting in this independent auditor's report is Bradley Willis.

Willis & Adams
Willis & Adams, LLP
Chartered Professional Accountants
Licensed Public Accountants
Toronto, Ontario
February 15, 2026

Take a moment to read through the report. You will see that the title refers to the "Independent Auditor's Report" issuing the audit report. The report is addressed to the shareholders and the board of directors.

The body of the report begins with a section titled "Opinion on the Financial Statements" indicating the name of the company being audited, the financial statements covered by the report, and the auditor's opinion concerning the fairness of financial statements. Note the phrase "present fairly … in accordance with International Financial Reporting Standards …" indicating the criteria against which the auditor assesses management assertions. Also, note that the opinion section contains the phrase "in all material respects," emphasizing that the auditor is only responsible for detecting misstatements that are large enough to affect the decisions of a reasonable user of the financial statements.

The second section, titled "Basis for Opinion," communicates to the users, in very general terms, what an audit entails. It also indicates that the audit was conducted in accordance with generally accepted auditing standards by an independent public accounting firm.

If required there may be an "Emphasis of Matter" paragraph.

The next section, "Key Audit Matters," identifies matters arising from the audit that involve especially challenging, subjective, or complex auditor judgement, and how the auditor responded to those matters. As noted in the start of the section, only matters communicated to the audit committee are included in this section. Note the repeated use of the phrase "material to the financial statements," reemphasizing the concept of materiality as it relates to auditor responsibility. Each key audit matter is described, including the considerations that led to the matter's identification, and how each key audit matter was addressed in the audit. Companies are required to include key audit matters (sometimes referred to as "KAMs") beginning in audit reports for fiscal year-ends on or after December 15, 2020.

It is the next section that states that the statements are the responsibility of management and that the auditor has a responsibility to express an opinion.

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The section "Auditor's Responsibilities for the Audit of the Financial Statements" emphasizes the fact that the audit provides only *reasonable assurance* that the financial statements contain no material misstatements, whether due to error or fraud. The other paragraphs in this section are sometimes referred to as the *scope paragraphs*. These disclose that an audit involves a performance of procedures to assess and respond to risks of material misstatement, an examination of evidence, an assessment of accounting principles and significant estimates, and an overall evaluation of financial statement presentation. Finally, this section of the report expresses the auditor's judgement that the audit provides a reasonable basis for the opinion expressed in the first section of the report.

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The financial statement audit report concludes with the signature of the CPA firm providing the audit, a line stating that they are licensed to provide audit services, the city and province or territory in which the report was issued, and the date of the report. The audit report date indicates the last day of the auditor's responsibility for the review of significant events that have occurred after the date of the financial statements.

Other Types of Audit Reports

For an audit report to be unqualified, the audit must be done in accordance with applicable standards (e.g., Canadian Audit Standards for public company audits), the auditor must be independent, there must be no significant limitations imposed on the auditor's procedures, and the client's financial statements must be free of material departures from GAAP, whether from error or fraud. If any one of these conditions is not met, the auditor issues a report that appropriately conveys to the reader the nature of the report and the reasons why the report is not unqualified.

For example, suppose a client's financial statements contain a misstatement that the auditor considers material and the client refuses to correct the misstatement. The auditor will likely *qualify* the report, explaining that the financial statements are fairly stated *except for* the misstatement identified by the auditor. If the misstatement is considered so material that it pervasively affects the interpretation of the financial statements, the auditor will issue an *adverse* opinion, indicating that the financial statements are not fairly stated and should not be relied upon.

Other types of reports are available to the auditor as well, depending on the circumstances. For example, if the auditor is unable to obtain all the necessary information to conclude whether the inventory account is fairly stated (which is called a "scope limitation"), the auditor will qualify the report, indicating that the financial statements are fairly stated *except for* the fact that the auditor was unable to obtain sufficient appropriate evidence about the inventory account. If the scope limitation is so pervasive that it limits the ability of the auditor to conclude on the financial statements as a whole (e.g., the client's financial records were all destroyed in a fire), the auditor will issue a "disclaimer of opinion," indicating that it is not possible to express an opinion on the fairness of the financial statements.

The audit report represents the culmination of the audit process and is the way the auditor communicates their opinion about a client's financial statements with outside parties. An example of an unqualified audit report is included in this chapter to give you a basic idea of what the most common type of audit report for a public company looks like and how auditors report their opinion to the public.

While it is important for you to be familiar with the basic components of the audit report as part of understanding an overview of the audit process, we cover the different types of financial statement audit reports in detail in Chapter 18. Our experience is that while it is helpful to get an idea of what an audit report looks like early on, students find it more useful to learn the fundamental concepts of auditing and how an audit is conducted before being immersed in the details of audit reporting.

LO 1-10 Audit Data Analytics

As we mentioned earlier in this chapter, many audit processes are being transformed by the use of data analytics and other emerging audit technologies. These are exciting developments as technology eventually will automate much of the more tedious work that auditors have traditionally done, leaving more time for them to better understand the businesses they are auditing and the underlying risks related to financial reporting. Emerging audit technologies, including audit data analytics, promise to make junior auditors' work more interesting and challenging, and have the potential to dramatically enhance the effectiveness and the value of the external audit. A whole host of technologies are emerging that promise to have dramatic effects on business and on the financial statement audit, including robotics, distributed blockchain databases, and artificial intelligence; you will need to stay up to date on these more advanced technologies as their uses and implications emerge in the coming years. Because audit data analytics is *already* reshaping the audit, we aim to give you a solid foundation in understanding and applying this aspect of emerging audit technology in this book.

This section gives a very brief overview of what audit data analytics is, and how technology promises to reshape what auditors do and how they do it. Appendix B at the back of this book covers audit data analytics in greater detail. In addition to that Appendix, several chapters provide specific examples of how audit data analytics are being applied to show you how that technology continues to shape the way audit work is done. Several chapters also have hands-on cases that use data analysis techniques such as data visualization using Tableau®. This section will provide you the basic understanding you need to take advantage of the data analytics discussions throughout this text.

Practice INSIGHT

A recent report by PwC titled "2018 AI Predictions" gives some insight into likely practical implications of advancing audit technology. The report indicates that while accounting and auditing jobs may change as AI use becomes more prevalent, these jobs won't go away. For example, PwC financial statement auditors are using AI-driven technologies to audit cash by taking over the tedious task of identifying and organizing relevant data from client bank statements. PwC indicates that this application of AI has not resulted in fewer people being involved in audits; rather, the nature of their duties has become more interesting and challenging.

According to the PwC report, AI and other audit technologies are helping to automate the process of extracting, organizing, and structuring relevant data before the auditor applies judgement and expertise in further analyzing them. As a result, PwC predicts, fundamental skills including skepticism, judgement, analytical abilities, as well as auditors' knowledge of business, technical accounting, and fundamental auditing concepts, will become even more vital. PwC believes that AI is unlikely to be able to replace these auditor attributes in the foreseeable future.

Audit Data Analytics (ADA)

The unprecedented improvements in computer-based analytics are fundamentally changing the way audits are being conducted. Computerization and cognitive technologies are allowing for greater precision, higher-quality information, and more in-depth analysis in audits. *Audit data analytics* (ADA), which is a key part of these emerging audit technologies, can be defined as follows:

> **Audit data analytics** is using analysis, modelling, and visualization to discover and analyze patterns, anomalies, and other information in data in the context of the audit.

This definition alludes to some significant changes in the audit process. First, the methods auditors use to assess risk and gather evidence are becoming much more heavily dependent on "*analysis, modelling, and visualization*" of large sets of data. Digital automation is allowing auditors to analyze and understand enormous sets of information instead of relying solely on samples to extrapolate the effectiveness of accounting processes and the accuracy of account balances. Predictive audit data analytics also work to combine firm, industry, and market data to provide auditors a deeper understanding of business risks and enhanced expectations of what account balances ought to be, making it easier for auditors to identify numbers that might be off. In terms of visualization, data can be presented to users of financial statements, management, and the audit team in ways that match their various needs and interests, including helping auditors spot patterns that don't match up with their knowledge of the client's business. Data analytics is also rapidly redefining the concepts of discovering and analyzing "*patterns*" and "*anomalies.*"

When applying data analytics to the audit process, the AICPA recommends a five-step process to plan, perform, and evaluate results: (1) plan the ADA, (2) access and prepare the data to be used in the ADA, (3) consider the relevance and reliability of the data used, (4) perform the ADA, and (5) evaluate and interpret the results of the ADA. A thorough discussion of each of these steps is provided in Appendix B, and examples of how to apply ADAs are found throughout the book, with additional online resources as assigned by your instructor.

Financial Technologies

The ability for auditors to better manipulate and analyze information using data analytics is facilitated by rapid advances in electronic technologies used by many businesses. Paper files and hard-copy documents are quickly being replaced with digital files on cloud-based servers, especially among larger companies. Auditors must understand risks associated with IT-infrastructure that encompasses the rapidly growing and changing digital environment. At the same time, with greater use of emerging technologies, audit trails can be created automatically, virtually tracking the digital signatures. The electronic authentication of user credentials and validation of data will facilitate the ability of auditors to efficiently corroborate the reliability of data.

Among other technologies, blockchain represents the potential to resolve many issues surrounding the growing use of digital data. Blockchain allows for the use of decentralized, distributed digital ledgers that record economic transactions. Transactions are divided into batches called blocks that are visible to all those with access across a distributed network and that cannot be altered retroactively. Each new block of transactions is chronologically *chained* to previously created blocks to connect information regarding all changes made and who made the changes. This technology allows for enhanced transparency of transactions, increased operating efficiency, and greater reliability of data and data trails. Blockchain eventually may lead to very significant changes in the business world, including financial statement auditing.

Technology and Professional Judgement

You will not need to be an expert in technology and computer programming to be successful in your career as a financial statement auditor, but you will need to be comfortable using a variety of software tools and you will need to develop a practical knowledge of how to use audit data analytics to query, manipulate, and interpret information. The good news is that audit data analytics will increasingly streamline the more tedious, mundane tasks that junior auditors have traditionally carried out. At the same time, it is important for you to know that increased use of technology will make it more and more important for audit professionals to be able to reason through challenging business, accounting, and auditing concepts, not less! Increasing use of audit data analytics places an even greater premium on auditors' ability to ask the right questions and to insightfully evaluate the answers yielded by the data. Such reasoning requires a solid understanding of the toolkit of fundamental auditing concepts we will share with you throughout this book. We think you will find it fascinating to better understand how the combined application of audit data analytics and auditor judgement can be used to change and enhance the role of the financial statement auditor!

LO 1-11 Conclusion

You can see from this chapter that a good financial statement auditor needs to understand not only accounting but also the concepts and techniques of gathering and evaluating evidence to assess management's financial statement assertions. In addition, an auditor needs a deep understanding of business in general as well as of the specific industries in which their clients operate. This is why professionals with auditing experience frequently have attractive opportunities to move into other areas of business and management. Chief executive officers, business owners, chief financial officers, consultants, and controllers are often former auditors.

This chapter is designed to help you develop an understanding of basic auditing concepts. As you study auditing, you will need to commit some details to memory. But we can't emphasize this enough*: you will understand and appreciate the details of the auditing process much more fully if you make a serious effort to understand at a common-sense level why financial statement auditing is in demand, the fundamental concepts and logic underlying an audit, and the basic processes by which it is carried out.*

Keep in mind that auditing is a fundamentally logical process of thinking and reasoning—do not be hesitant to exercise your common sense and reasoning skills! You will benefit much more from your reading of this text (and likely do better on exams) if you study it with a reasoning, inquisitive approach, rather than merely attempting to memorize details. As you learn new auditing concepts, take some time to understand the underlying logic and how the concepts interrelate with other concepts. As you learn about auditing procedures, ask yourself how and why the procedure might yield relevant evidence, and think of other ways you might obtain useful evidence. Rote memorization alone is not a good way to study auditing!

Being a good auditor sometimes requires imagination and innovation. For example, a few years back an auditor was faced with figuring out how to verify a client's assertion regarding the existence of inventory. The problem was that the "inventory" consisted of thousands of head of cattle on a ranch covering dozens of square miles. There was no standard procedure manual for the auditor to refer to—he simply had to figure out an effective and efficient way to obtain persuasive evidence that the cattle existed in the numbers asserted by the ranch's management.

In the end, the auditor decided to use a drone to fly over the ranch and systematically take photos. The auditor was able to obtain a count of the cattle from the photos. He also evaluated veterinary records to see if the number of required annual vaccinations delivered by the vet approximated the number of cattle counted in the photos. Finally, he did some calculations based on average bovine birth and death rates, taking into account recorded purchases and sales of livestock during the year. Using this combination of procedures, the auditor was able to obtain persuasive evidence supporting management's assertion regarding inventory.

We hope this example helps illustrate why you will need to approach the study of auditing differently from that of accounting courses, and how learning auditing concepts can benefit you even if you do not plan to become a financial statement auditor. We can promise you this—in learning the concepts and techniques of auditing, you will not only acquire the tools to become an effective financial statement auditor, you will also learn new ways of reasoning and analyzing that will be highly useful to you in many different contexts and settings.

KEY TERMS

- *Assertions*
- *Assurance services*
- *Attest services*
- *Audit data analytics*
- *Audit evidence*
- *Audit risk*
- *Auditing*
- *Information asymmetry*
- *Materiality*
- *Reasonable assurance*

REVIEW QUESTIONS

LO 1-1 **1-1** Why is studying auditing different from studying financial accounting? How might understanding auditing concepts prove useful for accountants, business managers, consultants, and other business decision makers?

LO 1-2 **1-2** Discuss why there is a demand for auditing and assurance services in a free-market economy. What evidence suggests that auditing would be demanded even if it were not required by government regulation?

LO 1-2 **1-3** What is meant by the statement "The agency relationship between absentee owners and managers produces a natural conflict of interest"?

LO 1-2 **1-4** Why is independence such an important requirement for auditors? How does independence relate to the agency relationship between owners and managers?

LO 1-4, 1-5 **1-5** Define *auditing*, *attest*, and *assurance services*.

LO 1-5 **1-6** The Committee on Basic Auditing Concepts has provided a widely cited definition of auditing. What does the phrase "systematic process" mean in this definition?

LO 1-6 **1-7** Define audit risk and materiality. How are these concepts reflected in the auditor's report?

LO 1-8 **1-8** What are the major phases of an audit?

LO 1-8 **1-9** What is the purpose of the planning phase of an audit? What are the primary elements involved in this phase?

LO 1-9 **1-10** Identify the main sections of the auditor's standard unmodified report for a public company client.

LO 1-10 **1-11** Discuss why the emergence of advanced audit technologies, such as audit data analytics, is placing an even greater premium on auditors' knowledge of fundamental business, accounting, and auditing concepts, and on their ability to exercise professional judgement.

LO 1-11 **1-12** Briefly discuss why auditors must often exercise creativity and innovation in auditing financial statements.

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MULTIPLE-CHOICE QUESTIONS

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LO 1-2, 1-5 1-13 An independent audit adds value to the communication of financial information because the audit

1. Confirms the exact accuracy of management's financial representations
2. Lends credibility to the financial statements
3. Guarantees that financial data are fairly presented
4. Assures the readers of financial statements that any fraudulent activity has been corrected

LO 1-2, 1-5 1-14 Which of the following best describes the reason why an independent auditor is often retained to report on financial statements?

1. Management fraud may exist, and it is more likely to be detected by independent auditors than by internal auditors.
2. Different interests may exist between the entity preparing the statements and the persons using the statements, and thus outside assurance is needed to enhance the credibility of the statements.
3. A misstatement of account balances may exist, and all misstatements are generally corrected as a result of the independent auditor's work.
4. An entity may have a poorly designed internal control system, and an independent auditor is required to detect deficiencies in internal control.

LO 1-4 1-15 Which of the following best describes relationships among auditing, attest, and assurance services?

1. Attest is a type of auditing service.
2. Auditing and attest services represent two distinctly different types of services—there is no overlap.
3. Auditing is a type of assurance service.
4. Assurance is a type of attest service.

LO 1-4 1-16 Which of the following statements relating to attest and assurance services is *not* correct?

1. Independence is an important attribute of assurance service providers.
2. Assurance services can be performed to improve the quality or context of information for decision makers.
3. Financial statement auditing is a form of attest service but it is not an assurance service.
4. In performing an attest service, the CPA determines the correspondence of the subject matter (or an assertion about the subject matter) against criteria that are suitable and available to users.

LO 1-6, 1-8 1-17 For what primary purpose does the auditor obtain an understanding of the entity and its environment?

1. To determine the audit fee
2. To decide which facts about the entity to include in the audit report
3. To plan the audit and determine the nature, timing, and extent of audit procedures to be performed
4. To limit audit risk to an appropriately high level

LO 1-6 1-18 Which of the following statements best describes the role of materiality in a financial statement audit?

1. *Materiality* refers to the "material" from which audit evidence is developed.
2. The higher the level at which the auditor assesses materiality, the greater the amount of evidence the auditor must gather.
3. The lower the level at which the auditor assesses materiality, the greater the amount of evidence the auditor must gather.
4. The level of materiality has no bearing on the amount of evidence the auditor must gather.

LO 1-8 1-19 Which of the following is the most important reason for an auditor to gain an understanding of an audit client's system of internal control over financial reporting?

1. Understanding a client's system of internal control can help the auditor assess risk and identify areas where financial statement misstatements might be more likely.
2. Understanding a client's system of internal control can help the auditor make valuable recommendations to management at the end of the engagement.
3. Understanding a client's system of internal control can help the auditor sell consulting services to the client.
4. Understanding a client's system of internal control is not a required part of the audit process.

LO 1-8 1-20

Preliminary engagement activities include

1. Understanding the client's operations and industry
2. Determining audit engagement team requirements
3. Ensuring the independence of the audit team and audit firm
4. All of the above

LO 1-9 1-21

Which of the following statements best describes what is meant by an unqualified audit opinion?

1. Issuance of an unqualified auditor's report indicates that in the auditor's opinion the client's financial statements are not fairly enough presented in accordance with agreed-upon criteria to qualify for a clean opinion.
2. Issuance of an unqualified auditor's report indicates that the auditor is not qualified to express an opinion that the client's financial statements are fairly presented in accordance with agreed-upon criteria.
3. Issuance of an unqualified auditor's report indicates that the auditor is expressing different opinions on each of the basic financial statements regarding whether the client's financial statements are fairly presented in accordance with agreed-upon criteria.
4. Issuance of a standard unqualified auditor's report indicates that in the auditor's opinion the client's financial statements are fairly presented in accordance with agreed-upon criteria, with no need for the inclusion of qualifying phrases.

LO 1-9 1-22

The auditing standards that are used to guide the conduct of the audit are

1. Implicitly referred to in the key audit matters section of the auditor's standard report
2. Explicitly referred to in the key audit matters section of the auditor's standard report
3. Implicitly referred to in the basis for opinion section of the auditor's standard report
4. Explicitly referred to in the basis for opinion section of the auditor's standard report

LO 1-9 1-23

A client has used an inappropriate method of accounting for its pension liability on the balance sheet. The resulting misstatement is material, but the auditor does not consider its effect to be pervasive. The auditor is unable to convince the client to alter its accounting treatment. The rest of the financial statements are fairly stated in the auditor's opinion. Which kind of audit report should the auditor issue under these circumstances?

1. Standard unqualified opinion
2. Qualified opinion due to departure from GAAP
3. Adverse opinion
4. No opinion at all

PROBLEMS

1-24 LO 1-2 Greenbloom Garden Centres is a small, privately held corporation that has two stores in Oshawa, Ontario. The Greenbloom family owns 100 percent of the company's shares, and family members manage the operations. Sales at the company's stores have been growing rapidly, and there appears to be a market for the company's sales concept—providing bulk garden equipment and supplies at low prices. The controller prepares the company's financial statements, which are not audited. The company has no debt but is considering expanding to other cities in Ontario. Such expansion may require long-term borrowings and is likely to reduce the family's day-to-day involvement in all of the company's operations. The family does not intend to sell shares in the company. ***Required*:** Discuss the factors that may make an audit necessary and potentially valuable for the company. Be sure to consider the concept of information risk.

1-25 LO 1-2, 1-5, 1-6 You were recently hired by the CPA firm of Honson & Hansen. Within two weeks, you were sent to the first-year staff training course. The instructor asks you to prepare answers for the following questions:

1. How is audit evidence defined?
2. How does audit evidence relate to assertions and to the audit report?
3. What characteristics of evidence should an auditor be concerned with when searching for and evaluating audit evidence?

1-26 LO 1-8 John Josephs, an audit manager for Tip, Acanoe & Tylerto, was asked to speak at a dinner meeting of the local Small Business Administration Association. The president of the association has suggested that he talk about the various phases of the audit process to help small business owners better understand what auditors do. John has asked you, his trusted assistant, to prepare an outline for his speech. He suggests that you answer the following:

1. List and briefly describe the various phases of an audit.
2. Describe how audit procedures involving tests of controls can provide indirect evidence about whether financial statement account balances are free of material misstatement.
3. One of the phases involves understanding an entity's internal control. Why might the members of the association be particularly interested in the work conducted by auditors in this phase of the audit?

1-27 LO 1-9 Many companies post their financial statements and auditor's report on their home pages, generally under a heading labeled "investor relations." Use one of the Internet search engines to do the following:

1. Visit U.S.-company home pages such as Intel's (www.intel.com) and Microsoft's (www.microsoft.com) home pages and review their financial statements, including their auditors' reports. (*Hint:* Look for the auditor's opinion in the company's annual report under an "investor relations" tab.)
2. Search the web for the home page of a Canadian company and review its financial statements, including its auditor's report. For example, RBC's home page (www.rbc.com, under Investor Relations) allows a visitor to download the financial statements and accompanying audit report as a PDF. Identify the auditing standards followed by the company's auditors.
3. Compare the standard Canadian audit report with the audit report for the U.S. company.
4. Visit the SEDAR website (www.sedar.com), and find the link for Search tools. Find and download the auditor's report for a company of your choice. Identify whether the audit report is an unqualified, or "clean," opinion and explain how you could tell.

1-28 LO 1-9 Using the audit report included in Chapter 1, identify and briefly explain the phrases or words that indicate to the users that the financial statements are not necessarily an "exact" representation of the results of operations and financial position of a company.

DISCUSSION CASE

LO 1-1, 1-2

1-29 You recently attended your five-year college reunion. At the main reception, you encountered an old friend, Dashawn Beagle, who recently graduated from law school and is now practising with a large law firm in town. When you told him that you are a CPA and employed by a regional CPA firm, he made the following statement: "You know, if the securities acts had not been passed in the 1930s, no one would be interested in having an audit performed." ***Required*:** Draft a one-page memo that highlights your thoughts about Dashawn's statement that audits only take place because they are required by law.

INTERNET ASSIGNMENT

LO 1-1, 1-11

1-30 Identify five Internet sites that contain accounting or auditing resources. For each site identified, prepare a brief summary of the types of information available. For example, the CPAB (Canadian Public Accountability Board, www.cpab-ccrc.ca) and PCAOB (Public Company Accounting Oversight Board, www.pcaobus.org) home pages contain extensive information on the organization's activities (you may use either the CPAB or the PCAOB site as one of the five). Your five summaries should not exceed a total of one typed page.

The Financial Statement Auditing Environment

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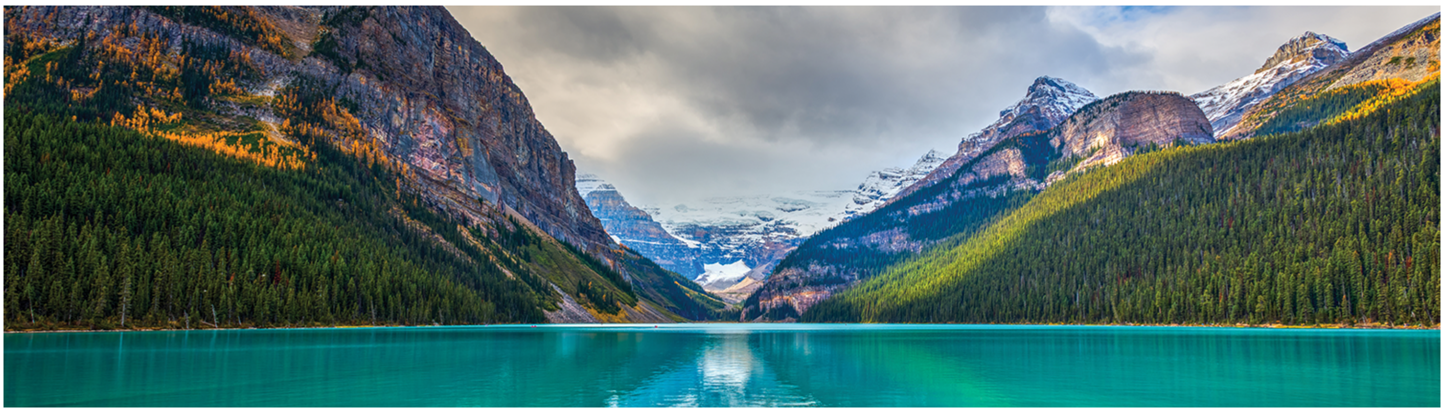

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LEARNING OBJECTIVES

Upon completion of this chapter you will

1. 2-1Be familiar with the different types of auditors.
2. 2-2Be familiar with the various types of audit, attest, and assurance services offered by accounting professionals.
3. 2-3Understand the organization of public accounting firms and the composition of audit teams.
4. 2-4Understand the significant changes that have taken place in the auditing profession over the past two decades.
5. 2-5Know that management is primarily responsible for the entity's financial statements and understand the auditor's responsibility for detecting errors, material fraud, and illegal acts.
6. 2-6Recognize that an audit is shaped by the auditee's business, industry, and economic environment and understand the essential components and processes characteristic of most business entities.
7. 2-7Be familiar with a model of business processes used to organize an audit.
8. 2-8Identify and be familiar with the major organizations that affect the public accounting profession's environment.
9. 2-9Understand that auditing standards are established by CPA Canada and are consistent with international standards.
10. 2-10Be familiar with the principles underlying an audit conducted in accordance with Canadian generally accepted auditing standards.
11. 2-11Understand the nature of auditing standards.
12. 2-12Understand that the auditing profession places a premium on ethical behaviour and is governed by the Rules of Professional Conduct.

RELEVANT ACCOUNTING AND AUDITING PRONOUNCEMENTS

***CPA Canada Handbook*, Part I—IFRS Standards**, The Conceptual Framework for Financial Reporting, Chapter 2, Qualitative Characteristics of Useful Financial Information

Preface to the *CPA Canada Handbook*—Assurance, Canadian Auditing Standards

CAS 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards

CAS 240, The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

CAS 250, Consideration of Laws and Regulations in an Audit of Financial Statements

CAS 260, Communications with Those Charged with Governance

CAS 315, Identifying and Assessing Risks of Material Misstatement

CAS 330, The Auditor's Responses to Assessed Risks

CAS 500, Audit Evidence

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This chapter is designed to give you an overview of the auditing profession and to help you understand the environment in which auditors function. The chapter begins by briefly introducing the various types of auditors and the types of audit, attest, and assurance services that auditors offer. This is followed by a description of public accounting firms and a discussion of the far-reaching changes in the public accounting profession over the past two decades. One of the most important and useful skills auditors develop is the ability to quickly understand and analyze various business models, strategies, and processes and to identify key risks relevant to a particular entity—these elements largely shape the immediate context in which auditing is performed. Accordingly, the chapter introduces a high-level model of business that is useful for organizing an audit. The chapter then discusses the major professional and regulatory organizations that affect the public accounting profession and explains how auditing standards are established in today's professional and regulatory environment. Because ethical behaviour and reputation play key roles in shaping the public accounting profession and its environment, the chapter provides a brief overview of the profession's Rules of Professional Conduct.

The book also includes Appendix A: Professional Judgement Framework on professional judgement in auditing, which your instructor may assign you to read. Based on the award-winning *KPMG Professional Judgment Framework*, this appendix will help you begin to develop your own professional judgement by learning what a good audit judgement process looks like and how to avoid common traps and biases.

LO 2-1 Types of Auditors

This book focuses primarily on external auditors and how they provide assurance on the financial statements they audit. However, before moving ahead to help you understand the environment in which external auditors work, let's briefly discuss exactly what an external auditor is and introduce you to some other types of auditors, including internal auditors, government auditors, and forensic auditors. One important requirement for each type of auditor is independence in some form from the entity being audited. As described below, each different type of auditor usually specializes in a particular type of audit work. However, each type of auditor often provides more than one of the various types of audit and other services described in the next section.

External Auditors

External auditors are often referred to as *independent auditors*. An external auditor may practise as a sole proprietor or as a member of a CPA firm, as discussed later in this chapter under "Public Accounting Firms." Such auditors are called "external" or "independent" because they are not employees of the entity being audited. The terms *external auditor* and *independent auditor* are generally used interchangeably. External auditors audit financial statements for publicly traded and private companies, partnerships, universities, government entities (such as counties, school districts, and municipalities) and other types of entities. They may also conduct compliance, operational, and forensic audits for such entities (see next section).

To sign an audit opinion on an entity's financial statements in Canada, an external auditor must be a *chartered professional accountant* (CPA). The CPA certificate is regulated by provincial or territorial law through departments in each province.[1] Provincial and territorial requirements for CPA certification can be summed up as the "Three Es"—Education, Examination, and Experience. The education requirement for becoming a CPA is usually a minimum certification requirement of a university degree with selected courses in business and accounting. In addition, the provinces and territories typically require 30 months of professional experience before the CPA certificate is granted. All provinces and territories require that an individual pass the Common Final Examination (CFE), administered by CPA Canada (see Exhibit 2–1). CPA Canada is the primary professional organization supporting external auditors, and is discussed in some detail later in this chapter under "Auditing Standards."

EXHIBIT 2–1 The CPA Common Final Examination*

The Common Final Examination is a national exam delivered across Canada. An individual must pass the examination in order to qualify for licensure as a CPA in Canada. There is no national CPA licensure process in Canada—CPA licences are issued by each province or territory. The purpose of the CPA Common Final Examination is to perform a competency-based assessment that enables those governing the profession to determine which candidates demonstrate readiness to enter the profession.

Examination Content

The CPA examination is conducted over three days and has six sections: Financial Reporting, Strategy and Governance, Management Accounting, Audit and Assurance, Finance, and Taxation.

Public accounting candidates must demonstrate depth in Financial Reporting and Assurance. All candidates must demonstrate depth in two areas: one of *either* Financial Reporting *or* Management Accounting *and* any other competency area.

The assessment of Day 1 is a case that focuses on enabling skills—for example, a candidate's ability to apply critical thinking, decision-making skills, professional judgement, and integration. The case on Day 2 will test the candidates depth within their two chosen areas of competence. The Day 3 assessment focuses on ensuring candidates are well-rounded professionals who can address an array of issues by presenting a variety of different small cases and roles. Day 3 provides additional depth opportunities in Financial Reporting and Management Accounting competencies and ensures candidates have sufficient breadth of competency in all six competency areas.

Sections

- *Financial Reporting:* Includes the role of financial reporting, the application of reporting frameworks, the reporting of routine and nonroutine transactions in different circumstances, and an understanding of the role of internal control, tax, and finance in financial reporting.
- *Strategy and Governance:* Includes the role of corporate governance within an organization and the formulation of strategies, the translation of those strategies into specific business objectives and actions, and their implementation.
- *Management Accounting:* Includes identifying management information needs and developing the systems required to meet those needs; planning, forecasting, budgeting, and cost and revenue management for an entity; and performance measurement systems.

- *Audit and Assurance:* Includes enhancing the reliability of information through internal activities such as internal control and internal and comprehensive auditing, and external, third-party assurance services such as auditing.
- *Finance:* Includes financial analysis and planning, treasury management, capital budgeting, business valuation, and corporate finance transactions.
- *Taxation:* Includes tax compliance and reporting, tax planning and implementation strategies for both corporate and personal taxpayers, and an understanding of the administrative processes in Canadian taxation.

In addition to the technical competencies listed above, candidates are expected to demonstrate capability in the following seven enabling competencies expected of a professional: (1) Acting Ethically and Demonstrating Professional Values, (2) Leading, (3). Collaborating, (4) Managing Self, (5) Adding Value, (6) Solving Problems and Making Decisions, and (7) Communicating.

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Internal Auditors

Auditors who are employees of individual companies, government agencies, and other entities are called internal auditors. In major corporations, internal audit staffs are often quite large, and the director of internal auditing is usually a senior executive title within the entity.

The Institute of Internal Auditors (IIA) is the primary professional organization supporting internal auditors. Its mission is to "provide dynamic leadership for the global profession of internal auditing." The IIA has developed a set of professional standards to be followed by internal auditors and has established a certification program. An individual who meets the certification requirements established by the IIA, including passing a uniform written examination, can become a certified internal auditor (CIA).[2] Many internal auditors also have a CPA designation.

The IIA defines internal auditing as "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."

Internal auditors often conduct financial, internal control, compliance, operational, and forensic audits within their organizations (see next section, "Types of Other Audit, Attest, and Assurance Services"). In some cases they may assist external auditors with the annual financial statement audit. Internal auditors also often are involved in assurance and consulting engagements for their entities. Chapter 21 offers details on the IIA and the internal auditing profession.

Government Auditors

Government auditors are employed by federal, provincial, and local governments or other government organizations. Government auditors are usually considered to be a type of internal auditor. At the federal level, two agencies use auditors extensively: the Office of the Auditor General (OAG) and Canada Revenue Agency (CRA). The OAG is under the direction of the Auditor General of Canada and is responsible to Parliament, not the government of the day. OAG auditors conduct audits of activities, financial transactions, and public accounts of the federal government. They also assist Parliament by performing value-for-money audits, special examinations, and investigations.

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The CRA is a Federal Government department. The main activity of CRA auditors is examining the books and records of organizations and individuals to determine whether their tax returns are accurate and in compliance with applicable tax laws and regulations.

Most provinces, territories, and local governments have departments or agencies that perform functions similar to the OAG and CRA but at the provincial, territorial, or local level.

Forensic Auditors

Forensic auditors are employed by corporations, government agencies, public accounting firms, and specialized consulting and investigative services firms. They are specially trained in detecting, investigating, and deterring fraud and white-collar crime (see the discussion of forensic auditing later in this chapter under "Forensic Audits"). Some examples of situations where forensic auditors are often involved are

- Reconstructing incomplete or damaged accounting records to settle an insurance claim over inventory valuation
- Probing money-laundering activities by tracking and reconstructing cash transactions
- Identifying and investigating transactions and assets in business or marital disputes
- Investigating and documenting embezzlement allegations and negotiating insurance settlements

The Association of Certified Fraud Examiners (ACFE) is the primary professional organization supporting forensic auditors. The ACFE is an 90,000-member professional organization dedicated to reducing the incidence of fraud and white-collar crime and assisting its members in fraud detection and deterrence.

The ACFE offers a certification program for individuals wanting to become CFEs. An individual interested in becoming a CFE must pass the CFE Examination.[3] CFEs have various professional backgrounds, including auditors, accountants, fraud investigators, loss prevention specialists, attorneys, educators, and criminologists. CFEs gather evidence, take statements, write reports, and assist in investigating fraud in its varied forms. They sometimes act as expert witnesses in court cases.

LO 2-2 Types of Other Audit, Attest, and Assurance Services

Opportunities where auditors can provide audit, attest, or assurance services arise from the need for management to be accountable to employees, shareholders, customers, and communities. In this section, examples of these types of services other than the standard audit of financial statements, which is the primary focus of this book, are briefly discussed.

Other Audit Services

In addition to the financial statement audit, there are four major types of audits: internal control audits, compliance audits, operational audits, and forensic audits. These audits are often performed by auditors employed by public accounting firms, but similar services may be performed by internal, forensic, or governmental auditors.

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Internal Control Audits

Financial statement auditors have always had the option of testing internal controls as a method of obtaining evidence about the fairness of the financial statements. However, until the early 2000s, auditors were generally neither required nor allowed to express an opinion on an entity's system of internal control as part of a financial statement audit.[4] This changed when the Sarbanes-Oxley Act (SOX) of 2002 required public companies listed on exchanges in the United States to engage an external auditor to provide an opinion on the effectiveness of internal control in addition to an opinion on the financial statements. Canadian companies listed on a U.S. exchange are also required to have such an audit. However, an audit of internal control is available but not required for private entities.

In 2003 the Ontario government passed Bill 198, which echoes the intent of Sarbanes-Oxley and is known as the Canadian Sarbanes-Oxley Act (C-SOX). This legislation requires chief executive officers and chief financial officers to verify that their annual and interim filings are accurate representations of their company's current financial status. This is similar to basic components of SOX 404. However, there is no requirement in C-SOX for Canadian companies to have auditors provide an opinion on the effectiveness of internal controls as there is for financial statements.

Because the objectives and work involved in performing an audit of internal control and an audit of financial statements are closely interrelated, auditing standards for publicly accountable enterprises require an *integrated audit* of internal control and financial statements. You will learn more about the audit of internal control for public companies in Chapter 7.

Compliance Audits

A compliance audit determines the extent to which rules, policies, laws, covenants, or government regulations are followed by the entity being audited. For example, a university may be required to obtain an audit to ensure that applicable rules and policies are being followed with respect to the granting of student loans. Another example of compliance auditing is the examination of tax returns of individuals and companies by the Canada Revenue Agency for compliance with the Income Tax Act.

Operational Audits

An operational audit involves a systematic review of part or all of an organization's activities to evaluate whether resources are being used effectively and efficiently. The purpose of an operational audit is to provide assurance, assess performance, identify areas for improvement, and develop recommendations with respect to operational effectiveness and efficiency. Sometimes this type of audit is referred to as a *performance audit* or *management audit*. Operational audits present different challenges than financial statement audits or compliance audits because operational audits often require the auditor to identify or create objective, measurable criteria against which to assess effectiveness and efficiency. Some operational audits, such as information technology (IT) or cybersecurity audits, require specialized skills and expertise. Operational auditing has increased in importance in recent years, and this trend will likely continue. An example of an operational audit is where an entity employs auditors to assess the efficiency and effectiveness of its use of information technology resources.

Forensic Audits

The purpose of a forensic audit is to detect or deter fraudulent activities. Forensic auditing has increased significantly in recent years. As we mentioned above in discussing forensic auditors, some examples of where a forensic audit might be conducted include business or employee fraud, various other types of criminal investigations where money or other assets are involved, and matrimonial disputes involving division of assets.

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Occupational fraud is a widespread problem that affects practically every organization. Occupational frauds fall into one of three major categories: asset misappropriations (e.g., stealing inventory), corruption (e.g., bribing government officials), and fraudulent financial statements (e.g., intentionally overstating assets in order to receive a bank loan). All three types of potential fraud are of concern to auditors but financial statement fraud typically represents the gravest concern because the amounts involved are often higher.

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Attest Services

Auditors can provide numerous types of attest services regarding almost any subject matter. For example, an auditor might be asked to attest to the nature and quantity of inventory stored in an entity's warehouse so that the entity can obtain a bank loan with the inventory as collateral. A promising new area of attestation services relates to assertions companies make about sustainability–claimed reductions in carbon emissions or appropriate handling of hazardous waste, for example. Chapter 21 presents more detailed information about attest services.

Assurance Services

As we discussed in Chapter 1, auditing and attestation are specialized forms of the more general category of assurance services. Thus, CPAs can offer a variety of services that provide assurance but that do not qualify as auditing or attestation. Assurance services provided by CPAs are governed by either the attest or consulting standards. Chapter 21 provides more detailed information on assurance services.

Non-audit Services

In addition to audit, attest, and assurance services, many public accounting firms perform three broad categories of *non-audit* services. Note that C-SOX prohibits external auditors from providing many forms of non-audit assurance and consulting work to public companies for which the auditor also provides a financial statement audit (see Chapter 19).

Tax Preparation and Planning Services

Many public accounting firms have tax professionals that assist clients with preparing and filing tax returns, provide advice on tax and estate planning, and represent clients on tax issues before the Canada Revenue Agency or tax courts.

Management Advisory Services

Management advisory services (MAS) involve providing advice and assistance concerning an entity's organization, human resources, finances, operations, IT systems, or other activities. Another significant MAS service area is helping public companies implement effective internal control over financial reporting in preparation for an integrated audit to be performed by a different public accounting firm. Due to independence requirements, CPA firms perform MAS primarily for private entities or for public companies for whom they do not provide a financial statement audit. The large public accounting firms all have very robust MAS consulting practices for non-audit clients.

Compilation and Bookkeeping Services

Public accounting firms perform a number of accounting-related services for their non-public or non-audit clients. These services include bookkeeping, payroll processing, and preparing financial statements. When a public accounting firm prepares the financial statements of companies, the services are known as *compilations*. These forms of services provide less assurance than a financial statement audit. You will learn more about them in Chapter 21.

LO 2-3 Public Accounting Firms

Small organizations can be audited by a single auditor operating as the sole owner of a *public accounting firm*. However, larger businesses and other organizations require significantly more resources than a single auditor can provide. Thus, public accounting firms range in size from a single proprietor to thousands of owners (or "partners") together with tens of thousands of professional and administrative staff employees. In addition to financial statement audits, public accounting firms typically offer a wide variety of professional services, including many of those already discussed in this chapter.

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Organization and Composition

Public accounting firms are organized as proprietorships, general or limited liability partnerships, or corporations. Typically, relatively small, local public accounting firms are organized as proprietorships, general partnerships, or corporations. Regional, national, and international accounting firms are normally structured as limited liability partnerships (LLPs). Structuring public accounting firms as proprietorships and ordinary general partnerships does not provide limited liability for the owners (known as partners). In such cases, aggrieved parties can seek recourse not only against the CPA firm's assets but also against the personal assets of individual partners.

Because of the risk of litigation against CPAs, public accounting firms would typically organize as corporations if possible. However, provinces and territories do not allow accounting firms to organize as corporations; this prevents them from hiding behind the corporate veil to avoid claims of negligence if they occur. Hence, it is generally not possible for firms to structure themselves as corporations. This is why large national and international public accounting firms have structured themselves as limited liability partnerships (LLPs). An LLP is generally governed by the laws applicable to general partnerships. However, this organizational structure provides greater personal protection against lawsuits. Under an LLP, partners are not *personally* responsible for liabilities arising from *other* partners' and most employees' negligent acts. However, the personal assets of the *responsible* partner(s) and the assets of the partnership itself are vulnerable to lawsuits resulting from partners' or employees' acts.

Public accounting firms are often categorized by size. For example, the largest firms are the "Big 4" public accounting firms: Deloitte, Ernst & Young, KPMG, and PwC. These large international organizations have annual global revenues ranging from about US$29 billion to US$48 billion. Canadian revenues for these firms are estimated to range from about $1.5 billion to $3 billion. As a group, the Big 4 audit approximately 98 percent of all Canadian reporting issuers by market capitalization (typically on the TSX), according to the Canadian Public Accountability Board.[5]

Following the Big 4 in size are several national firms with international affiliations. This "mid-tier" group includes such firms as Grant Thornton, MNP, and BDO. The total annual revenue for each of these firms is estimated at less than $1 billion in Canada.

Lastly, there are many regional and local CPA firms that have one or a few offices. These firms provide audit, tax, accounting, and other services, generally to smaller entities than those served by the Big 4.

Audits are usually conducted by teams of auditors. The typical audit team is composed of a partner, a manager, one or two seniors, and several staff members. Audit teams for large international entities are typically made up of several partners and managers and many seniors and staff. The lead engagement partner has the authority and decision-making responsibility for auditing matters, including the issuance of the audit report. Table 2–1 summarizes some of the duties performed by each member of the audit team.

TABLE 2–1Selected Duties of Audit Team Members

Audit Team Member	**Selected Duties**
Partner	• Reach agreement with the auditee on the scope of the service to be provided. • Ensure that the audit is properly planned and that the audit is conducted in accordance with applicable auditing standards. • Assemble an audit team that has the required skills and experience. • Supervise the audit team and review the working papers. • Conclude on the adequacy of audit evidence and sign the audit report.

Audit Team Member	Selected Duties
Manager	• Ensure that the audit is properly planned, including scheduling of team members. • Supervise the preparation of and approve the audit program. • Review the working papers, financial statements, and audit report. • Recommend key audit judgements to partner, oversee the work of seniors and staff. • Deal with invoicing and ensure collection of payment for services. • Inform the partner about any auditing or accounting problems encountered.
Senior/In-charge	• Assist in the development of the audit plan. • Prepare budgets. • Assign tasks to associates and direct the day-to-day performance of the audit. • Perform procedures, gather and evaluate audit evidence. • Supervise and review the work of associates. • Inform the manager about any auditing or accounting problems encountered.
Associate/Staff	• Perform the audit procedures assigned to them. • Prepare adequate and appropriate documentation of completed work. • Inform the senior about any auditing or accounting problems encountered.

LO 2-4 Two Decades of Challenge and Change for Financial Statement Auditors

Events taking place in the business world during the past two decades have dramatically reshaped the environment in which external auditors work. You need to understand these events, because they continue to impact auditing today.

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During the economic boom of the late 1990s and early 2000s, accounting firms aggressively sought opportunities to market a variety of high-margin non-audit services to the entities they audited. Independence standards in force at the time allowed auditors to perform many such services, including information systems design and implementation and internal audit services, even for public company auditees. The consulting revenue of the largest public accounting firms grew very rapidly, until in many instances consulting revenues from auditees far exceeded the fee for the external audit.

In 1997 Bre-X Minerals, a Canadian company, was involved in one of the largest share swindles in history. Its Indonesian gold property, which was reported to contain more than 200 million ounces of gold, was said to be the richest gold mine ever. The share price for Bre-X skyrocketed, making millionaires out of ordinary people overnight. At its peak, Bre-X had a market capitalization of $4.4 billion.

For Bre-X the party ended on March 19, 1997, when the gold mine proved to be fraudulent, and the shares tumbled to pennies shortly after. The major losers were the Quebec public-sector pension fund, which lost $70 million, the Ontario Teachers' Pension Plan Board, which lost $100 million, and the Ontario Municipal Employees Retirement Board, which lost $45 million.

In October 2001, Enron, an energy trader based in Houston, Texas, became the subject of the United States Securities and Exchange Commission (SEC) investigation into its accounting practices. The investigation quickly uncovered massive financial deception that had been going on for several years. Arthur Andersen, the then "Big 5" public accounting firm that audited Enron's financial statements, immediately became embroiled in the controversy, because the firm had failed to report the extent of Enron's improper accounting. Many argued that this failure came about at least in part because Andersen was paid tens of millions of dollars in separate fees for consulting and internal auditing services, which amounted to significantly more than the fee for the external audit. Andersen stopped providing audits of public companies and began to dismantle its business in August 2002, after the firm was federally indicted and subsequently convicted on charges of obstruction of justice relating to the Enron situation. Though the conviction was later overturned by the U.S. Supreme Court, it was too late—the accounting firm of Arthur Andersen had already been broken up and sold off.

Shortly after the Enron incident, numerous other scandals involving corporate giants, brokerage firms, stock exchanges, mutual fund managers, and several of the large public accounting firms were uncovered. The Enron scandal alone weakened investor confidence in the stock market, but the subsequent series of scandals caused a crisis of confidence in the integrity of the entire system of public ownership and accountability in the United States, Canada, and nations around the world.

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Government Regulation

Under pressure to restore public confidence, in the United States the U.S. Congress passed the Sarbanes-Oxley Public Company Accounting Reform and Investor Protection Act in July 2002. The Act started a process of broad reform in corporate governance practices that would affect the duties and practices of public companies, financial analysts, external auditors, and securities exchange markets.[6]

Following the U.S. lead, Ontario introduced C-SOX in 2003. Also in that year, the Canadian Public Accountability Board (CPAB) was started. The CPAB ensures that the auditing standards for public companies are adhered to. As well, C-SOX mandated stricter independence rules, prohibiting auditors from providing many types of non-audit services to public companies that they had provided previously. C-SOX imposed several other important mandates, including that audit firms rotate audit partners on audit engagements every five years. C-SOX is important in its implications for boards and managements of public companies, for the accounting profession, and for the capital markets.

It would be difficult to overemphasize the impact of the events of the late 1990s and early 2000s on the auditing profession. While these changes caused pain and turmoil, they served to highlight and reaffirm the essential importance of auditing in our economic system, and the importance of integrity and professionalism in protecting the public interest.

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LO 2-5 Society's Expectations and the Auditor's Responsibilities

Because financial statement audits play an important role in the functioning of our economy, society expects auditors to exercise due care in their work. Due professional care requires that the auditor exercise *professional skepticism*, which is an attitude that includes a questioning mind and a critical assessment of audit evidence.[7] If the auditor fails to exercise due professional care, they can be held liable for civil damages or even criminal penalties.

Many people believe that auditors are ultimately responsible for the financial statements or at least that they have a responsibility to detect *all* errors, fraud, and *illegal acts*. This is simply not true, and is sometimes referred to as the *expectations gap*. While auditors must exercise professional skepticism and due care in their work, the effectiveness of internal control over financial reporting and the fairness of the financial statements ultimately are the responsibility of management. In fact, as noted in the Auditor's Report example given in Exhibit 1–1, it clearly states that management is responsible for the preparation and fair presentation of the financial statements in accordance with IFRS, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error. It is important to remember that while auditors have important responsibilities, *management* is primarily responsible for maintaining effective internal control and for ensuring the fairness of the company's financial statements.

The auditor's responsibility to provide reasonable assurance with respect to errors, fraud, and illegal acts clearly shapes the auditor's environment and the work that they perform. We share more information on auditors' responsibility for errors, fraud, and illegal acts in Chapters 3 and 4, and we provide details on auditors' potential legal liability in Chapter 20.

LO 2-6 The Context of Financial Statement Auditing

Chapter 1 explained why assurance is in demand, defined what auditing is, and laid out the phases through which financial statement auditing is carried out. This chapter is designed to help you understand how business and professional contexts shape the environment in which external auditors operate. You've already learned about different kinds of auditors and audit services, public accounting firms, and the auditor's role in society. Now let's turn our attention to the primary context that shapes the external auditor's environment: the organization being audited.

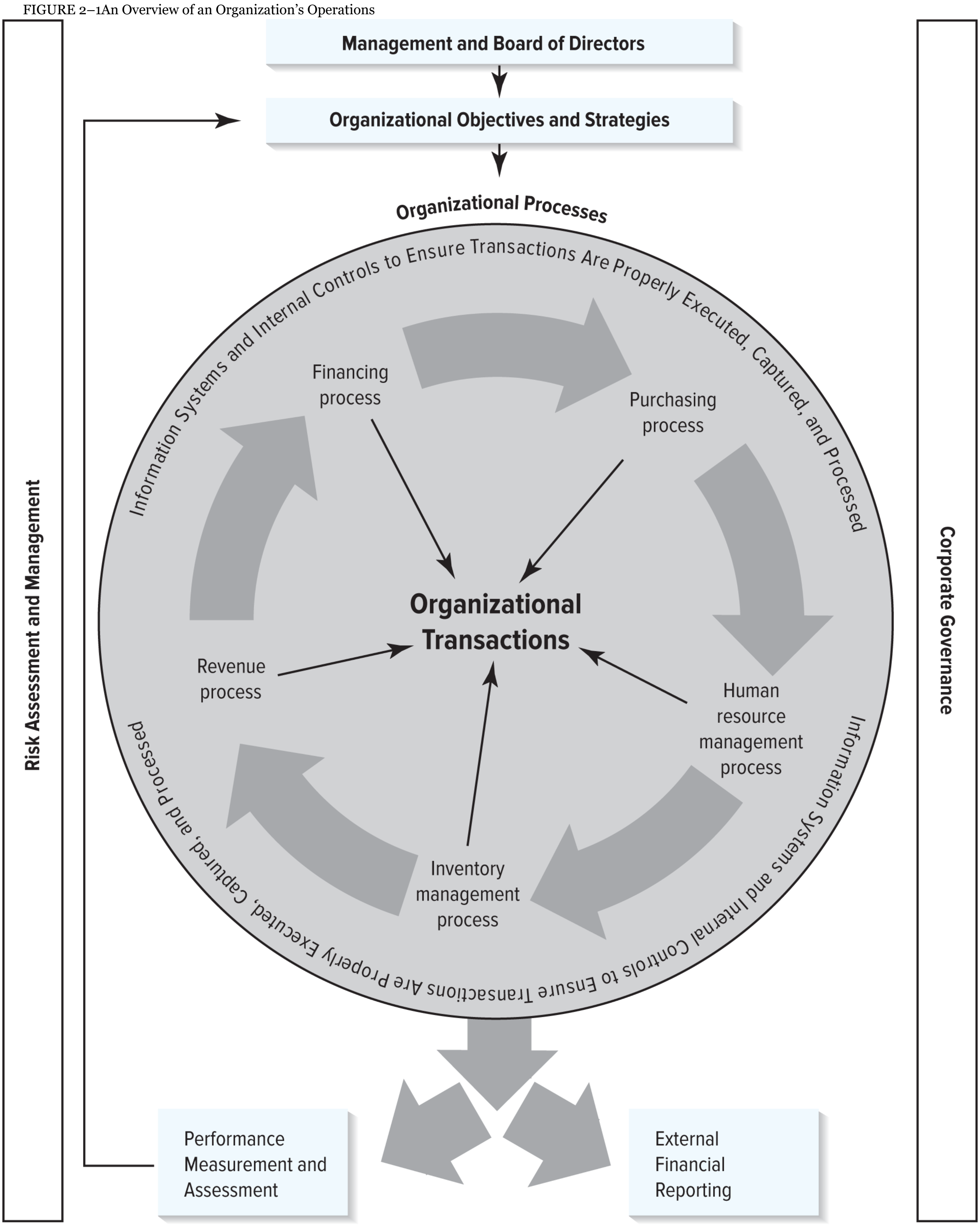
The Organization as the Primary Context of Auditing

In studying subsequent chapters, you will be building your auditing tool kit. How you apply auditing tools on any particular engagement will depend greatly on the nature of the entity's business. For example, if you are auditing a salmon farm in British Columbia coastal waters, some of your concerns will be whether the entity's inventories have been counted properly (which can be a real challenge when the inventory consists of live fish in multiple large ocean pens!) and whether they are free of disease. Otherwise, such inventory might not be properly valued on the entity's financial records. If, on the other hand, you are auditing the Toronto Raptors, inventories will not be a major issue. But you would certainly want to keep up on the ins and outs of player negotiations and the dynamics of television contracts and the free agent market. The point is that the context provided by the organization greatly impacts the auditor and the nature of the audit and is thus a primary aspect of the environment in which financial statement auditing is conducted.

A Model of Business

While businesses in different industries can have strikingly different characteristics, most have some fundamental conceptual characteristics in common. These commonalities provide a way for auditors to organize how they approach financial statement audits, regardless of the type of entity they are auditing. Figure 2–1 presents a fundamental, widely accepted model of business, representing the central context in which auditors operate. Take some time now to study the figure and be sure to understand this important model! The components of the model are governance, objectives, strategies, business processes, risks, controls, and reporting.

FIGURE 2–1An Overview of an Organization's Operations



Practice INSIGHT

The nature of an auditee's organization can have a dramatic effect on the nature of the auditor's work and work environment. For example, an auditor working at a meat-packing company will have very different experiences (with very different sights, sounds, and smells!) from an auditor working at a banking entity. Further, many auditors eventually specialize in certain industries and acquire significant expertise in those industries. This expertise and specialization often leads to attractive employment opportunities in industry, for example as a controller or CFO. Thus, in choosing which firm (or which office of a large firm) at which to seek a job, new auditors are well advised to carefully consider whether the firm (or office) has a significant presence in the industries in which the prospective auditor is most interested.

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Corporate Governance

To put together an organization, leaders decide on an appropriate organizational form (e.g., corporation, partnership, or not-for-profit entity) and hire managers to manage the resources that have been made available to the enterprise through investment or lending. Due to the way resources are invested and managed in the modern business world, a system of *corporate governance* is necessary, through which managers are overseen and supervised. Simply defined, corporate governance consists of all the people, processes, and activities in place to help ensure proper stewardship over an entity's assets. This is why in Figure 2–1 corporate governance runs along the entire right-hand side of the model. Strong corporate governance ensures that those managing an entity properly utilize their time, talents, and the entity's resources in the best interests of absentee owners, shareholders, or members, and that they faithfully report the economic condition and performance of the enterprise. The body primarily responsible for management oversight in Canadian entities is the *board of directors*. The *audit committee*, consisting of a subset of independent board members, oversees the internal and external auditing work done for the organization. Through this link, and through the audit of financial statements, auditors play an important role in facilitating effective corporate governance.

Practice INSIGHT

It has been said that no person can serve two masters. In some respects, this saying reflects the delicate balance that the external auditor must achieve—working in close contact with and being paid by the entity, while protecting the public interest. Prior to 2003, the external auditor might be engaged by and report directly to the entity's senior management, which would also be responsible for preparing the financial statements being audited. Multilateral Instrument 52-110 in C-SOX mandated that the entity's *audit committee* be directly responsible for the appointment, compensation, and oversight of the work of the auditor instead of management. Hence, the auditor now *must* report directly to the audit committee.

Objectives, Strategies, Processes, Controls, Transactions, and Reports

As depicted at the centre-top of Figure 2–1 and running down through the model, management, with guidance and direction from the board of directors, decides on a mission, which can be translated into a set of *objectives*, along with *strategies* designed to achieve those objectives. The organization must also assess and manage risks that may threaten the achievement of its objectives. The organization then undertakes certain *processes* in order to implement its strategies.

While the processes implemented in organizations are as varied as the different types of businesses themselves, most business enterprises establish processes that fit in five broad *business process categories*, sometimes known as *business cycles*. The five categories that characterize the processes of most businesses are the *financing process*, the *purchasing process*, the *human resource management process*, the *inventory management process*, and the *revenue process*. Each business process involves a variety of important transactions.

As depicted around the inside edge of the circle in Figure 2–1, the enterprise designs and implements *accounting information systems* to capture the details of those transactions. It also designs and implements a *system of internal control* to ensure that the transactions are handled and recorded appropriately and that its resources are protected. The accounting information system must be capable of producing reliable financial reports, which summarize the effects of the organization's transactions on its account balances and which are used to establish management accountability to outside owners (see bottom of Figure 2–1).

The following section provides a brief overview of the five business process categories listed above. Auditors often rely on this process model to divide the audit of a business's financial statements into manageable pieces. Chapters 10 through 16 go into considerable detail regarding how these processes typically function and how they are used to organize an audit.

LO 2-7 A Model of Business Processes: Five Components

At the centre of Figure 2–1 are the five basic business processes into which auditors typically organize a financial statement audit. Let's briefly discuss each.

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The Financing Process

Businesses obtain capital through borrowing or soliciting investments from owners and typically invest in assets such as land, buildings, and equipment in accordance with their strategies. As part of this process, businesses also need to repay lenders and provide a return on owners' investments. These types of transactions are all part of the financing process. Let's illustrate using our example company, EarthWear Clothiers. EarthWear tends not to rely on long-term debt financing. Instead, it primarily uses capital provided by shareholders to invest in long-term assets, such as its headquarters building, retail stores, and various order and distribution centres across Canada, the United States, Japan, Germany, and the United Kingdom.

The Purchasing Process

Businesses must acquire goods and services to support their operations. For example, EarthWear purchases clothing from various wholesale suppliers to sell to its customers. The company must also purchase electrical power, office supplies, custodial services, and other items to support its activities.

The Human Resource Management Process

Business organizations hire personnel to perform various functions in accordance with the enterprise's mission and strategy. At EarthWear this process starts with the establishment of sound policies for hiring, training, evaluating, compensating, terminating, and promoting employees. The main transaction in this process that affects the financial statement accounts is a payroll transaction, which usually begins with an employee performing a job and ends with payment being made to the employee.

The Inventory Management Process

This process varies widely between different types of businesses. Manufacturers, wholesalers, and retailers, including EarthWear, all typically have significant, numerous, and often complex transactions belonging to the inventory management process. While the transactions to purchase finished goods or raw materials inventories are included in the purchasing process, the inventory management process for a manufacturer includes such transactions as accumulating and allocating costs to inventory and making adjustments to record inventory at the lower of cost or market. Service providers (such as auditors, lawyers, or advertising agencies) rarely have significant inventories to manage, since their primary resources typically consist of information, knowledge, and the time and effort of people.

The Revenue Process

Businesses generate revenue through sales of goods or services to customers. They collect the proceeds of those sales in cash, either immediately or through collections on receivables. For example, EarthWear Inc. retails high-quality clothing for outdoor activities. To be successful, EarthWear must successfully process orders for, and deliver its clothing to, customers. It must also collect cash on those sales, either at the point of sale or through later billing and collection of receivables. Management establishes controls to ensure that sales and collection transactions are appropriately handled and recorded.

Stop and Think: Take another look at Figure 2–1. How might the components of our model differ for an entity in automobile manufacturing versus banking, and how might those differences affect the auditor's work? How might differences in these components affect the risk of material misstatement in the financial statements?

Relating the Process Components to the Business Model

Management engages in the five business processes discussed above to implement the organization's strategies and achieve its objectives. The enterprise integrates risk management in its strategy-setting and operations, part of which entails identifying and appropriately responding to possible threats to the achievement of its objectives, including those threats (or risks) involved with compliance with laws and regulations, and with reliable external financial reporting. Of direct relevance to the financial statement audit, management ensures that the organization's system of internal control over financial reporting mitigates financial reporting risks to acceptably low levels.

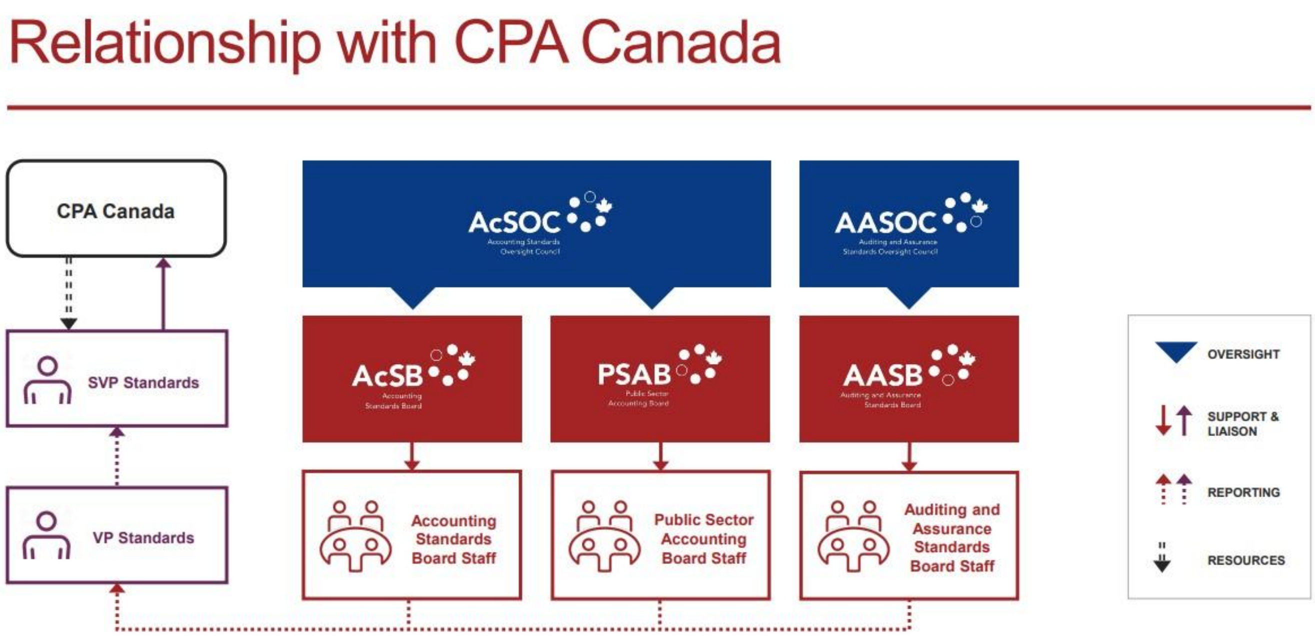
The organization's accounting information system must be capable of reliably measuring the performance of the business to assess whether objectives are being met and to comply with external reporting requirements. Financial statements, which are affected by all the different components of our business model, represent an important output of the entity's efforts to measure the organization's performance and an important form of external reporting and accountability.

This discussion illustrates how important an entity's environment is to the work of a financial statement auditor. That's why auditors must become expert not only in accounting and auditing but also in the businesses and industries in which their auditees operate. Next we'll discuss the professional and regulatory organizations that play key roles in shaping the external auditing environment.

LO 2-8 Organizations That Affect the Public Accounting Profession

A chapter on the environment of auditing would not be complete without a discussion of the professional and regulatory organizations that affect the practice of auditing by independent auditors. Figure 2–2 provides a representation of the relationship of these organizations to a financial statement audit conducted in Canada. The following subsections discuss the activities of four of these organizations plus two international standard-setting bodies.

FIGURE 2–2Organizations That Affect Financial Statement Audits in Canada



Source: Reprinted by permission from Financial Reporting & Assurance Standards Canada, https://www.frascanada.ca/en/acsoc/about

Auditing and Assurance Standards Board (AASB)

The Auditing and Assurance Standards Board (AASB) is an independent body with the authority and responsibility to set standards for quality management, audit, and other assurance and related services engagement and guidance in Canada.

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The AASB contributes to the development of International Standards on Auditing (ISAs), which are adopted as Canadian Auditing Standards (CASs), by participating in consultations and activities of the International Auditing and Assurance Standards Board (IAASB) to ensure Canadian entities' auditing needs are considered.

The AASB issues the following standards:

- Statements on Auditing Standards
- Statements on Standards for Assurance Engagements
- Statements on Standards for Review and Compilation Engagements
- Statements on Audit Quality Control Standards

International Auditing and Assurance Standards Board (IAASB)

The IAASB is sponsored and funded by the International Federation of Accountants (IFAC), which describes itself as "the global organization for the accountancy profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies." IFAC was founded in 1977 and is based in New York City. In addition to the IAASB, IFAC houses independent standard-setting boards that develop international standards on ethics, education, and public sector accounting standards. The IAASB, whose predecessor organization was established in 1978, was reorganized and renamed to its current name in 2002. The IAASB issues *International Standards on Auditing (ISA)* and as of 2018 is the predominantly recognized international auditing standard setter, its standards being used in over 125 international jurisdictions.

International Accounting Standards Board (IASB)

The IASB is the international counterpart to Canada's Accounting Standards Board (AcSB). The IASB's standards are the predominantly recognized international accounting standards. The IASB is responsible for the development and publication of *International Financial Reporting Standards* (IFRS), and for approving *interpretations of IFRS*. The IASB is sponsored and funded by the IFRS foundation, which is an independent, not-for-profit, private-sector organization.

Chartered Professional Accountants of Canada (CPA Canada)

CPA Canada is the national organization of the accounting profession in Canada. It represents and supports more than 210,000 members as the Canadian profession under a single designation. The mission of CPA Canada is to enhance the influence, relevance, and value of the Canadian CPA profession by

- Acting in the public interest
- Supporting its members
- Contributing to economic and social development

Canadian Securities Administrators (CSA)

The Canadian Securities Regulators (CSA) is the umbrella organization of Canada's provincial and territorial securities regulators, whose objective is to improve, coordinate, and harmonize regulation of the Canadian capital markets. It ensures that listed companies file audited financial statements that have been prepared in accordance with IFRS. While the CSA may provide issuers with helpful guidance on various issues it does not issue accounting or auditing standards. This is different from the U.S. SEC, which has the authority to implement and oversee standards relating to all aspects of the audits of public companies, including standards relating to auditor independence.

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Canadian Public Accountability Board (CPAB)

The *Canadian Public Accountability Board (CPAB)*, formed in 2003, is Canada's public company audit firm regulator charged with protecting the investing public's interests. The public's interests are achieved through the promotion of high-quality audits in Canada. The founding institutions include the Canadian Institute of Chartered Accountants, the Canadian Securities Regulators, and the federal Office of the Superintendent of Financial Institutions. Auditors of organizations that issue shares to the public must be members in good standing with CPAB. CPAB reviews member firms' audit files to ensure they are in compliance with *Canadian Audit Standards (CAS)*.

Securities and Exchange Commission (SEC)

The U.S. SEC is a federal government agency that administers the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002, among others. The Securities Act of 1933 regulates disclosure of material information in a registration statement for an initial public offering of securities. The Securities Exchange Act of 1934 regulates ongoing reporting by companies whose securities are listed and traded on a stock exchange or that possess assets greater than US$10 million and its equity securities are held by 500 or more persons. The most common documents encountered by auditors under the Securities Exchange Act of 1934 are the annual and quarterly reports, which include the financial statements filed with the SEC by a publicly traded company.

Public Company Accounting Oversight Board (PCAOB)

The U.S. PCAOB describes itself as "a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect the interests of investors and further the public interest in the preparation of informative, accurate and independent audit reports." While the board is a nonprofit corporation, it is in reality a quasi-governmental regulatory agency overseen by the SEC. The Sarbanes-Oxley Act of 2002 essentially transferred authority for standard setting, inspection, investigation, and enforcement for public company audits from the profession (as represented by the AICPA) to the PCAOB. All public accounting firms providing audits for public companies are required to register with, pay fees to, and follow the rules and standards of the PCAOB.

The PCAOB conducts a program of regular inspections to assess the degree of compliance of registered public accounting firms with SOX, PCAOB, and SEC rules and professional standards. The PCAOB also has broad investigative and disciplinary authority over registered audit firms. However, the PCAOB does not have authority to set standards relating to the audits of entities that are not broker-dealers or publicly traded companies.

Financial Accounting Standards Board (FASB)

The FASB is a privately funded body whose mission is to establish standards in the United States for financial accounting and reporting. The FASB's Accounting Standards Codification (or ASC) is recognized as the source of U.S. *generally accepted accounting principles (GAAP)* by the SEC, the PCAOB, and the AICPA. GAAP are accounting principles that are generally accepted for the preparation of financial statements in Canada, GAAP standards are currently issued by CPA Canada. International Financial Reporting Standards (IFRS) are set by the International Accounting Standards Board.

American Institute of Certified Public Accountants (AICPA)

The AICPA is a private professional association of over 431,000 members in 143 different countries. It performs a number of functions that directly bear on the activities of member CPAs. The most important of these functions is the promulgation of rules and standards that guide audit and related services provided to nonpublic companies; governmental entities such as states, counties, municipalities and school districts; and other entities such as universities and charities.

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In addition to the Auditing Standards Board (ASB), the AICPA houses several standing committees that issue professional rules and standards relevant to assurance providers. The most important of the standards are

- The Code of Professional Conduct
- Quality control and peer review standards
- Attestation standards
- Compilation and review standards

In addition to its standard-setting role, the AICPA supports accounting and auditing research, produces a number of important publications, and provides a wide range of continuing education programs. For example, the AICPA publishes the *Journal of Accountancy*, *The Tax Advisor*, and various Auditing Research Monographs, Auditing Practice Releases, and Industry Audit and Accounting Guides.[8]

LO 2-9 Auditing Standards

Auditing standards help to ensure that financial statement audits are conducted in a consistent and thorough manner to add value to the financial statements. Auditing standards also serve as an important set of criteria for evaluating the quality of the auditor's performance. As discussed earlier, one organization sets auditing standards that are relevant for financial statement auditors in Canada. International standards are issued by IFAC's IAASB.

Auditing Standards: The Roles of the AASB and the IAASB

The CPA's Auditing and Assurance Standards Board is responsible for establishing all auditing standards in Canada. The AASB's standards are influenced by the auditing standards of the IAASB. Over 125 international jurisdictions countries use the IAASB's standards.

(As a side note, currently, accounting firms that audit the financial statements of *nonpublic entities* in the United States are required to comply with the auditing standards established by the ASB of the AICPA. Firms that audit the financial statements of *public companies registered by the SEC* in the U.S. are required to follow the auditing and related professional practice standards established by the PCAOB. However, global accounting firms in the U.S., which provide financial statement audits for nonpublic U.S. entities, U.S. public companies, and international companies around the world, must ensure that their audit approaches and methodologies meet the requirements of the ASB of the AICPA, the PCAOB, and the IAASB standard setters.)

Typically the global firms are able to apply a single audit methodology that is generally the same for audits of all entities around the world while ensuring that the additional requirements of the U.S. standard setters are met.

At this point you may be wondering which set of standards you will be learning in this book or whether, heaven forbid, you might have to learn all three. Not to worry—similar to the approach taken by the large, international accounting firms, you will learn a single set of foundational auditing concepts that apply to any type of entity in Canada. Because the IAASB and AASB standards are practically identical, you will be acquiring a solid understanding of auditing concepts that underlie the standards used internationally. The bottom line is that the concepts you will learn in this book encompass the requirements of, and are consistent with the audit policies and methodologies of, the world's leading accounting firms.

LO 2-10 Principles Underlying an Audit Conducted in Accordance with Generally Accepted Auditing Standards

The AASB's auditing standards contain information that includes a coherent description of the principles underlying an audit conducted in accordance with generally accepted auditing standards. These principles are grouped into four areas: the purpose and premise of an audit, responsibilities of the auditor, auditor actions in performing the audit, and reporting.

This description of the principles provides a valuable overview of the importance of an audit, the fundamental responsibilities of management and of the auditor, and the basic concepts of how an auditor should go about performing and reporting on an audit. These basic principles apply to any audit. Understanding them will help you understand the big picture of auditing. A word to the wise—investing some time to understand the fundamental principles laid out in Exhibit 2–2 will pay off big time in helping you understand the next several chapters of this book!

EXHIBIT 2–2 Principles Underlying an Audit Conducted in Accordance with Canadian Auditing Standards*

Purpose of an Audit and Premise upon Which an Audit Is Conducted

1. The purpose of an audit is to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework.
2. An audit in accordance with Canadian auditing standards is conducted on the premise that management and, where appropriate, those charged with governance, have responsibility
    1. for the preparation of the financial statements in accordance with the applicable financial reporting framework, including, where relevant, their fair presentation;

or such internal control as management and, where appropriate, those charged with governance determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error;

2. to provide the auditor with

    1. access to all information of which management and, where appropriate, those charged with governance are aware that is relevant to the preparation of the financial statements such as records, documentation and other matters;
    2. additional information that the auditor may request from management and, where appropriate, those charged with governance for the purpose of the audit; and
    3. unrestricted access to those within the entity from whom the auditor determines it necessary to obtain audit evidence.

Responsibilities

3. Auditors are responsible for having appropriate competence and capabilities to perform the audit; complying with relevant ethical requirements; and maintaining professional skepticism and exercising professional judgment, throughout the planning and performance of the audit.

Performance

4. To express an opinion, the auditor obtains reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.
5. To obtain reasonable assurance, which is a high, but not absolute, level of assurance, the auditor
    - plans the work and properly supervises any assistants.
    - determines and applies appropriate materiality level or levels throughout the audit.
    - identifies and assesses risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
    - obtains sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
6. The auditor is unable to obtain absolute assurance that the financial statements are free from material misstatement because of inherent limitations, which arise from
    - the nature of financial reporting;
    - the nature of audit procedures; and
    - the need for the audit to be conducted within a reasonable period of time and so as to achieve a balance between benefit and cost.

Reporting

7. Based on an evaluation of the audit evidence obtained, the auditor expresses, in the form of a written report, an opinion, modification of opinion, or denial of opinion, in accordance with the auditor's findings. The opinion states whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework.

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Purpose of an Audit and Premise upon Which an Audit Is Conducted

The first section of the "Principles Underlying an Audit" explains the purpose and value of a financial statement audit and lays out the responsibilities of management and those charged with governance that must be discharged for an effective audit to be possible. As you can see in Exhibit 2–2, the purpose of an audit is to allow the auditor to express an opinion about the fairness of the financial statements in all material respects, in accordance with "an applicable financial reporting framework" (which in Canada is IFRS for publicly traded entities). Consistent with what you learned in Chapter 1, the value of an independent auditor's opinion is that it can reduce information risk and thereby "enhance the degree of confidence that intended users can place in the financial statements."

In terms of what is expected of management and those charged with governance, these parties are primarily responsible for the preparation and presentation of financial statements that are free from material misstatement, including designing, establishing, and maintaining effective internal control over financial reporting to that end. Management and those charged with governance also have the responsibility to provide the auditor with all relevant records and documents, and any other information the auditor deems relevant, as well as free access to anyone in the organization from whom the auditor wishes to obtain information.

Responsibilities

The next section of the "Principles Underlying an Audit" deals with the fundamental responsibilities of the auditor. These responsibilities will remind you of the characteristics of a reliable house inspector listed in Chapter 1. Auditors must ensure they are competent and have the capabilities to perform the audit. Relevant competencies and capabilities are gained through formal education, continuing education programs, and experience—auditors should stay current with the latest accounting and auditing pronouncements and with developments in the business world that may affect the entities that they audit.

The auditor is also responsible for complying with relevant ethical requirements, such as integrity and maintaining independence on an engagement. *Independence* requirements preclude relationships that may impair the auditor's objectivity. An auditor must not only be independent in fact (i.e., actually be objective) but also avoid actions or relationships that may appear to affect independence. If an auditor is perceived as lacking independence, users may lose confidence in the auditor's ability to report truthfully on financial statements. As you will learn in Chapter 19, there are a number of relationships (such as the auditor having business or financial interests in, or providing certain types of consulting services for, entities that they audit) that are believed to impair the auditor's appearance of independence and are thus prohibited.

Auditors are also responsible to maintain an attitude of professional skepticism (which includes having a questioning mind and a willingness to challenge management's assertions), and to consistently exercise professional judgement, both in planning and in performing the audit. As noted in the preface to this chapter, this book includes an appendix on professional judgement in auditing, which your instructor may assign you to read. Appendix A: Professional Judgement Framework of this text will help you begin to develop your own professional judgement by learning what a good audit judgement process looks like and how to avoid common traps and biases.

Performance

The third section deals with the auditor's responsibilities in performing an effective audit. These responsibilities provide the conceptual background for the audit process (and will remind you of some of the desirable characteristics of a house inspection service). First, in order to express an opinion, the auditor is responsible to obtain "reasonable assurance" that the financial statements are free from material misstatement, whether due to error or fraud. We discussed the key, fundamental concept of reasonable assurance in Chapter 1—if you're shaky on this concept, please take a couple minutes to review it now! The other concept to highlight here is that the auditor's responsibility to obtain reasonable assurance does not depend on whether a misstatement happens intentionally (fraud) or unintentionally (error).

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The next point in the performance section deals with the auditor's responsibility in a number of fundamental areas, including to appropriately plan the audit and supervise the work of any assistants, determine and apply appropriate levels of materiality throughout the audit, and appropriately identify and assess risks of material misstatement based on a thorough understanding of the entity and its environment. Understanding the entity and its environment includes understanding the nature of the entity's business, industry, objectives, strategy, and competitive position; the state of the economy; the incentives and integrity of the entity's management; and the strengths and weaknesses of the entity's internal control, among others. As an example of why such understanding is important, if the auditor identifies areas of weakness in an entity's internal control, this information can help the auditor focus on areas where misstatements may be more likely to occur. Understanding the entity and its environment helps the auditor effectively plan the nature, timing, and extent of further audit procedures. In this context, *nature* refers to what procedures are performed, *timing* refers to when the audit work is done (whether at interim or at period-end), and *extent* refers to how much work is done. Taken together, the nature, timing, and extent of audit procedures are referred to in practice as the "scope" of the audit procedures.

Once the auditor has identified and assessed any risks of material misstatement, the auditor is responsible to design and execute procedures to obtain "sufficient, appropriate evidence" about the presence or absence of material misstatements. "Sufficient" refers to the quantity of evidence obtained by the auditor, while "appropriate" refers to the relevance and reliability of the evidence. You should be aware that auditing standards typically give only general guidance—the point at which the evidence for a particular management assertion is sufficient and appropriate usually is a matter of professional judgement. These concepts are important because most of the auditor's work involves the search for and evaluation of evidence regarding management's assertions in the financial statements. The auditor uses various audit procedures to gather this evidence, which you will learn about in coming chapters.

The last point in the section highlights the inherent limitations of an audit, even when performed appropriately and in accordance with relevant auditing standards. These limitations arise from the inherent nature of financial reporting and of audit procedures, and from time constraints stemming from cost-benefit trade-offs.

Reporting

The last section of the "Principles Underlying an Audit" relates to the culmination of the audit: the auditor expresses a written opinion about "whether the financial statements are presented fairly, in all material respects, in accordance with the applicable financial reporting framework" (e.g., IFRS). In other words, based on an assessment of the audit evidence, the auditor provides a written report, expressing an opinion on whether the financial statements are free of material misstatement. However, if circumstances prevent the auditor from obtaining reasonable assurance or from reaching a conclusion, the auditor reports that an opinion about the fairness of the financial statements must be modified or cannot be expressed.

LO 2-11 The Nature of Auditing Standards and the Codification of Standards

The Nature of Auditing Standards

Canadian Auditing Standards (CAS) are issued by the AASB and are based on the standards promulgated by the IAASB. Standards issued by the IAASB are called International Standards on Auditing (ISA).

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Unlike financial accounting pronouncements, which often provide very specific rules, the CASs and ISAs tend to be relatively general in nature. The auditor must apply due diligence and sound professional judgement given the particular circumstances of the engagement in conducting an audit. Keep in mind that the auditor often has to rely on evidence that is persuasive rather than conclusive, and *never* has sufficient evidence to "guarantee" that the financial statements are free from material misstatements. A great deal of professional judgement is required to determine when the evidence obtained is sufficient and appropriate to achieve reasonable assurance.

CASs include requirements that convey varying levels of auditor responsibility. The words "must," "shall," and "is required" indicate unconditional responsibilities with which the auditor must comply. The word "should" indicates a responsibility to comply unless the auditor decides on alternative actions that are sufficient to achieve the objectives of the requirement. Finally, the words "may," "might," and "could" describe actions and procedures that auditors have a responsibility to consider.

The Codification of Auditing Standards

CASs are classified by numbering categories. The numbering applies to the order in which the standards are issued by the IAASB and are thus chronological. The summary below shows how the CASs are organized:

CAS 200	General Principles and Responsibilities
CAS 300–499	Planning and Risk Assessment
CAS 500	Audit Evidence
CAS 600	Using the Work of Others
CAS 700	Audit Conclusions and Reporting
CAS 800–999	Special Considerations

Each of these categories contains subcategories to further organize similar topics at more detailed levels, so that each detail-level standard is assigned a unique subsection number. For example, Audit Sampling is a subtopic of Audit Evidence, and is found in CAS 530.

The International Standards on Auditing (ISA) promulgated by the IAASB consist of 36 individual standards covering the full range of auditing topics. In the end, the coverage and sequence of topics is quite similar to CASs. If changes are made within the listing of standards, the IAASB simply revises and reissues its numbered, topically organized standards as needed.

For an audit conducted in Canada, using CASs is a straightforward matter. This can get complicated, though, if one is auditing the operations of a United States corporation listed on a U.S. exchange. A major complication for auditors conducting audits of U.S. companies is the development of two different sets of U.S. auditing standards: standards developed by the U.S. PCAOB may diverge from those adopted by the Audit Standards Board (ASB) of the AICPA. The ASB is attempting to converge its own standards with those of the IAASB. While ASB and PCAOB standards are still reasonably similar in most respects, their standards continue to diverge. As might be expected, such a development greatly and unnecessarily complicates the auditing standards environment for U.S. companies. The widespread use of international auditing standards in countries outside the United States further complicates the environment for large public accounting firms that practise both within the U.S. and internationally.[9]