Part I INTRODUCTION TO AUDITING AND ASSURANCE SERVICES

Introduction to Auditing and Assurance Services

Chapter 1

Learning Objectives

Upon completion of this chapter, you will be able to

1. Explain the demand for auditing and assurance.
2. Recognize the auditor's role in the information revolution.
3. Describe the relationships among assurance services, attestation, and auditing.
4. List the different types of audits.
5. Describe the different types of auditors.
6. Describe the public accounting profession.
7. Identify the organizations that affect financial statement audits.

RELEVANT ACCOUNTING AND ASSURANCE PRONOUNCEMENTS

***CICA Handbook*, INTRODUCTION TO ASSURANCE AND RELATED SERVICES RECOMMENDATIONS**

***CICA Handbook*,** Introduction to assurance and related services

***CICA Handbook*, section 5021,** Authority of auditing and assurance standards and other guidance

***CICA Handbook*, section 5090,** Audit of financial statements—an introduction

***CICA Handbook*, section PS 5000,** Introduction to assurance recommendations that apply only to the public sector

***CICA Handbook*, section PS 5400,** Value-for-money auditing

There is now more information available than ever before, both to businesses and about businesses. Corporations maintain large databases that provide detailed information on suppliers and customers. Various credit agencies collect information on individuals and sell this information to financial institutions. The websites of publicly listed companies provide a wealth of information, including annual reports containing financial statements, to investors and potential investors. In all of these situations, there is a need for the information to be reliable, credible, relevant, and timely. Auditing and assurance services can ensure that information meets these criteria.

Reliable information is necessary if managers, investors, creditors, and regulatory agencies are to make informed decisions about resource allocation. Auditing and assurance services play an important role in this process. The examples on the next page present situations where auditing enters into economic transactions and increases the reliability and credibility of an entity's financial statements.

WHO USES AUDIT SERVICES?

Jay Johnstone is the owner of a small auto parts distributor. His one-store operation has been very profitable. He financed his current store mainly from personal savings and some borrowings from his family. Mr. Johnstone would like to expand his operations by opening two stores in nearby towns. Mr. Johnstone approached his local bank to request the necessary financing. He provided the loan officer with a set of financial statements that he prepared with the assistance of his bookkeeper. The loan officer informed Mr. Johnstone that because of the amount of the requested financing and his lack of prior credit with the bank, he would have to have his company's financial statements audited by an independent public accountant. The financial statements were audited and an unqualified audit report was issued. Based on the company's financial performance and prospects and the credibility added by the auditor's report, the bank granted the loan.

Sara Thompson, 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. Thompson has applied to Human Resources Development Canada (HRDC) requesting a large grant to expand her two shelters to accommodate more women. In completing the grant application, Ms. Thompson discovered that federal law for government grants requires that recipients have their financial statements audited prior to the final granting of funds. Based on the centre's activities, the intended use of the funds, and the auditor's report on the centre's financial statements, the grant was approved.

Conway Computer Company has been a successful wholesaler of computer peripheral products such as disk drives and tape backup systems. The company was started by George and Jimmy Steinbuker five years ago. Two years ago, a venture capital firm provided needed capital for expansion by acquiring 40 percent of the company. Conway Computer has been very successful, with revenues and profits increasing by 25 percent in each of the last two years. The Steinbuker brothers and the venture capital firm are considering taking the company public through a stock sale. They have contacted a number of underwriters about the public offering. The underwriters have informed the company that the company's financial statements will need to be audited by a major public accounting firm before a registration statement can be filed with the Ontario Securities Commission. The company hired a major public accounting firm. Subsequently, the company successfully sold stock to the public.

The situations in the box above show the importance of auditing and audited financial statements to both private and public enterprise. By adding the audit function to each situation, the users of the financial statements have reasonable assurance that the financial statements do not contain material misstatements or omissions.

You will find that the study of auditing is different from any of the other accounting courses you have taken in college, and for good reason. Most other accounting courses focus on learning the rules, techniques, and computations required to prepare and analyze financial information. Auditing focuses on learning the analytical and logical skills necessary to evaluate the relevance and reliability of the systems and processes responsible for recording and summarizing that information, and preparing financial statements, as well as of the information itself. As such, you will find the study of auditing to be more conceptual in nature than your other accounting courses. Learning auditing essentially helps you understand how to gather and assess evidence so you can evaluate assertions made by others.

This text is filled with the tools and techniques used by external auditors. You'll find that the "tool kit" used by auditors consists of a coherent logical framework, filled with tools and techniques useful for analyzing financial data and gathering evidence in a variety of settings from small business to consulting and even executive decision making. An important implication is that learning this framework makes the study of auditing valuable to future accountants and business decision makers, whether or not they plan to become auditors!

While we are convinced the concepts and techniques covered in this book will be useful to you regardless of your career path, our experience is that students frequently fall into the trap of defining auditing in terms of memorized lists of rules, tools, and techniques. The study of auditing and the related rules, tools, and techniques will make a lot more sense to you if you can first build up your understanding of why audits are needed, what an auditor does, and what are the necessary characteristics of audits and auditors. Reliable information is important for managers, investors, creditors, and regulatory agencies to make informed decisions. Auditing helps ensure that information is reliable, credible, relevant, and timely. In fact, you will find that the concepts behind financial statement auditing provide a framework or tool kit that can be used for improving the reliability of information for decision makers of all kinds.

The purpose of this chapter is to provide a context for your study of auditing. The chapter starts by analyzing why there is a demand for auditing and discussing assurance services, attest services, and auditing. Next, the types of audits and auditors are presented. The remainder of this chapter provides information on the public accounting profession and the major organizations that affect the auditing profession. In response to the changing business environment, especially advances in technology, the auditing profession has expanded its scope to offer other assurance services. Chapter 19 discusses some of these other types of professional services that auditors now perform for their clients.

The Demand for Auditing and Assurance[1]

LO 1 An important question a student might ask is "Why do entities request an audit?" The answer to this question can be found in the economic relationships both within an entity, and between the entity and other parties that have a vested interest in the entity. A historic relationship exists between accounting and auditing in entities. For example, evidence shows that some forms of accounting and auditing existed in early Greece in approximately 500 BC.[2] Until the late 18th and early 19th centuries most

[1]See G. L. Sundem, R. E. Dukes, and J. A. Elliott, *The Value of Information and Audits* (New York: Coopers & Lybrand, 1996), for a more detailed discussion of the demand for accounting information and auditing.

[2]G. J. Costouros, "Auditing in the Athenian State of the Golden Age (500–300 BC)," *The Accounting Historians Journal* (Spring 1978), pp. 41–50.

organizations were relatively small and were owned and operated as sole proprietorships or partnerships. However, the birth of modern accounting and auditing occurred during the industrial revolution, when corporations needed to raise capital to finance expansion.[3] Corporations issued stocks and bonds to the public and borrowed funds from financial institutions. Thus, the growth of the modern corporation led to the presence of absentee owners (shareholders) and the use of professional managers who ran the corporation on a day-to-day basis. In this setting, the managers served as *agents* for the shareholders (referred to as *principals*) and *contracted* to fulfil a *stewardship* function by managing the corporation's assets.

Accounting and auditing play an important role in this principal–agent relationship. First, the agency relationship between an owner and manager produces a natural *conflict of interest* because of the *information asymmetry* that exists between the manager and the absentee owner. 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. If both parties seek to maximize their own self-interest, it is likely that the manager will not act in the best interest of the owner. For example, the risk exists that a manager may follow the example of Dennis Kozlowski, who is accused of spending Tyco funds on excessive personal benefits such as $6,000 shower curtains. Or the manager might follow the example of 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 and other individuals involved could earn larger bonuses and could sell their shares at artificially high prices.

The owner can protect himself or herself against such activities by adjusting the manager's compensation by the amount of such perquisites that the owner expects the manager to consume. In an attempt to compensate for this possibility, the manager may agree to some type of monitoring provisions in his or her employment contract. For example, the two parties may agree that the manager will periodically report on how well he or she has managed the owner's assets. The reporting of this financial information to the owner generally follows some agreed-upon accounting principles. Thus the role of accounting information is to hold the manager accountable to the owner—hence the origin of the word "accounting."

However, because the manager is responsible for reporting and the absentee owner cannot observe the manager's actions, the manager may manipulate the reports. The owner protects against this possibility by again assuming that the manager will manipulate the reports to his or her 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 for the owner to hire an auditor to monitor his or her activities. The auditor's role is determining 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. The following numerical example will illustrate the foregoing agency relationship concepts. Suppose the owner

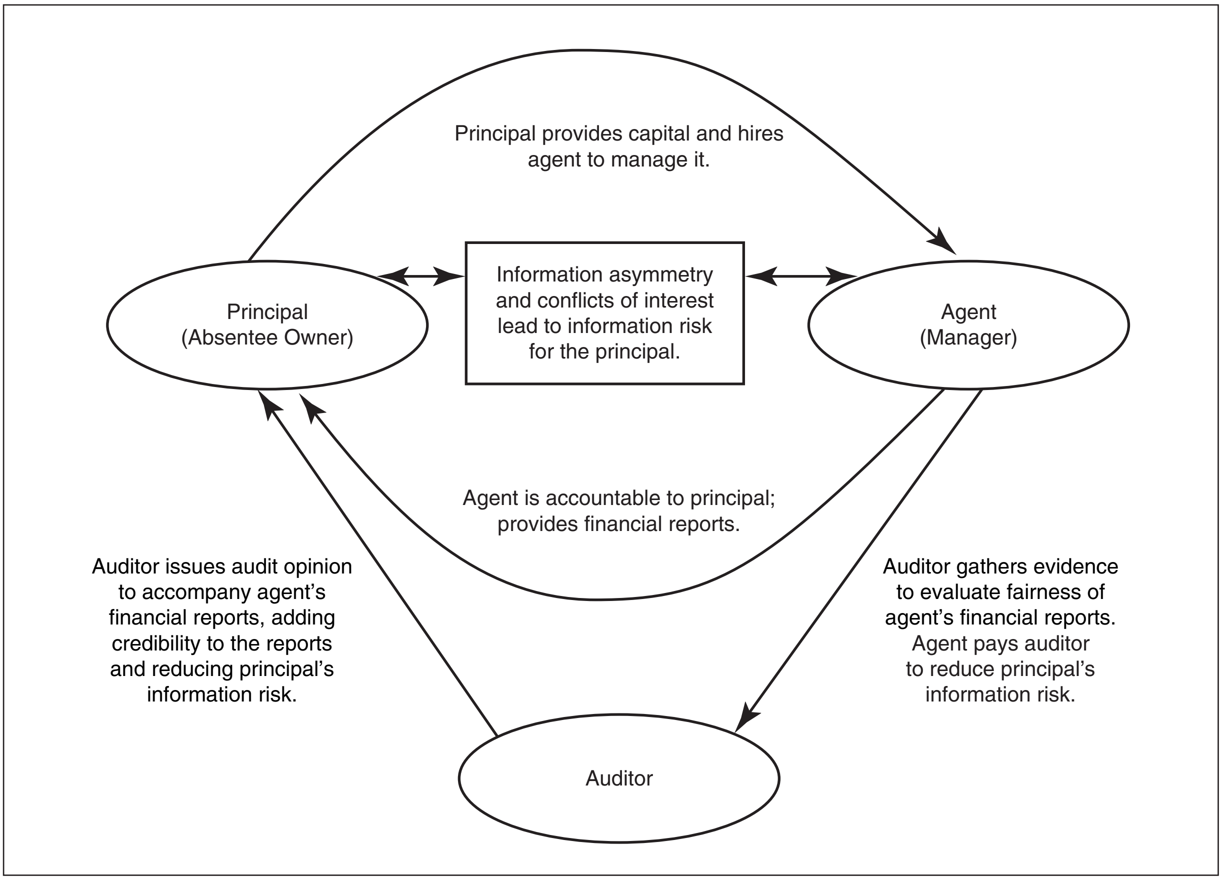
[3]See M. Chatfield, *A History of Accounting Thought* (Hinsdale, IL.: Dryden Press, 1974), for a discussion of the historical development of accounting and auditing.

and the manager of a company agree to a contract which will pay the manager a 10 percent bonus of net income before the bonus. The company's net income is $400. If the manager were to falsely report income of $500, his/her bonus would be $50 instead of $40. The owner may anticipate this behaviour on the part of the manager and only offer a 6 percent bonus. This would result in a bonus on the "false" $500 of $30, less than the 10 percent of $400 originally contemplated. If, in return for a 10 percent bonus, the manager agreed to have the financial results monitored (i.e., audited), and if the audit cost less than $10, the manager would be better off because of earning a higher bonus, and the owner would have a truthful report on the results of the company's operations. Figure 1–1 provides an overview of this agency relationship.

An understanding of the basic owner-manager relationship is a powerful conceptual tool that can be extrapolated to other contractual relationships that involve the entity. For example, how can a debtholder prevent management from taking the borrowed funds and using them for its own purposes? One way is to place restrictive covenants in the debt agreement that must be complied with by the entity and its management. Covenants requiring minimum values of indicators such as the current ratio, or

FIGURE 1–1

Overview of the Principal-Agent Relationship Leading to the Demand for Auditing



minimum requirements for interest coverage on the debt, may be included in the debt agreement. Again, this arrangement gives rise to a demand for auditing. Ratios and coverages computed using audited financial statement numbers give the debtholders greater confidence that management is abiding by the terms of the restrictive covenants.

This characterization of the demand for auditing may seem quite simplistic given current audit practice. However, it does realistically portray the initial development of auditing. While some have argued that the demand for auditing resulted from events such as the Wall Street collapse of 1929 and from regulations such as the *US Securities Act* of 1933, the *US Securities Exchange Act* of 1934, and the *Canada Business Corporations Act* (CBCA), the empirical evidence does not support this view. A research study showed that in 1926, 82 percent of the companies on the New York Stock Exchange were audited by independent auditors.[4] Additional evidence for the demand for auditing is also provided by the fact that many private companies and municipalities, which are not subject to securities acts, contract for audit services nonetheless.

The purpose of this discussion has been to demonstrate that there is a demand for auditing services in a free market. While regulations account for some demand, they cannot account for all of it. Auditing is demanded because it plays a valuable role in monitoring the contractual relationships between the entity and its shareholders, managers, employees, and debtholders.

The Role of the Auditor

LO 2 The exponential growth in the amount of information available creates tremendous opportunities for auditors to provide services that add reliability, credibility, relevance, and timeliness to the information. The companion website presents a model of the accountability cycle for a corporation. This model demonstrates how auditors can add value to the various types of information produced by the corporation.

Accounting and Auditing

It must be emphasized that to be a good auditor, one must first be a good accountant. Accounting in a business context consists of identifying, recording, classifying, summarizing, and reporting the effect of economic events in the financial statements. With few exceptions, the financial statements are prepared in accordance with generally accepted accounting principles, which in Canada would be Canadian GAAP. A critical aspect of the auditor's job as monitor is to ensure that the information provided in management's financial statements comply with GAAP. In order to do so he or she must have a comprehensive knowledge of GAAP to be able to evaluate the information in the financial statements, including how it was recorded, analyzed, summarized, and classified for reporting.

The auditor must collect and evaluate audit evidence in order to assess the representations in the financial statements to ensure that they comply

[4] G. J. Benston, "The Value of the SEC's Accounting Disclosure Requirements," *The Accounting Review* (July 1969), pp. 515–532.

with GAAP. However, the auditor does more than just consider whether the financial statement information complies with GAAP. The auditor carefully exercises his or her professional judgement to evaluate whether financial statement information reflects the intent of GAAP (the "spirit of the law") and not just the literal interpretation of GAAP (the "letter of the law"). It is the exercise of professional judgement that is the hallmark of the auditor.

The following section provides examples of various types of services that auditors can provide.

Assurance, Attest, and Audit Services

LO 3 Figure 1–2 shows the relationship among assurance, attestation, and auditing. Auditing services are a subset of attest services, which are in turn a subset of assurance services. The remainder of this section explains each of these forms of services in more detail.

Assurance

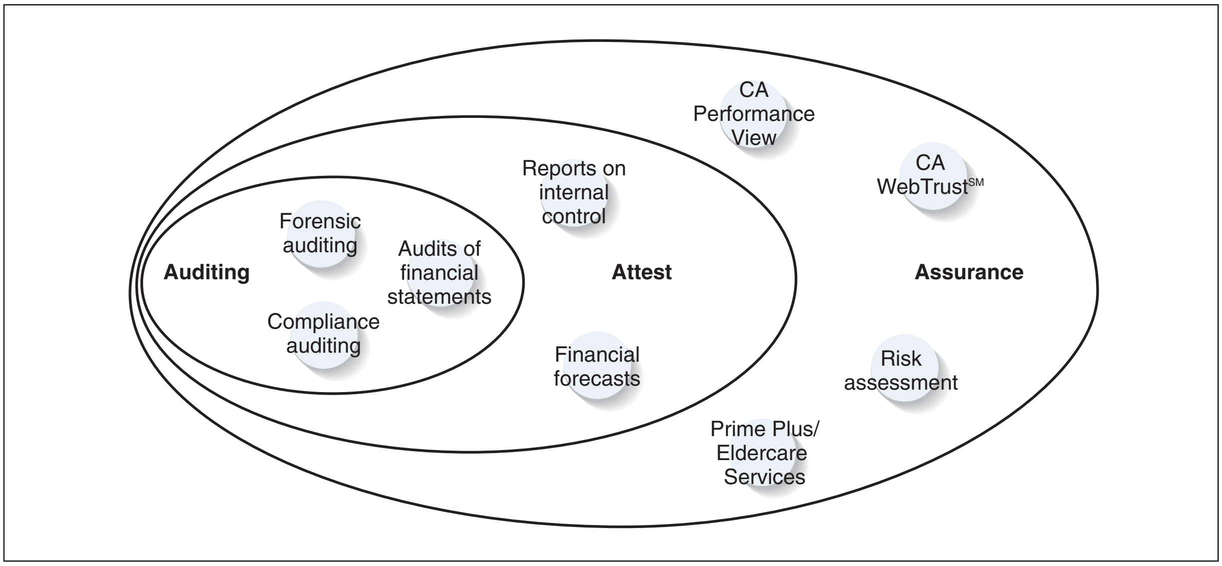
The broadest perspective on the role of the independent public accountant is conveyed by the term "assurance." An assurance engagement is defined in section 5025 of the *Handbook* of the Canadian Institute of Chartered Accountants (*CICA Handbook*) as:

> an engagement where, pursuant to an accountability relationship between two or more parties, a practitioner is engaged to issue a written communication expressing a conclusion concerning a subject matter for which the accountable party is responsible.

The breadth of the previous definition of assurance services may include dimensions such as the relevance and timeliness of information, as well as the reliability and credibility of both financial and nonfinancial information.

FIGURE 1–2

The Relationship among Auditing, Attest, and Assurance Services



Some examples of assurance services include the following:

- *Electronic commerce*—assurance that systems and tools used in electronic commerce provide appropriate data integrity, security, privacy, and reliability—an example of this type of assurance service is CA*WebTrust*.SM
- *Information system reliability*—assurance that an entity's internal information systems provide reliable information for operating and financial decisions—an example of this type of assurance service is CA*WebTrust*.SM
- *Performance measurement*—assurance that an entity is measuring the critical success factors that will allow it to assess progress being made in achieving specific targets linked to the entity's vision—an example of this type of assurance service is CA *Performance View*.
- *Risk assessment*—assurance that the entity's profile of business risks is comprehensive and evaluation of whether the entity has appropriate systems in place to effectively manage those risks.
- *CA ElderCare*—assurance that specified goals regarding the elderly are being met by various caregivers.

Chapter 19 provides extended coverage of assurance services, including discussion of the standards for assurance services in the *CICA Handbook*, section 5025.

Attest

Attest engagements are a subset of assurance engagements and the standards for attest engagements are subsumed under the standards for assurance engagements. The term "attest engagements" is used to describe those engagements where an auditor issues a written communication expressing a conclusion *regarding a written assertion* prepared by a party responsible for that assertion.

Some examples of engagements that belong in this category are as follows:

- reports on internal control[5]
- reports on financial information other than financial statements
- reports on future-oriented financial information
- reports on compliance with statutory, regulatory, or contractual obligations

Chapter 19 provides extended coverage of some of the attest engagements that may be offered by public accountants.

Auditing

Since a company's annual financial statements are a written assertion by management, audits are a special subset of attest engagements. However the audit predates the other two types of engagements, both of which can be said to have evolved from it.

[5]See H. M. Hermanson, "An Analysis of the Demand for Reporting on Internal Control," *Accounting Horizons* (September 2000), pp. 325–342, for a survey of user groups on the demand for reporting on internal control.

One of the best general definitions of auditing is provided by the Committee on Basic Auditing Concepts of the American Accounting Association:

> **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]

A number of phrases in this definition require additional explanation. The phrase *systematic process* implies that there should be a well-planned approach for conducting an audit. This plan involves *objectively obtaining and evaluating evidence.* Two activities are involved here. The auditor must *objectively search for* and *evaluate* the relevance and validity of evidence. While the type, quantity, and reliability of evidence may vary between audits, this process of gathering and evaluating evidence makes up most of the auditor's activities on an audit.

The evidence gathered by the auditor must relate to *assertions about economic actions and events.* For example, financial statements prepared by management contain numerous assertions. If the balance sheet contains an amount of $10 million for property, plant, and equipment, management is asserting that the company owns the assets, that it uses them in the production of goods and services, and that this amount represents their undepreciated historical cost. The auditor compares the evidence gathered to assertions about economic activity in order to assess *the degree of correspondence between those assertions and established criteria.* While numerous sets of criteria are available for measuring the degree of correspondence, generally accepted accounting principles (GAAP) are normally used for preparing financial statements.

The last important phrase, *communicating the results to interested users,* is concerned with the type of report the auditor provides to the intended users. The type of communication will vary depending on the type and purpose of the audit. In the case of financial statement audits, very specific types of reports communicate the auditor's findings. For other types of audits, the content and form of the reports vary with the circumstances, and the intended users.

Table 1–1 summarizes the relationship among assurance, attestation, and auditing services. Notice that the definitions included in Table 1–1 progress from very general for assurance services to very specific for auditing services. This text focuses on one type of auditing, financial statement audits, because it represents the major service offered by public accounting firms. However, in many instances, the approach, methods, and techniques used for financial statement audits also apply to attest and assurance service engagements.

Types of Audits

LO 4 While there are many types of audits, five types are generally referred to: *financial statement audits, compliance audits, operational audits,*

[6] American Accounting Association, Committee on Basic Auditing Concepts, "A Statement of Basic Auditing Concepts" (Sarasota, FL: AAA, 1973).

Table 1–1 Relationships among the Assurance, Attestation, and Auditing Services

Service	*Characteristics of Information Reported On*	*Definition of Service*
Assurance	Reliability Credibility Relevance Timeliness	A service in which a professional accountant is engaged to issue a written communication expressing a conclusion regarding a subject matter for which the accountable party is responsible.
Attestation	Reliability Credibility	A written communication regarding the reliability of a written assertion of another responsible party.
Auditing	Reliability Credibility	A service in which an auditor issues a written opinion on the correspondence between the information on the financial statements and the criteria established for reporting on economic events.

value-for-money audits, and *forensic audits*. Each of these types of audits will now be explained briefly. Excellent textbooks and articles are available that provide detailed coverage of these different types of audits.

Financial Statement Audits

A financial statement audit determines whether the overall financial statements present fairly in accordance with specified criteria. This type of audit usually covers the basic set of financial statements (balance sheet, income statement, statement of retained earnings, and a statement of cash flows), and *generally accepted accounting principles* (GAAP) serve as the criteria. Figure 1–3 graphically presents a simplified overview of the audit function for a financial statement audit. The auditor gathers evidence about the business transactions that have occurred (economic activity and events) and about management (the preparer of the report). The auditor uses this evidence to compare the assertions contained in the financial statements to the criteria chosen by the user and the auditor's report communicates to the user whether the assertions are consistent with the criteria.

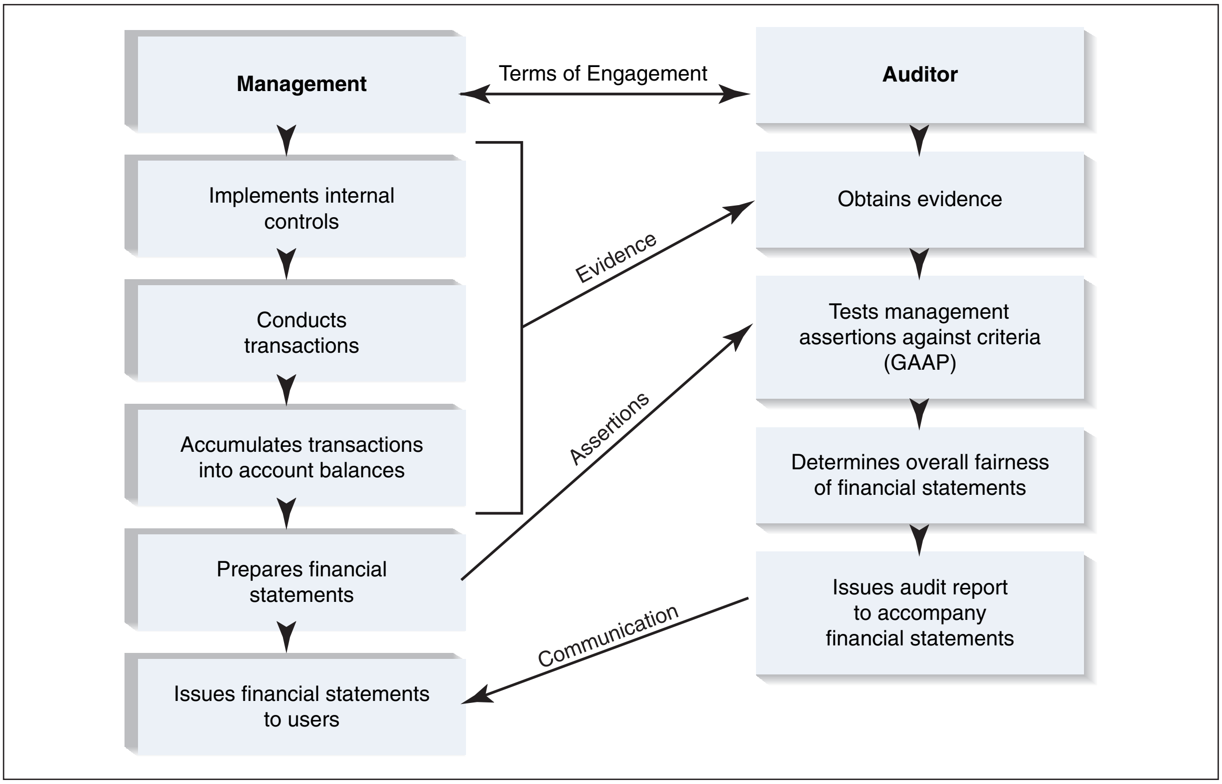
In deciding where to focus audit effort and attention, the auditor often uses the strategic systems approach.[7] The strategic systems approach is consistent with the profession's new standards emphasizing the risk-based approach to auditing. The auditor focuses on those systems in an entity that are critical to the entity's success and to the attainment of its strategic goals. Audit effort is concentrated in those areas (*key business processes*) which, because of their strategic importance, are more sensitive.

The auditor seeks assurance that the key business processes are functioning properly and are free of material misstatement. An example of a

[7]For more information see T. Bell, F. Marrs, I. Solomon, and H. Thomas, *Auditing Organizations Through A Strategic-Systems Lens* (KPMG Peat Marwick LLP, Montvale, NJ: 1997) and D. Leslie, *Audit Methodologies of Large Firms* (Stephen Austin & Sons Ltd, Claxton Hill, UK: 2000).

FIGURE 1–3

An Overview of the Financial Statement Audit Process



key business process could be the revenue recognition process for an entity in the high-technology software sector. This approach requires that the auditor understand the entity, the entity's strategic goals and initiatives, and be able to identify the key business processes which need to be examined in that context. Strategic Systems Auditing will be discussed in more detail in subsequent chapters.

Compliance Audits

A compliance audit determines the extent to which rules, policies, laws, covenants, or governmental regulations are followed by the entity being audited. For example, a company may have auditors determine whether corporate rules and policies are being followed by departments within the organization. The corporate rules and policies serve as the criteria for measuring the departments' compliance. Another example is examination of tax returns of individuals and companies by the Canada Revenue Agency (CRA) for compliance with the tax laws. In this example, the *Income Tax Act* provides the criteria for measuring compliance.

Operational Audits

An operational audit involves a systematic review of an organization's activities, or a part of them, in relation to the *efficient* and *effective* use of resources. The purpose of an operational audit is to assess performance, identify areas for improvement, and develop recommendations. Sometimes this type of audit is referred to as a *performance audit* or *management audit*. Operational audits are generally more difficult to conduct than financial statement audits or compliance audits because it can be very difficult to identify objective, measurable criteria that can be used to assess effectiveness and efficiency.

Operational auditing has increased in importance in recent years, and it is likely that this trend will continue. With entities restructuring and downsizing, many aspects of the entity's operations are being evaluated. For example, in the public sector, an operational audit may be undertaken to assess the effectiveness and efficiency of the disbursement of grants by Human Resources Development Canada. In the private sector, an operational audit could be performed to assess the efficiency and effectiveness of the entity's use of IT resources.

Value-for-Money Audits

Value-for-money auditing is a "made in Canada" development, primarily in the public sector. Former Auditor General of Canada, James J. MacDonnell, characterized the audits performed by his office as having three interrelated components.

The components, which together were termed a comprehensive audit, are a value-for-money audit, which is similar to an operational audit but considers economy as well as efficiency and effectiveness; a traditional financial statement audit; and a compliance audit.[8]

Forensic Audits

A forensic audit's purpose is the detection or deterrence of a wide variety of fraudulent activities. The use of auditors to conduct forensic audits has grown significantly, especially where the fraud involves financial issues. Some examples where a forensic audit might be conducted include

- business or employee fraud[9]
- criminal investigations
- shareholder and partnership disputes
- business economic losses
- matrimonial disputes

For example, in a business fraud engagement, an audit might involve tracing funds or asset identification and recovery. An employee fraud investigation might involve the existence, nature, extent, and identification of the perpetrator of asset misappropriation. A forensic audit can also be conducted to trace and locate assets in a divorce proceeding. Exhibit 1–1 describes a recent forensic audit conducted by a major accounting firm for the board of directors of Lernout & Hauspie Speech Products NV. Some public accounting firms specialize in forensic audit services.

[8]Canadian Comprehensive Auditing Foundation. *Comprehensive Auditing: Concepts, Components and Characteristics* (Ottawa: CCAF, 1980).

[9]See J. T. Wells, *Occupational Fraud and Abuse* (Austin, TX: Obsidian, 1997), for an excellent discussion of various types of business fraud.

EXHIBIT 1–1

PricewaterhouseCoopers Issues Report on Fraudulent Activities at Lernout & Hauspie

Lernout & Hauspie Speech Products NV (L&H), headquartered in Leper, Belgium, was a leader in speech translation software. L&H went public in late 1995 on the NASDAQ stock exchange and at one time had a market capitalization of nearly $US 6 billion. In 2000, the highflying company came under a SEC probe for reported revenues in Asia. Subsequently, the company filed for bankruptcy in both Belgium and the United States.

At the request of the company's new management, PricewaterhouseCoopers (PwC) was hired to conduct a forensic audit of the accounting fraud. Their audit discovered that most of the fraud occurred in L&H's Korean unit. In an effort to obtain bonuses based on sales targets, the managers of the Korean unit went to great lengths to fool L&H's auditor, KPMG. The PwC auditors reported that the Korean unit used two types of schemes to perpetrate the fraud. One involved factoring of receivables with banks to obtain cash to disguise the fact that the receivables were not valid. L&H Korea gave the banks side letters that provided that the money would be given back if the banks could not collect them. These side letters were concealed from KPMG. The second scheme arose after KPMG questioned why L&H Korea was not collecting more of its outstanding receivables. L&H Korea had its customers transfer their contracts to third parties who then took out bank loans to pay L&H Korea. L&H Korea provided the collateral for the loans. PwC reported that nearly 70 percent of the $160 million in sales booked in the Korean unit of L&H were fictitious.

Source: M. Maremont, J. Eisinger, and J. Carreyrou, "How High-Tech Dream at Lernout & Hauspie Crumbled in a Scandal," *The Wall Street Journal* (December 7, 2000), Al, A18; J. Carreyrou and M. Maremont, "Lernout Unit Engaged in Massive Fraud to Fool Auditors, New Inquiry Concludes," *The Wall Street Journal* (April 6, 2001), A3; and J. Carreyrou, "Lernout Unit Booked Fictitious Sales, Says Probe," *The Wall Street Journal* (April 9, 2001), B2.

Types of Auditors

LO 5 There are a number of different types of auditors; however, they can be classified under four headings: *external auditors, internal auditors, government auditors,* and *forensic auditors*. Each type of auditor will be discussed briefly. One important requirement of each type of auditor is independence, in some manner, from the entity being audited.

External Auditors

External auditors are often referred to as *independent auditors* or *public accountants*. Such auditors are called "external" because they are not employed by the entity being audited. External auditors audit financial statements for publicly traded and private companies, partnerships, municipalities, individuals, and other types of entities. They may also conduct compliance, operational, and forensic audits for such entities. An external auditor may practice as a sole proprietor or as a member of a public accounting firm.

In Canada, there are three professional accounting bodies, Chartered Accountants (CAs) (members of the Canadian Institute of Chartered Accountants), Certified General Accountants (CGAs) (members of the Certified General Accountants Association of Canada), and Certified Management Accountants (CMAs) (members of the Society of Management Accountants of Canada). Currently, as the designation would suggest, the majority of CMAs are employed in private industry, although CMAs do have the right to perform the attest audit function in some provinces.

Although each of the three is distinct, there are similarities across the three organizations. Each institute or association is comprised of provincial bodies responsible for such elements as student education, professional conduct, and continuing professional development. The provincial bodies have delegated some of their functions to the above-mentioned national organizations, which ensures uniform standards for professional designation (e.g., the Uniform Evaluation in the case of the CICA, and the national examinations in the case of the CGA-Canada), and the development and promulgation of professional standards (e.g., the *CICA Handbook*). The website addresses of each of the three national organizations are as follows:

- Canadian Institute of Chartered Accountants (CICA): www.cica.ca. See also *CAMagazine* at www.camagazine.com
- Certified General Accountants Association of Canada (CGA-Canada): www.cga-canada.org. See also *CGA Magazine* at www.cga-canada.org/eng/magazine/default.htm
- Society of Management Accountants of Canada (CMA Canada): www.cma-canada.org. See also *Management* magazine at www.managementmag.com

For other related auditing and assurance services websites, visit the text's website under "Auditing Web Links."

Professional standards require that external auditors maintain their objectivity and independence when providing auditing or other attest services for clients. Later in the text, independence and objectivity will be discussed in depth.

Internal Auditors

Auditors employed by individual companies, partnerships, government agencies, individuals, and other entities are called internal auditors.[10] In major corporations, internal audit staffs may be very large, and the director of internal auditing (sometimes called the chief audit executive, or CAE) is usually a major job title within the entity.

The Institute of Internal Auditors (IIA) is the primary organization representing internal auditors with over 120,000 members in internal auditing governance and internal control, IT audit, education, and security from more than 100 countries.[11]

The IIA defines internal auditing as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations" with a view to "help[ing] 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 auditing reviews the reliability and integrity of information, compliance with policies and regulations, the safeguarding of

[10]See D. Galloway, *Internal Auditing: A Guide for the New Auditor*, 2nd ed. (Altamonte Springs, FL: The Institute of Internal Auditors, 2001).

[11]See the IIA's home page (www.theiia.org) for more information on the IIA and the certified internal auditor program.

assets, the economical and efficient use of resources, and established operational goals and objectives. Internal audits encompass financial activities and operations including systems, production, engineering, marketing, and human resources.

The IIA has developed a set of standards that should be followed by internal auditors and has established a certification program. An individual meeting the certification requirements set up by the IIA, which include passing a uniform written examination, can become a certified internal auditor (CIA). Many internal auditors are also CAs or CGAs.

Like external auditors, internal auditors must be objective and independent. To help ensure the objectivity and independence of internal auditors, the IIA suggests that the director of internal auditing report directly to either the board of directors or the audit committee of the board or have free access to the board. If the internal auditors report to the chief financial officer or a similar financial officer within the organization, a conflict of interest may arise. Internal auditors may not be objective and independent when evaluating certain organizational functions if they are direct subordinates of the same individuals whose stewardship they are reporting on.

Internal auditors can be involved in all types of audits. They may conduct compliance, operational, and forensic audits within their organizations; they may assist the external auditors with the annual financial statement audit. Internal auditors may also be involved in assurance and consulting engagements for their entities.

Government Auditors

Government auditors are employed by federal, provincial, and local agencies. At the federal level is the Office of the Auditor General of Canada (www.oag-bvg.gc.ca/domino/oag-bvg.nsf/html/menue.html). Each province has a provincial counterpart (e.g., The Office of the Provincial Auditor of Ontario—www.auditor.on.ca/). It is the offices of the Auditor General that perform comprehensive audits on the financial information of government agencies and Crown corporations, both federally and provincially. Such examinations are mandated at least every five years. Similar requirements exist at provincial and municipal or local levels of government. The addition of economy to the effectiveness and efficiency criteria of an operational audit (the three together are termed a value-for-money audit) reflect the fact that these agencies and Crown corporations are supported in whole or in part by public (taxpayer) funds and therefore have a responsibility to use those funds wisely.

Another group of government auditors are those employed by the Canada Revenue Agency (www.cra-arc.gc.ca/) (formerly the Canada Customs and Revenue Agency). Their job is to audit the books and records of individuals and organizations to ensure adherence to tax laws, including income tax, sales tax, and GST. These audits are typically compliance audits.

Forensic Auditors

Forensic auditors are employed by corporations, government agencies, public accounting firms, and consulting and investigative services firms. They are trained in detecting, investigating, and deterring fraud and white-collar crime. Some examples of situations where forensic auditors have been involved include

- analyzing financial transactions involving unauthorized transfers of cash between companies
- reconstructing incomplete accounting records to settle an insurance claim over inventory valuation
- proving money-laundering activities by reconstructing cash transactions
- embezzlement investigation and documentation, and negotiation of insurance settlements

The Association of Certified Fraud Auditors (ACFE) is the primary organization supporting forensic auditors. The ACFE (www.cfenet.com/home.asp) is a 28,000-member professional organization dedicated to educating Certified Fraud Examiners (CFE), who are trained in the specialized aspects of detecting, investigating, and deterring fraud and white-collar crime.

The ACFE offers a certification program for individuals to become CFEs. An individual interested in becoming a CFE must pass the Uniform CFE Examination, which covers four areas: (1) financial transactions, (2) legal elements of fraud, (3) fraud investigation, and (4) criminology and ethics. CFEs are required to follow the association's Code of Professional Ethics and meet certain continuing education requirements.[12] CFEs come from various professions, including auditors, accountants, fraud investigators, loss prevention specialists, lawyers, educators, and criminologists. The CICA also offers the opportunity for its members, once they have obtained the CA designation, to specialize in this area. Such CA specialists are known as CA·IFA (Investigative and Forensic Accountant).

The Public Accounting Profession

LO 6 As this text focuses on financial statement audits and assurance services, both of which are conducted by external auditors, this section provides an overview of the public accounting profession.

Public Accounting Firms

Public accounting firms may be organized as proprietorships or partnerships. Typically, local public accounting firms are organized as proprietorships or partnerships. Regional, national, and international firms are normally structured as partnerships. Structuring public accounting firms as proprietorships and partnerships offers additional protection for users of their services because such organizational structures, unlike a corporation, do not provide limited liability for the owners or partners. Thus, users can seek recourse not only against the public accounting firm's assets but also against the personal assets of individual partners. This lends additional credibility to the services provided to the public because the individuals are willing to risk the loss of their personal wealth.

[12]See the Association of Certified Fraud Examiners home page (www.acfe.org) for more information on the association and the CFE program.

Regional, national, or international firms may also be structured as limited liability partnerships (LLPs), a form of organization that offers somewhat more individual financial protection, and is allowed by some provinces. An LLP is generally governed by the laws applicable to general partnerships. This organizational structure offers accounting firms the ability to preserve the partnership structure, culture, and taxation but provides more personal protection against lawsuits. Under an LLP, partners are not personally responsible for firm liabilities arising from other partners' and most employees' negligent acts. However, the assets of the partnership are available for settlements of lawsuits resulting from other partners' or employees' acts.

Public accounting firms can be categorized by size. The four largest international public accounting firms in the world, all of which have Canadian partnerships, are Deloitte & Touche, KPMG, Pricewaterhouse-Coopers, and Ernst & Young.[13] In Canada, most audits of public companies are performed by one of the Big 4 plus Grant Thornton and BDO Dunwoody. Together, they audit the majority of the 1,000 largest companies in Canada. In 2006 their gross revenues ranged from a low of $261 million to a high of $1,151 million.[14] A significant advantage of internationalization is the ability to serve the increasing number of multinational clients.

Another group of firms, often referred to as national firms, have offices in most major cities and international affiliations. This allows them to compete with the Big 4 domestically and internationally and offer basically the same range of services. The gross revenues of these firms ranged from $34 million to $115 million in 2006.[15]

Local or regional firms may be quite large in scope either through having a number of offices in different locations or through membership in an association of public accounting firms, or they may have only one or a few offices. These firms provide audit, tax, and accounting services, generally to smaller organizations.

Audits are usually conducted by teams of auditors. The typical audit team is composed of, in order of authority, a partner, a manager, a senior, and staff members. Staff members are typically responsible for conducting portions of the audit work assigned to them by the senior. The senior or in-charge auditor participates in the planning, conduct, and supervision of the audit work. The senior also reviews the staff members' work prior to reviews by the manager and partner. In addition to reviewing the staff and senior's work, the manager and partner have various administrative responsibilities related to the audit engagement, such as scheduling the engagement and billing the client. The partner has the final authority and decision-making responsibility for accounting and auditing matters, including the issuance of the audit report. Table 1–2 summarizes the duties performed by each member of the audit team.

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[13]Subsequent to the Enron crisis, the firm of Arthur Andersen & Co., which had been one of the Big 5, ceased to continue. Many of the individual partners and employees of Arthur Andersen & Co. are now with other public accounting firms.

[14]"The Annual Top 30 Survey of Canadian Accounting Firms," *The Bottom Line* (April 2006), p. F3.

[15]Ibid, p. F3.

Table 1–2 Selected Duties of Audit Team Members

Audit Team Member	*Selected Duties*
Partner	• Reaching agreement with the client on the scope of the service to be provided. • Ensuring that the audit is properly planned. • Ensuring that the audit team has the required skills and experience. • Supervising the audit team, reviewing the working papers, and quality control. • Signing the audit report.
Manager	• Ensuring that the audit is properly planned, including scheduling of staff. • Supervising the preparation and approving the audit program. • Reviewing the working papers, financial statements, and audit report.
Senior/Auditor-in-charge	• Assisting in the development of the audit plan. • Preparing budgets. • Assigning audit tasks to staff and directing the day-to-day performance of the audit. • Supervising and reviewing the work of the staff.
Staff	• Performing the audit procedures assigned to them. • Preparing adequate and appropriate working papers. • Informing the senior about any auditing or accounting problems encountered.

Other Types of Services Offered by Public Accounting Firms

In addition to auditing and assurance services, public accounting firms perform three broad categories of services.

Tax Services Clients of public accounting firms are required to pay various types of federal, provincial, and local taxes. Public accounting firms have tax departments that assist clients with preparing and filing tax returns, provide advice on tax and estate planning, and may provide assistance on tax issues before the Canada Revenue Agency or tax courts.

Management Advisory Services Management advisory services (MAS) are consulting activities that may involve providing advice and assistance concerning an entity's organization, personnel, finances, operations, systems, or other activities. Because of concerns regarding potential impairment of independence and other issues, a number of the major firms have sold their consulting practices. The consulting practice of KPMG is now BearingPoint, the consulting practice of PriceWaterhouseCoopers (PWC) is now part of IBM Global Services, and the consulting practice of Ernst & Young (EY) is now part of Cap Gemini. Consulting practices that are still associated with audit firms are prohibited from providing certain kinds of management advisory services, in particular IT consulting and internal audit services to their publicly listed audit clients.

Accounting and Review Services Public accounting firms perform a number of accounting services for their non-audit or nonpublic clients. These services may include bookkeeping, payroll processing, and preparing financial statements. When accounting services for financial statements are provided for nonpublic companies, either a compilation or a review is performed. These forms of services provide less assurance on the correspondence between assertions and established criteria than a financial statement audit does. A *compilation* presents financial statement information that is the representation of management, and the compilation report issued by the public accountant does not provide any assurance on the compiled financial statements. A *review,* on the other hand, provides limited assurance that no material modifications are necessary in order for the financial statements to conform to established criteria. In contrast, an audit provides reasonable assurance that the financial statements conform to established criteria. Accounting services are discussed in more detail in Chapter 19.

Issues and Challenges Currently Affecting the Profession

This section briefly discusses some of the important issues currently confronting the auditing and assurance profession. You are encouraged to examine the references cited for further details.

Expanded Services In recent years there has been a growing demand for external auditors to expand their services beyond the traditional financial statement audit. The list of assurance services discussed earlier in this chapter is evidence of this demand for expanded services by external auditors. Other types of auditors are also being asked to perform assurance services. Internal and governmental auditors are conducting assurance services that go beyond their traditional activities of compliance and operational audits. The IIA's definition of internal auditing recognizes this fact. Forensic auditors are also performing assurance services that involve investigations beyond their traditional work related to thefts of assets.

All of the major accounting organizations (e.g., CICA, CGA-Canada, CMA, AICPA, IIA, ACFE) that support auditing have taken actions to create an environment where their members can develop their competencies to perform these expanded services. For example, the CICA has developed a number of specialization streams for members. In addition to the CA·IFA previously mentioned in connection with forensic accounting, a CA may choose to specialize in Information Technology (CA·IT), business valuations (CA·CBV), Internal Auditing (CA·CIA), information systems auditing (CA·CISA), or insolvency and restructuring (CA·CIRP). At the time of writing, specializations in corporate finance and in taxation are also under development. More information about these specializations is available on the CICA website.

Globalization More and more business entities are involved with either the manufacture or distribution of products around the world. One public accounting firm has noted the following about the global business environment:[16]

[16]T. B. Bell, F. O. Marrs, I. Solomon, and H. Thomas, *Auditing Organizations Through a Strategic-Systems Lens: The KPMG Business Measurement Process* (New York: KPMG Peat Marwick LLP, 1997).

> In today's world, distance is no longer a barrier to market entry, technologies are rapidly replicated by competitors, and information and communications technologies are shaping a new economic order. To manage their business risks effectively, organizations must now view their playing field as the whole global economy (pp. 26–27).

This firm also stated that

> Today's global economy and the business organizations operating within it, however, have become so complex and interdependent that new approaches to auditing must be developed (p. 1).

The public accounting profession is being affected by the globalization of business. While most of the major public accounting firms have international operations, the need to deliver many different services worldwide to clients has led to mergers among the major firms. Smaller firms have found it necessary to establish international affiliations or associations in order to service their clients' foreign operations. Issues have also been raised about the diversity of accounting and auditing standards between countries. As a consequence of this problem, we have seen the establishment of international accounting and auditing standards.

Litigation Recent years have seen an increase in litigation against auditors, most frequently for negligence. Although the auditor's exposure to legal liability in Canada is not as extreme as that in the United States, nor, in the opinion of at least one expert, is it likely to become so, it is instructive to keep abreast of developments there.[17]

The most dramatic recent example of litigation against an auditor is the prosecution in the United States of the firm of Arthur Andersen in relation to its involvement in the events surrounding the Enron bankruptcy in the fall of 2001. In June 2002, Arthur Andersen was found guilty of obstruction of justice. The official sanction was that Arthur Andersen was legally prevented from performing audits of publicly listed clients. However, the unofficial outcome was the almost complete erosion of its client base resulting in the demise of Arthur Andersen as a firm.[18] (Other consequences of the Enron affair are discussed in the following section on Organizations that Affect Financial Statement Audits and more detailed coverage of the legal issues will be provided in Chapter 18.)

Even before Enron, litigation settlements by audit firms in the United States were in the hundreds of millions of dollars. For example, Table 1–3 shows some recent settlements by US auditors. While the numbers in Canada are substantially smaller, litigation is a major concern for the profession. In Canada, the Ontario government, as part of Bill 198, has passed legislation that may both hurt and help auditors of OSC-listed companies. On one hand, the new legislation makes it easier for third parties to sue the auditor for negligence, but on the other hand it puts a cap on the maximum amount of the auditor's liability. Legal liability for auditors in Canada, including Bill 198, is discussed in detail in Chapter 18.

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[17]M. Paskell-Meade, "What Liability Crisis," *CAMagazine* (May 1994), pp. 42–43.

[18]The 2002 conviction by Arthur Andersen was overturned by the US Supreme Court on May 31, 2005, but by that time the firm had long ceased to exist, except as a name.

Table 1–3 Recent Litigation Settlements by Auditors in the United States

Auditor	Company Audited	Settlement Amount
Ernst & Young	Cendant	$335 million
Andersen	Waste Management	75 million
Andersen	Sunbeam	110 million
PricewaterhouseCoopers	Microstrategy	51 million
Ernst & Young	Savings & Loans*	400 million
Deloitte	YBM Magnex International	76 million
KPMG	Rite Aid	125 million

*Various Savings & Loans, including Lincoln and Silverado.

Source: M. Maremont, "KPMG, Former Auditor of L&H, May Draw Investor Ire," *The Wall Street Journal* (January 18, 2001); N. Harris, "Andersen to Pay $110 Million to Settle Sunbeam Accounting-Fraud Lawsuit," *The Wall Street Journal* (May 2, 2001); J. Weil, "Pricewaterhouse Agrees to Settle Microstrategy Suit for $51 Million," *The Wall Street Journal* (May 10, 2001); securities, stanford.edu/news-arhive/2002; and www.philly.com/mld/inquirer.

Independence Issues Independence is fundamental to the credibility of auditing and assurance services. One of the biggest challenges currently facing the profession is restoring its reputation for independence. In the wake of Enron, the entire profession's reputation suffered serious harm, and confidence in auditors' independence on the part of government, regulators, and the investing public was significantly impaired. In the post-Enron era, there have been initiatives in both Canada and the United States to strengthen auditor independence. The Public Interest and Integrity Committee (PIIC) of the CICA proposed new rules of professional conduct regarding independence, which have been adopted by the provincial institutes.

In Canada, the three professional accounting bodies have all responded by increasing their oversight of auditor independence. In Canada, both the CICA and CGA-Canada have amended their rules of professional conduct to address *independence in fact*, where the auditor is able to maintain an unbiased attitude to the client throughout the audit, and *independence in appearance*, which is concerned with an external observer's view and interpretation of the auditor's relationship with the client. If independence in appearance is lost to observers, even if the auditor does maintain independence in fact, the value added by the audit function is negated.

The rules of professional conduct require the auditor to consider, before accepting, and throughout the audit, five specific threats to independence.

- ***Self-interest threat*** may arise from a financial interest in the client or its financial results.
- ***Self-review threat*** may arise where the auditor is in the position of auditing his or her own work (hence the prohibition of MAS for audit clients).

- ***Familiarity threat*** may arise where it may be difficult for the auditor to exercise professional scepticism during the audit (potentially arising as a result of long auditor tenure with a client, or family membership).
- ***Intimidation threat*** may arise where actual or perceive threats from the client may deter the auditor from acting objectively with respect to the conduct of the audit and/or the content of the audit report.
- ***Advocacy threat*** may arise when an individual on the audit team promotes an assurance client's position (e.g., choice of accounting policy) to the point where objectivity is, or appears to be, impaired.

Specific prohibitions relate financial or business relationships, and family relationships. The rules of professional conduct are discussed further in Chapter 17.

Organizations That Affect Financial Statement Audits

Professional Accounting Associations in Canada

The oldest professional accounting organization in Canada is the CICA. Auditing standards as stated in the *CICA Handbook* must be followed by all public accountants performing audits of companies chartered either federally or provincially. This authority comes from the federal *Canadian Business Corporations Act* and the various provincial corporations acts under which companies are chartered. The standards, issued by the Auditing and Assurance Standards Board (AASB) of the CICA, are codified as "Assurance and Related Services Recommendations" and make up the italicized portions of sections 5000 to 9200 of the *CICA Handbook*. The Auditing and Assurance Standards Oversight Council (AASOC) was established in 2002 by the CICA to oversee the AASB to provide strategic direction and to ensure the inclusion of the user's perspective into the setting of auditing and assurance standards.

LO 7

In addition, the AASB issues Assurance and Related Services Guidelines. These guidelines (AuGs) may be interpretations of the *CICA Handbook* recommendations or guidance concerning a specific matter. They may be withdrawn or incorporated into the *Handbook* as recommendations. At present there are approximately 40 Audit and Related Services Guidelines outstanding, some of which relate to either auditing in an EDP environment or auditing using EDP techniques.

AASB recommendations relating to auditing in the public sector (i.e., government) appear in sections PS5000 and PS6000 of the *Handbook*. Many of the recommendations concern value-for-money audits for various levels of federal, provincial, and territorial governments.

The usual process by which new recommendations are incorporated into the *Handbook* is through the issuance by the AASB of exposure drafts (EDs). These exposure drafts are available on their website and comments are solicited from interested parties. As a result of their responses, an ED may be amended as the AASB thinks appropriate. It may or may not be issued again as a re-exposure draft. When the AASB is satisfied with the form and content of the ED, it is incorporated into the *Handbook*.

CGA-Canada and SMAC have the same governance role for their members as does the CICA for chartered accountants. They set educational policy and standards, undertake research, and publish materials for their members. However, they are bound by the recommendations of the *CICA Handbook* in their professional practice.

Professional Accounting Organizations Outside Canada

Besides the direct influence of the professional accounting bodies in Canada, professional accounting bodies outside Canada indirectly influence Canadian standards governing financial statement audits. Two of these in particular are the International Federation of Accountants (IFAC, www.ifac.org/) and the American Institute of Certified Public Accountants (AICPA, www.aicpa.org/index.htm).

For Canadian auditors, an important external professional organization is the International Federation of Accountants (www.IFAC.org). IFAC is made up of the professional associations of its member countries. In Canada, the CICA, CGA-Canada, and SMAC are all members of IFAC. The objective of IFAC is to harmonize auditing standards on an international basis through the issuance of International Standards on Auditing (ISAs) and International Auditing Practice Statements. Currently, the Auditing and Assurance Standards Board (AASB) of the CICA is in the process of harmonizing Canadian standards with international standards on auditing.

Complete convergence is to be achieved by 2008, to coincide with the International Auditing and Assurance Standards Board's target completion of its Clarity Project, a major initiative to ensure that the ISAs are based on clear objectives, and are unambiguous and readable. The AASB will continue the process of incorporating ISAs into the existing structure of the *CICA Handbook* until complete convergence is achieved, at which time the sections of the *Handbook* will be renumbered to be consistent with the numbering of the ISAs.

Organizations External to the Profession

A major influence in Canada is the Canadian Public Accountability Board (CPAB), which was formed jointly in 2002 by the Office of the Superintendent of Financial Institutions (a federal regulator), the Canadian Securities Administrators (representing the provinces), and the CICA. CPAB oversees auditors of public companies in Canada and involves such activities as more rigorous inspection of auditors of public companies, tougher auditor independence rules, and new quality control requirements for firms auditing public companies. To date, CPAB has issued three annual reports on the results of its inspections. They can be accessed through its website, www.cpab-ccrc.ca.

CPAB is comprised of 11 members, including professional accountants and representatives from the regulatory agencies. Also, in Canada, any companies that issue securities must adhere to the rules established by their respective securities commissions. The securities exchanges of B.C., Alberta, Saskatchewan, Manitoba, Ontario, and Quebec belong to the Canadian Securities Administration (CSA). The CSA has stated that its members require the use of the *CICA Handbook* GAAP for companies issuing securities under their members' jurisdictions. Because the Toronto Stock Exchange (TSE) is the senior exchange in Canada, the regulations of the Ontario Securities Commission (OSC) are particularly important.

Shares of many Canadian companies are traded on one of the exchanges in the United States (NYSE, AMEX, NASDAQ). Those companies must meet the requirements of the US Securities Exchange Commission (SEC). The SEC is a US federal government agency that administers the *Securities Act* of 1933 which regulates information disclosure in a registration statement for an initial public offering, and the *Securities Exchange Act* of 1934 which regulates ongoing reporting by companies whose securities are listed and traded on a US exchange. The *Securities Exchange Act* of 1934 gives the SEC authority to establish accounting and auditing standards. Since Canadian auditors audit Canadian companies listed on a US exchange, it is important for Canadian public accountants with US-listed clients to be familiar with the SEC.

A number of other US organizations affect auditing standards and practice in the US (and thereby indirectly influence the Canadian environment). The Financial Accounting Standards Board (FASB) is a privately funded body, with membership from the profession, industry, government and academe, whose mission is to establish standards for financial accounting and reporting through the issuance of Statements of Financial Accounting Standards (SFAS). The Government Accounting Standards Board (GASB) is similar in makeup to FASB and operates in the public sector.

In 2002, in response to Enron and other dramatic business events, the US Congress passed the *Sarbanes-Oxley Act* (which will be discussed in more detail in Chapter 18). This Act places many new requirements on auditors and the public companies they audit, but most relevant to this discussion is the fact that the *Sarbanes-Oxley Act* created the Public Company Accounting Oversight Board (PCAOB). PCAOB is a private non-profit corporation funded principally by fees from public companies, made up of representation from a cross-section of public interests. The mandate of PCAOB is to protect the public interest by ensuring that public company financial statements are audited according to the highest standards of quality, independence, and ethics. Public accounting firms are required to register with PCAOB and conform to its rules which are administered and enforced by the SEC, in order to be eligible to perform audits of publicly listed companies.

REVIEW QUESTIONS

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

1,2 **1-2** Why is studying auditing different from studying other accounting topics? How might understanding auditing concepts prove useful for consultants, business managers, and so forth?

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

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

1,3,4 **1-5** The Committee on Basic Auditing Concepts has provided a widely cited definition of auditing. What does the phrase *systematic process* mean in this definition?

3 **1-6** Define auditing, attest, and assurance services. Provide two examples of each.

4 **1-7** Identify and describe four general types of audits.

4 **1-8** Give three examples each of compliance, operational, and forensic audits.

5 **1-9** List the various types of auditors.

4,5 **1-10** What types of audits are typically conducted by government and CRA auditors?

6 **1-11** What forms of organizations can be used by public accounting firms? What is a limited liability partnership?

6,7 **1-12** What are the issues currently affecting the public accounting profession?

2,5 **1-13** What types of services are commonly offered by public accounting firms?

6 **1-14** What professional accounting organizations inside and outside Canada influence the Canadian public accounting profession?

7 **1-15** What organizations external to the profession inside and outside Canada influence the Canadian public accounting profession?

MULTIPLE-CHOICE QUESTIONS FROM PROFESSIONAL EXAMINATIONS

Unless otherwise indicated, these multiple-choice questions were adapted from the CPA examinations, courtesy of the American Institute of Certified Public Accountants.

1,2,3 **1-16** An audit aids in the communication of economic data because the audit

a. Confirms the accuracy of management's financial representations.
b. Lends credibility to the financial statements.
c. Guarantees that financial data are fairly presented.
d. Assures the readers of financial statements that any fraudulent activity has been corrected.

4 **1-17** Operational auditing is oriented primarily toward

a. Future improvements to accomplish the goals of management.
b. The accuracy of data reflected in management's financial records.
c. Verification that a company's financial statements are fairly presented.
d. Past protection provided by existing internal control.

4 **1-18** Which of the following is least likely to be a component of a comprehensive audit performed in the public sector?

a. Compliance audit.
b. Value-for-money audit.
c. Financial audit.
d. Tax audit.

(CGA-Canada, adapted. Extract from *Auditing 2*, published by the Certified General Accountants Association of Canada, © CGA-Canada, 1995 to 2006, reproduced with permission. Because of *Tax Act* updates and/or changes to the *CICA Handbook*, the contents of these examinations may be out of date; therefore the currency of the contents is the sole responsibility of the user.)

6 **1-19** Which of the threats to independence identified in the Rules of Professional Conduct may be created by deliberately underbidding to obtain an audit engagement?

a. Self-review threat.
b. Familiarity threat.
c. Advocacy threat.
d. Self-interest threat.
e. Intimidation threat.

(CGA-Canada, adapted)

6,7 **1-20** The International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board of the International Federation of Accountants can best be described by which of the following statements?

a. ISAs are written to supplement Canadian and other domestic auditing standards by filling in areas not covered by these standards.
b. ISAs have little influence and are rarely used either in Canada or internationally.
c. ISAs are a set of standards that are adopted in whole or in part by many countries around the world, including Canada.
d. ISAs are currently an effective substitute for Canadian auditing standards, and an auditor can choose to audit a domestic company either in accordance with the *CICA Handbook* or the ISAs.

(CGA-Canada, adapted)

PROBLEMS

1,2,3 **1-21** Felix Potvine, the sole owner of a small hardware business, has been told that the business should have financial statements reported on by an independent auditor. Potvine, having some bookkeeping experience, has personally prepared the company's financial statements and does not understand why such statements should be examined by an auditor. Potvine discussed the matter with Steve Barber, an auditor, and asked Barber to explain why an audit is considered important.

Problems continue on page 27

Required:

a. Describe the objectives of an audit.

b. Identify five ways in which an audit may be beneficial to Potvine.

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1,2 **1-22** Greenbloom Garden Centres is a small, privately held corporation that has two stores in London, 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 control of the operations. The family does not intend to sell shares in the company to the public.

Required:

Discuss the factors that may make an audit necessary for the company.

4 **1-23** Audits can be categorized into five types: (1) financial statement audits, (2) compliance audits, (3) operational audits, (4) forensic audits, and (5) value-for-money audits.

Required:

For each of the following descriptions, indicate which type of audit (financial statement audit, compliance audit, operational audit, forensic audit, or value-for-money audit) best characterizes the nature of the audit being conducted. Also indicate which type of auditor (external auditor, internal auditor, government auditor, or forensic auditor) is likely to perform the audit engagement.

a. Examine the financial records of the Health Protection Branch and evaluate the policies and procedures of the Health Protection Branch in terms of bringing new drugs to the market.

b. Determine the fair presentation of Ajax Chemical's balance sheet, income statement, and statement of cash flows.

c. Review the payment procedures of the Accounts Payable Department for a large manufacturer.

d. Examine the financial records of a division of a corporation to determine if any accounting irregularities have occurred.

e. Evaluate the feasibility of forecasted rental income for a planned low-income public housing project.

f. Evaluate a company's Computer Services Department in terms of the efficient and effective use of corporate resources.

g. Audit the partnership tax return of a real estate development company.

h. Investigate the possibility of payroll fraud in a labour union pension fund.

1,2 **1-24** You recently attended your five-year university reunion. At the main reception, you encountered an old friend, Lee Beagle, who recently graduated from law school and is now practising with a large law firm in town. When you told him that you were an auditor and employed by a regional public accounting firm, he made the following statement and snickered. “You know, if a statutory and requirement did not exist, no one would be interested in having an audit performed. You auditors are just creatures of regulations.” Since you did not wish to cause a scene at the reunion, you let his comment pass. You and Lee agreed to have lunch the following week to talk over old times. However, you were still upset over Lee’s comment.

Required:

In preparation for your luncheon with Lee, draft a memo that highlights your thoughts about why auditors are not “creatures of regulations.” Cite any relevant evidence of a demand for auditing services in your memo. Focus on the value that auditing provides.

DISCUSSION CASES

1,2,3,6,7 **1-25** Four years ago, the International Cultural Club (ICC) was formed in an effort to create a united social group out of several separate regional clubs in the vicinity of the city of Burlington, located in central Canada. The purpose of the group is to combine resources to meet the recreational, cultural, and social needs of its collective members. ICC was formed through the collaboration of 10 clubs including Russians, Italians, Portuguese, Greeks, Germans, and others.

ICC’s board of governors has spent the last four years planning and preparing for its operation. They expect the club’s community centre to be fully completed next year. The facilities of the club will include a multi-purpose building to house banquets, meetings, and arts activities; hiking trails; indoor/outdoor tennis facilities; bicycle trails; baseball diamonds; an indoor/outdoor pool, and a soccer field.

The multi-purpose building is 75 percent complete, and ICC’s treasurer has stated that it is “approximately within budget” of the total $3.5 million cost. The two hectares of land on which the facility is built were provided by the provincial government by way of a five-year lease at $1 a year. The adjacent land of 24 ha was contributed to the club by a private donor. Previously, this land had been leased to a farmer for $54,000 a year. The 26 ha will be used for the previously mentioned activities, incurring estimated annual operating costs of $2 million. Estimated additional operating and administrative costs are $900,000.

William Cznoro, the newly elected president of the club, recognizes the importance of starting out on a sound footing. He has approached your firm to prepare a report providing recommendations on accounting, finance, and internal control issues. He has also asked you to prepare a presentation for the next meeting of the board of governors identifying the merits of an audit for ICC, and potential problems that might exist.

Required:

Prepare a presentation to the board of governors explaining why it would be beneficial to ICC to have a public accounting firm provide recommendations on accounting, finance, and internal control issues. In your memo, include a discussion of the advantages to ICC of having an audit conducted and identify other assurance services that could be of benefit to ICC now or in the future.

(CICA, adapted)

1,2,3,7 **1-26** You have been invited to make a presentation to a "Town and Gown" symposium for the members of the business faculty of your university and representatives of the local business community, to be held at the downtown campus of your university. The faculty has invited representatives from industry, the investment community, and the banking community and you, a professional accountant in public practice, to sit on the panel. In light of the current sluggish economy and the precipituous drop in the equity markets, one of the topics on the agenda is the usefulness of the financial statement auditor and the auditor's report. You have noted the following excerpts from presentations by the other participants.

Mr. John Wilton, Vice-President, Finance, Casablanca Industries:

The annual audit has become an unnecessary evil. Our audit fees, in my opinion, are already far too high for the value we receive from the audit. I believe you should reconsider the need for increased auditor involvement. If the auditor's role is to be expanded, something must be done to reduce the costs and maximize the benefits.

Ms. Irene Wong, Financial Analyst:

We are increasingly sceptical of the relevance of audited financial statements to the decisions we have to make. As they are based on the past, we find them of limited value as information for the decisions we need to make. I would be more comfortable if the independent auditor attested to business viability, management credibility, and future-oriented data.

Mr. Ravi Puri, Senior Corporate Loan Officer:

I agree with Irene. In addition to historical-cost financial statements, we need financial statements that portray current values, and prospective information on which to base our decision. We would like more assurance from the auditor than is presently conveyed with the financial statement audit that the company will be able to turn its assets into profits. In order to make loan decisions we need current and future information, not information about events that have already occurred.

Required:

Draft your presentation.

(CICA, adapted)

INTERNET ASSIGNMENTS

1,6,7 **1-27** Using an Internet browser, identify five Internet sites that contain accounting resources. For each site identified, prepare a brief summary of the types of information that are available. For example, IFAC's website (www.IFAC.org) contains extensive information on the organization's activities.

3 **1-28** Visit the CICA's website and identify three new assurance services that are being developed by the CICA.

1,2,3 **1-29** Visit the website for The Royal Bank of Canada (www.royalbank.com) and view the most recent annual report. Does the site contain any other financial or nonfinancial information that might be helpful to potential investors?

EarthWear 1,2 **1-30** EarthWear Clothiers makes high-quality clothing for outdoor sports and sells most of its products through mail order. Use the Internet to obtain information about the mail-order retail industry.