An Overview of Financial Statement Auditing

LEARNING OBJECTIVES

Upon completion of this chapter you will

[1] Understand generally accepted accounting principles as audit criteria.
[2] Understand the relationships among financial statements, management assertions, and audit objectives.
[4] Understand the importance of ethics and independence to the audit function.
[5] Understand why the auditor must be a business and industry expert.
[6] Develop a preliminary understanding of how the concepts of materiality, audit risk, and evidence apply to the audit process.
[8] Learn the major phases of the audit process.
[9] Know the basic elements of audit reporting.

RELEVANT ACCOUNTING AND AUDITING PRONOUNCEMENTS

CICA Handbook, section 5130, Materiality and risk in conducting an audit
CICA Handbook, section 5135, Auditor’s responsibility to detect and communicate misstatements
CICA Handbook, section 5136, Misstatements—Illegal acts
CICA Handbook, section 5140, Knowledge of the entity’s business
CICA Handbook, section 5150, Planning and supervision
CICA Handbook, section 5200, Internal control in the context of an audit—scope and introduction
CICA Handbook, section 5300, Audit evidence
CICA Handbook, section 5400, The auditor’s standard report
CICA Handbook, section 7500, The auditor’s involvement with annual reports
Assurance and Related Services Guideline AuG-7, Applying materiality and audit risk concepts in conducting an audit
Assurance and Related Services Guideline AuG-10, Legislative requirements to report on the consistent application of generally accepted accounting principles
Assurance and Related Services Guideline AuG-14, Auditor’s report on the financial statements of federally regulated financial institutions
This chapter provides an overview of a financial statement audit. For those readers who have relatively little knowledge about the conduct of an audit engagement, this overview is intended to introduce the important concepts and material presented in subsequent chapters. References to chapters where the concepts and material are covered in more depth are provided throughout this chapter.

The chapter covers the following topics:

- Generally accepted accounting principles as an audit criterion.
- Management assertions and audit objectives.
- The auditor’s responsibility for errors, fraud, and illegal acts.
- Ethics and independence.
- The auditor as a business and industry specialist.
- Three fundamental concepts in conducting an audit.
- Sampling: inferences based on limited observations.

The last two sections of the chapter present an overview of the audit process and an introduction to audit reporting.

Generally Accepted Accounting Principles as an Audit Criterion

The demand for auditing arises from the potential conflict of interest that exists between owners (shareholders) and managers. The contractual arrangement between these parties normally requires that management issue a set of financial statements that purports to show the financial position and results of operations of the entity. In order to properly evaluate the financial statements, the parties to the contract must agree on a benchmark or criterion to measure performance. Without an agreed-upon criterion, it is impossible to measure the fair presentation of the financial statements.

Generally accepted accounting principles (GAAP) have, over time, become the primary criteria used to prepare financial statements. As the term implies, these principles are generally accepted by the diverse users of financial statements. The authority for using GAAP as the benchmark comes from generally accepted auditing standards (GAAS). The fourth reporting standard requires that the auditor’s report indicate whether the financial statements are presented in accordance with GAAP. The auditor’s standard audit report states that “the financial statements . . . present fairly . . . in accordance with generally accepted accounting principles.” In making this statement in the audit report, the auditor judges whether (1) the accounting principles have general acceptance, (2) the accounting principles are appropriate in the circumstances, (3) the financial statements, including the footnotes, contain adequate disclosure, (4) the information in the financial statements is classified and summarized in a reasonable manner, and (5) the financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits.

In judging the proper accounting treatment for a transaction or event, the auditor should always consider whether the substance of the transaction differs from its form. Transactions should be recorded to reflect their economic substance. For example, if a company enters into a lease transaction in which the substance of the transaction is the purchase of the asset with debt, the transaction should be recorded as a capital lease rather than an operating lease.
It is important to consider how GAAP and GAAS are related in the audit function. Figure 1–4 in Chapter 1 presented an overview of the audit function for a financial statement audit. Management and their accountants record business transactions through the entity’s accounting system in accordance with GAAP. Therefore, the financial statements that are prepared based on the entity’s operations should also be in accordance with GAAP. GAAS, on the other hand, guide the auditor on how to gather evidence to test management’s assertions to determine if they are in accordance with GAAP. If the auditor has gathered sufficient evidence to provide reasonable assurance that the financial statements present fairly in accordance with GAAP, an unqualified report can be issued.

Financial Statements, Management Assertions, and Audit Objectives

[LO 2] Financial statements issued by management contain assertions about the components of those financial statements (refer to Figure 1–4). For example, when the financial statements contain a line item that inventory is $2,500,000, management asserts among other things that inventory exists, that the entity owns the inventory, and that it is properly valued. Similarly, if the financial statements contain a line item that states accounts payable are $750,000, management asserts among other things that the accounts payable are obligations of the entity and the amount for accounts payable contains all such obligations (an assertion as to completeness).

Management assertions can be classified into five categories:

- Existence or occurrence
- Completeness
- Ownership
- Valuation or measurement and allocation
- Statement presentation

Table 2–1 summarizes and explains management assertions.

The independent auditor’s work consists of searching for and evaluating evidence concerning assertions. Operationally, this is accomplished by developing audit objectives that relate to management’s assertions. In the

<table>
<thead>
<tr>
<th>TABLE 2-1</th>
<th>Summary of Management Assertions</th>
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<tr>
<td>Existence or occurrence</td>
<td>The assets and liabilities exist, and the recorded transactions have occurred.</td>
</tr>
<tr>
<td>Completeness</td>
<td>The accounts and transactions that should be included are included; thus, the financial statements are complete.</td>
</tr>
<tr>
<td>Ownership</td>
<td>The assets are owned by the entity, and the liabilities are owed by the entity, at a given date.</td>
</tr>
<tr>
<td>Valuation or measurement and allocation</td>
<td>Assets, liabilities, equity, revenues, and expenses are appropriately valued and are allocated to the proper accounting period.</td>
</tr>
<tr>
<td>Statement presentation</td>
<td>Amounts shown in the financial statements are properly presented and disclosed.</td>
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previous example, management asserted that accounts payable of $750,000 were complete (all accounts payable were included). The completeness assertion can be divided into two audit objectives: completeness and cutoff. By disaggregating the assertions into more specific audit objectives, the auditor is better able to design audit procedures for obtaining sufficient appropriate evidence to test management assertions. In our example, the audit objective for completeness is tested to determine if all accounts payable were included in the account, while the audit objective for cutoff tests whether all accounts payable were recorded in the proper accounting period. One audit procedure that would provide evidence about the completeness objective would be a search for unrecorded liabilities. One step in this search would be to examine vendor bills recorded in the period after year-end to determine if those liabilities relate to the current period. Once the auditor has sufficient evidence that the audit objective is met, he or she has reasonable assurance that the assertion is appropriate.

Figure 2-1 graphically represents the relationships among management assertions, audit objectives, audit procedures, and audit evidence. Chapter 4 contains detailed coverage of these relationships.
The Auditor's Responsibility for Errors, Fraud, and Illegal Acts

The financial statements are the responsibility of management, while the auditor’s responsibility is to express an opinion on the financial statements. Many readers of financial statements believe that auditors have a responsibility to detect all errors, fraud, and illegal acts. Section 5135 of the CICA Handbook, “Auditor’s responsibility to detect and communicate misstatements” and section 5136, “Misstatements–Illegal acts,” discuss the auditor’s responsibility regarding error, fraud, and illegal acts. According to the Handbook, the auditor’s responsibility is to conduct the audit in accordance with GAAS and to detect material misstatements. This implies that the auditor is responsible for material misstatements regardless of source. Conversely, it implies that the auditor is not responsible for detecting immaterial misstatements, regardless of source.

The Handbook requires the auditor to adopt an attitude of professional scepticism, but also points out that the auditor’s ability to detect fraud, which involves intent, is hampered by the fact that fraud is usually accompanied by acts designed to conceal its existence.

The issue of auditor responsibility in this area is one where a major “expectation gap” still exists. Chapter 6 will cover in detail the auditor’s responsibility with respect to fraud and illegal acts.

The general auditing standard (see Table 1–5) requires that the auditor exercise due professional care in the planning and performance of the audit. Due professional care requires that the auditor exercise professional scepticism, which is an attitude that includes a questioning mind and a critical assessment of audit evidence. Section 5090 of the Handbook indicates that, in the absence of evidence to the contrary, the auditor is entitled to assume good faith on the part of management; however, professional scepticism requires that the auditor objectively evaluate audit evidence. If the auditor suspected that there might be a material misstatement due to fraud, the auditor would be more sensitive to the selection and type of evidence examined.

Ethics and Independence

Ethical behaviour and independence on the part of an auditor are vital to the audit function. As discussed in Chapter 1, the demand for auditing arose from the need for a competent, independent person to monitor the contractual arrangements between the principal and agent. If an auditor is neither competent nor independent, the parties to the contract will place little or no value on the service provided.

Ethics refers to a system or code of conduct based on moral duties and obligations that indicates how we should behave. Professionalism refers to

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the conduct, aims, or qualities that characterize or mark a profession or professional person. All professions operate under some type of code of ethics or code of conduct. Professions establish such codes to demonstrate to the users of their services that members of the profession follow standards of behaviour. In addition to GAAS, each provincial Institute of Chartered Accountants has established a Code of Professional Conduct to govern the behaviour of its members (and students). The Code of Professional Conduct is made up of Principles, Rules, and Interpretations of the Rules. Although each provincial institute has the authority to establish and enforce its own code, they have harmonized their rules to be generally the same for CAs across Canada. CGAs are governed by the rules of the Certified General Accountants Association, both provincially and nationally, and CMAs are governed by provincially determined rules. Professional conduct is covered in more detail in Chapter 19. A major portion of the code identifies actions that may impair auditors’ independence. For example, auditors are not allowed to have financial or managerial interests in their clients.

In today’s audit environment, auditors are faced with situations that may test their ethical behaviour and independence. For example, competition among public accounting firms for audit clients has led to heavily discounted audit fees (referred to as low-balling). Low-balling involves intentionally underbidding for the engagement not only in order to obtain the audit, but also with the hope of entering into lucrative management consulting services. In such situations, the auditor may decrease the time allocated to the audit and the extent of audit procedures. This may compromise the auditor’s integrity, objectivity, and independence. Auditors may also have their independence tested when a client engages in opinion shopping—that is, when a client seeks the views of other CAs who will agree with the client’s desired accounting treatment. The client may attempt to force the auditor to go along with the desired accounting treatment by threatening to change auditors.

The point of this section is to emphasize the importance of ethical behaviour and independence on the part of auditors. Independence is the hallmark of the auditing profession. If auditors do not demonstrate to users that they perform audit services in an ethical and independent manner, the service will lose its value and the demand for auditing will decline.

The Auditor as a Business and Industry Expert

The auditor must have extensive knowledge about the nature of the client’s business and industry in order to determine whether financial statement assertions are valid. The auditor must also understand the strategic business risks faced by the client in addition to understanding the risks that affect the traditional processing and recording of transactions.

A paradigm that is becoming dominant amongst the large public accounting firms is the strategic systems approach (SSA) to auditing. Using SSA, the auditor seeks to understand and document: (1) management’s

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strategies to achieve its objectives, (2) management’s analysis of the risks the business faces, and (3) the business processes that management has put in place to manage those risks. This in-depth analysis allows the auditor to obtain a thorough understanding of the business risks facing the client, the inherent risk factors in the audit and the control risks associated with the major processes management has developed for the operation of the business. The ultimate objective of this detailed analysis is to assist the auditor in designing an effective, efficient audit of the client’s financial statements. A recent KPMG monograph contained the following observation:

As the global economy, the business organizations operating within it, and organizations’ business strategies become increasingly complex and interdependent, we believe more attention should be paid to the development of auditing methods and procedures that focus on assertions at the entity level—methods and procedures that promise greater power to detect material misstatements as they allow the auditor to ground key judgments in a more critical and holistic understanding of the client’s systems dynamics (p. 12).

Consideration of an entity’s business risks requires that the auditor know the client’s business strategy and how it plans to respond to, or control, changes in its business environment. Numerous rapid or momentous changes have significantly affected an industry or an entity within that industry. For example, the sale of books over the Internet by Amazon.com through a “virtual” bookstore significantly affected the retail book industry. Traditional bookstores (like Barnes & Noble) had to respond to this new competitor or lose sales and customers. Similarly, rapid and significant technological changes in telecommunications and in computers and peripheral equipment increase the business risks for entities that operate in those industries. Lastly, deregulation in banking and utilities has significantly increased the risks for entities that operate in those industries.

This focus on the client’s business risks leads to a more strategic and systematic approach to the audit. The auditor uses knowledge of the client’s business and industry to develop a more efficient and effective audit. The auditor places less emphasis on routine transactions that are likely to be tightly controlled through the client’s internal control system. Instead, the focus shifts to identifying nonroutine transactions, accounting estimates, and valuation issues that are much more likely to lead to misstatements in the financial statements. A detailed discussion of the strategic systems approach to auditing is found in Chapter 3.

Three Fundamental Concepts in Conducting an Audit

A financial statement audit requires an understanding of three fundamental concepts: materiality, audit risk, and evidence. The auditor’s judgment of materiality and audit risk establishes the type and amount of the audit work to be performed (referred to as the scope of the audit). In establish-
ing the scope of the audit, the auditor must make decisions about the nature, extent, and timing of evidence to be gathered. This section briefly discusses each of these concepts. The next two chapters cover these concepts in greater depth.

**Materiality**

The auditor’s consideration of materiality is a matter of professional judgment and is affected by what the auditor perceives as the view of a reasonable person who is relying on the financial statements. There are no formal standards or guidelines for making this judgment. Paragraph 5130.05 of the CICA Handbook defines materiality as follows:

A misstatement or the aggregate of all misstatements in financial statements is considered to be material if, in light of surrounding circumstances, it is probable that the decision of a person who is relying on the financial statements, and who has a reasonable knowledge of business and economic activities (the user), would be changed or influenced by such misstatement or the aggregate of all misstatements.

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 the users’ decisions. This is sometimes referred to as accounting materiality. The auditor uses accounting materiality as a starting point for determining an amount that will be used for establishing the preliminary judgment about materiality. This assessment is sometimes referred to as auditing materiality. Auditing materiality is generally assessed to be less than accounting materiality because the auditor needs to allow for the difficulty in assessing what is material to the diverse groups of financial statement users. When “materiality” is used in the remainder of this text, it refers to auditing materiality.

The earlier example of an inventory balance of $2,500,000 is used to demonstrate this approach. Suppose the auditor assesses that the inventory component of the financial statements can be misstated by $50,000 before users’ decisions will be affected. The $50,000 is accounting materiality. The auditor may set auditing materiality at a lower amount, say $40,000, to provide for any uncertainty that may be present in his or her assessment of accounting materiality. The $40,000 is used by the auditor to design the planned audit work. This amount would also be used to evaluate the auditor’s findings. By establishing an auditing materiality level such as $40,000, the auditor is focusing on material misstatements, where a misstatement is the difference between what management asserts is the balance and the balance based on the auditor’s findings.

As we shall see later in this chapter, the wording of the auditor’s standard audit report includes the phrase “the financial statements present fairly in all material respects.” This is the manner in which the auditor communicates the notion of materiality to the users of the auditor’s report. Further, there is no guarantee that the auditor will uncover all material misstatements. The auditor can only provide reasonable assurance that all material misstatements are detected. The notion of reasonable assurance leads to the second concept.
Audit Risk

The second major concept involved in auditing is audit risk.

Audit risk is the risk that the auditor will fail to express a reservation in his or her opinion on financial statements that are materially misstated.4

As mentioned previously, an audit does not guarantee or provide absolute assurance that all misstatements will be detected. The auditor’s standard report states that the audit provides only reasonable assurance that the financial statements do not contain material misstatements. The term reasonable assurance implies some risk that a material misstatement could be present in the financial statements and the auditor will fail to detect it. In conducting an audit, the auditor decides what level of audit risk he or she is willing to accept and plans the audit to achieve that level of audit risk. The auditor controls the level of audit risk by the effectiveness and extent of the audit work conducted. The more effective and extensive the audit work, the less the risk that the misstatement will go undetected and the auditor will issue an inappropriate report. However, as discussed previously, an auditor could conduct an audit in accordance with GAAS and issue an unqualified opinion, and the financial statements might still contain material misstatements.

Evidence

Most of the auditor’s work in arriving at an opinion on the financial statements consists of obtaining and evaluating evidence. Evidence supporting the financial statements consists of the underlying accounting records and source documents available to the auditor.

In designing an audit program to obtain evidence about management’s assertions contained in the financial statements, the auditor develops specific audit objectives that relate to each management assertion (see Figure 2–1). The audit objectives, in conjunction with the assessment of materiality and audit risk, are used by the auditor to determine the nature, extent, and timing of evidence to be gathered. Because the audit objectives are derived from management’s assertions, once the auditor has obtained sufficient appropriate evidence that the audit objectives are met, reasonable assurance is provided that the financial statements are fairly presented.

In searching for and evaluating evidence, the auditor is concerned with the relevance and reliability of the evidence. Relevance refers to whether the evidence relates to the specific audit objective being tested. If the auditor relies on evidence that relates to a different audit objective from the one being tested, an incorrect conclusion may be reached about a management assertion. For example, suppose the auditor wants to test whether the client owns certain property. If the auditor physically examines the property, this would not be relevant evidence. It is possible, for example, that the client is leasing the property the auditor examined.

4CICA Handbook, paragraph 5130.05.
Reliability refers to the diagnosticity of the evidence. In other words, can a particular type of evidence be relied upon to signal the true state of the assertion or audit objective? Suppose an auditor has the choice of gathering evidence from an independent, competent source outside the client or from a source inside the client. For example, evidence provided by a lawyer on the outcome of a lawsuit against the client would be considered more reliable than the controller’s assessment of the outcome. In this instance, the external source, the lawyer, would be chosen because evidence from the outside source would be viewed as independent and thus more reliable.

The auditor seldom has convincing evidence about the true state of an audit objective and, therefore, the related management assertion. In most situations, the auditor obtains only enough evidence to be persuaded that the audit objective is fairly stated. The nature of the evidence obtained by the auditor seldom provides absolute assurance about an audit objective because the types of evidence have different degrees of reliability. Additionally, for many parts of an audit, the auditor examines only a sample of the transactions processed during the period. Thus, as explained in the next section, the auditor reaches a conclusion based on a subset of the evidence available.

Sampling: Inferences Based on Limited Observations

The reader might ask why the auditor uses concepts such as materiality and audit risk to set the scope of an audit. Why not test all transactions that occurred during the period? The main reason is the cost and feasibility of such an audit. In a small business, the auditor might be able to examine all transactions that occurred during the period and still issue the audit report in a reasonable amount of time after year-end. 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 prevents the auditor from examining every transaction. Thus, there is a trade-off between the exactness or precision of the audit and its cost.

To deal with this problem, the auditor uses (1) his or her knowledge about the transactions and/or (2) a sampling approach to examine the transactions. Many times the auditor is aware of items in an account balance that are likely to contain misstatements based on factors such as previous audits of the client or knowledge of the industry. For example, the auditor’s prior knowledge may indicate that transactions with certain types of customers or large dollar transactions are likely to contain misstatements. The auditor can use this knowledge to select those transactions for examination. When the auditor has no special knowledge about which transactions may be misstated, he or she uses sampling procedures that increase the likelihood of obtaining a sample representative of the population of transactions. In such cases, the auditor is using the laws of probability to identify transactions that are misstated.

The size of a sample is a function of materiality and acceptable audit risk. There is an inverse relationship between sample size and either materiality or acceptable audit risk. For example, if an auditor assesses materi-
ality to be a small amount for a given level of audit risk, a larger sample will be needed than if materiality was a larger amount. This occurs because the auditor must gather more evidence (a larger sample) to support a lower level of materiality. Similarly, as the amount of audit risk the auditor is willing to accept decreases for a given materiality amount, the sample size necessary to test the audit objective becomes greater. This occurs because the auditor must gather more evidence in order to reduce the amount of uncertainty or risk associated with the test.

Overview of the Audit Process

This section discusses the major phases of a financial statement audit. The presentation provides the reader with an overall picture of the steps necessary to complete an audit engagement. While these steps are presented as separate phases, on many engagements some of these steps may be conducted concurrently. Note also that there is important feedback among the various phases about the results of the audit work conducted. For example, when testing an accounts receivable balance, the auditor sets the scope of the tests based on the assessment of the internal controls over the revenue cycle. If the auditor detects more misstatements than expected when auditing the accounts receivable account, it may provide evidence that the internal controls in the revenue cycle are not operating as effectively as originally assessed. In this case, the auditor should revise the internal control assessment for the revenue cycle and adjust other planned audit tests that may be affected by the revenue cycle.

The phases of the audit are shown in Figure 2–2. The first phase, client acceptance and continuance, is covered in some detail below. This is followed by a brief discussion of the other phases shown in Figure 2–2. Subsequent chapters cover the other phases in more detail.

Client Acceptance and Continuance

Prudence requires that public accounting firms establish policies and procedures for deciding whether to accept new clients or retain current clients. The purpose of such policies is to minimize the likelihood that an auditor will be associated with clients who lack integrity. If an auditor is associated with a client who lacks integrity, material misstatements may exist and not be detected by the auditor. This can lead to lawsuits brought by users of the financial statements.5 In discussing this issue, a distinction is made between evaluating a prospective client and continuing a current client. In the case of a continuing client, the auditor has more firsthand knowledge about the entity’s operations and management’s integrity.

Prospective Client Acceptance  Public accounting firms should investigate a prospective client prior to accepting an engagement. Table 2–2 lists procedures that a firm might conduct to evaluate a prospective client. Performance of such procedures would normally be documented in a memo or by completion of a client acceptance questionnaire or checklist.

When the prospective client has previously been audited, the successor auditor is required by provincial and national codes of conduct, and by acts of incorporation such as the CBCA, to make certain inquiries of the predecessor auditor before accepting the engagement. The successor auditor should request permission of the prospective client before contacting the predecessor auditor. Because the Code of Professional Conduct does not allow an auditor to disclose confidential client information without the

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client’s consent, the prospective client must authorize the predecessor auditor to respond to the successor’s requests for information. The successor auditor’s communications with the predecessor auditor should include questions related to the integrity of management; disagreements with management over accounting and auditing issues; communications with audit committees or an equivalent group regarding fraud, illegal acts, and internal-control-related matters; and the predecessor’s understanding of the reason for the change in auditors. Such inquiries of the predecessor auditor may help the successor auditor determine whether to accept the engagement. The predecessor auditor should respond fully to the successor’s requests unless an unusual circumstance (such as a lawsuit) exists. If the predecessor’s response is limited, the successor auditor must be informed that the response is limited.

In the unusual case where the prospective client refuses to permit the predecessor to respond, the successor auditor should have reservations about accepting the client. Such a situation should raise serious questions about management’s motivations and integrity.

After accepting the engagement, the successor auditor may need information on beginning balances and consistent application of GAAP in order to issue an unqualified report. The successor auditor should request that the client authorize the predecessor auditor to permit a review of his or her working papers. In most instances, the predecessor auditor will allow the successor auditor to make copies of any working papers of continuing interest (for example, details of selected balance sheet accounts).

If the client has not previously been audited, the public accounting firm should complete all the procedures listed in Table 2–2, except for the communication with the predecessor auditor. The auditor should review the prospective client’s financial information and carefully assess management integrity by communicating with the entity’s bankers and lawyers, as well as other members of the business community. In some cases, the public accounting firm may even hire an investigative agency to check on management’s background.

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**TABLE 2-2 Procedures for Evaluating a Prospective Client**

1. Obtain and review available financial information (annual reports, interim financial statements, income tax returns, etc.).
2. Inquire of third parties about any information concerning the integrity of the prospective client and its management. (Such inquiries should be directed to the prospective client’s bankers and lawyers, credit agencies, and other members of the business community who may have such knowledge.)
3. Communicate with the predecessor auditor about whether there were any disagreements about accounting principles, audit procedures, or similar significant matters.
4. Consider whether the prospective client has any circumstances that will require special attention or that may represent unusual business or audit risks, such as litigation or going-concern problems.
5. Determine if the firm is independent of the client and able to provide the desired service.
6. Determine if the firm has the necessary technical skills and knowledge of the industry to complete the engagement.
7. Determine if acceptance of the client would violate the Code of Professional Conduct.
Client Continuance Public accounting firms need to evaluate periodically whether to retain their current clients. This evaluation may take place at or near the completion of an audit or when some significant event occurs. Conflicts over accounting and auditing issues or disputes over fees may lead a public accounting firm to disassociate itself from a client.

Establish the Terms of the Engagement

The auditor should establish an understanding with the client regarding the services to be performed. For small, privately held entities, the auditor normally negotiates directly with the owner-manager. For larger private or public entities, the auditor will normally be appointed by a vote of the shareholders after recommendation by the audit committee of the board of directors. In all cases, an engagement letter should document the terms agreed to by the auditor and client. Such terms would include, for example, the responsibilities of each party, the assistance to be provided by client personnel and internal auditors, and the expected audit fees. Chapter 5 provides an example of an engagement letter and discusses the audit committee and internal auditors.

Preplanning There are generally two preplanning activities: (1) determining the audit engagement team requirements and (2) ensuring the independence of the audit team and audit firm. The engagement partner or manager should ensure that the audit team is composed of team members who have the appropriate audit and industry experience for the engagement. The partner or manager should also determine whether the audit will require IT or other types of specialists (e.g., actuaries or appraisers). The second issue that needs to be addressed during preplanning is independence of the team members and the firm from the client. Chapter 5 addresses this phase of the audit process in more detail.

In order to properly plan the audit, the audit team must establish a preliminary judgment about materiality and make a preliminary assessment of the client’s business risks. The materiality judgment and risk assessments are used to set the scope for the audit. Chapter 3 discusses both of these concepts.

Plan the Audit Proper planning of an audit is important to ensure that the audit is conducted in an effective and efficient manner. The steps taken during this phase include (1) gaining knowledge of the client’s business and industry so that the auditor understands events, transactions, and practices that may affect the financial statements, particularly important in the Strategic Systems Approach to auditing, and (2) conducting preliminary analytical procedures (such as ratio analysis) to identify specific transactions or account balances that should receive special attention because they may contain material misstatements. In many instances, audit planning may include a preliminary consideration of the client’s internal control system. Based on this initial work, an overall audit strategy is developed. This includes the preliminary assessment of materiality and audit risk, as well as a written audit plan which sets out the nature, extent, and timing of audit work. The audit plan serves as a starting point for the engagement, but adjustments may be required as the audit progresses. As part of the planning
process, the audit partner or manager should also discuss with the other members of the audit team the susceptibility of the entity to material misstatements due to error or fraud. Appendix B to Chapter 3 discusses the auditor’s responsibility for fraud and error in more detail.

Internal control is a process affected by an entity’s board of directors, management, and other personnel that is designed to provide reasonable assurance regarding the achievement of objectives such as: (1) effectiveness and efficiency of operations, (2) reliability of financial reporting, and (3) discharge of statutory obligations. The auditor must sufficiently understand the client’s internal controls in order to determine which controls exist within the entity. The auditor then evaluates the internal controls in order to assess the risk that they will not prevent or detect a material misstatement in the financial statements. In considering internal control, the auditor focuses on how the entity’s use of IT and manual procedures may affect the controls relevant to the audit. This risk (referred to as control risk) directly impacts the scope of the auditor’s work.

When the auditor assesses control risk at less than the maximum, examination standard (ii) of GAAS requires that the internal controls should be tested. The auditor’s tests are intended to ensure that the internal controls are operating in the manner intended and therefore are effective in preventing or detecting misstatements. The evidence gathered from testing the internal controls is used to arrive at a final assessment on the level of control risk. When control risk is assessed low, based on tests of the internal controls (referred to as tests of controls), less audit work is required to audit the account balances (referred to as substantive tests) because the auditor has evidence that the accounting systems are generating materially accurate financial information. Conversely, if control risk is high, the auditor has to conduct more extensive audit work in the account balances because the evidence about internal controls suggests that material misstatements could occur because controls do not exist or are not operating effectively. Chapter 6 provides detailed coverage of internal control in a financial statement audit. Later chapters apply this process to various business processes; for example, see Chapter 10.

In this phase, the auditor conducts more analytical procedures and examines the details of the account balances. For example, the auditor may calculate an estimate of interest expense by multiplying total debt by the average interest rate on the entity’s debt. This estimate of interest expense can be compared to interest expense reported in the general ledger for reasonableness. The purpose of such analytical procedures is to determine whether the accounts contain a material misstatement. The auditor will examine other account balances by testing the detailed transactions that make up the balance. For example, the auditor can examine the vendors’ bills for newly acquired equipment that is included in the machinery and equipment account to ensure that the equipment is recorded at its acquisition cost. On most engagements, this phase comprises most of the time spent on the audit. Later chapters in this textbook discuss substantive audit procedures for business processes and related accounts.
After the auditor has completed testing the account balances, the sufficiency of the evidence gathered needs to be evaluated. The auditor must have sufficient appropriate audit evidence in order to reach a conclusion on the fairness of the financial statements. In this phase, the auditor also assesses the possibility of contingent liabilities, such as lawsuits, and searches for any events subsequent to the balance sheet date that may impact the financial statements. Chapter 17 covers each of these issues in detail.

The final phase in the audit process is choosing the appropriate audit report to issue. When the auditor has gathered sufficient appropriate audit evidence and complied with GAAS, and the financial statements conform to GAAP, the auditor can issue a standard unqualified audit report. When sufficient evidence is not gathered or the financial statements are not in accordance with GAAP, the auditor will issue a different type of report. The remainder of this chapter presents coverage of the auditor’s standard unqualified audit report and an overview of the exceptions to the unqualified report. Audit reporting is covered early in the text so that the reader has a better understanding of how the results of the evidence-gathering process affect the auditor’s choice of audit reports. Chapter 18 provides detailed coverage of audit reporting.

The auditor’s report is the main product or output of the audit. This report communicates the auditor’s findings to the users of the financial statements. It is the culmination of a process of collecting and evaluating sufficient appropriate evidence concerning the fair presentation of management’s assertions in the financial statements. The audit report adds value to the financial statements because of the auditor’s objective and independent opinion on the fairness of the financial statements. Figure 2–3 provides an overview of audit reporting.

The most common type of audit report issued is the standard unqualified audit report because management’s assertions about the entity’s financial statements are usually found to conform to generally accepted accounting principles. Such a conclusion can be expressed only when the audit was performed in accordance with generally accepted auditing standards. Section 5400 of the CICA Handbook, “The auditor’s standard report,” provides authoritative guidance for situations where a standard, unqualified audit report is appropriate.

Exhibit 2–1 presents an audit report for Molson Inc., a well-known Canadian company. This report is for the consolidated entity and covers two years of balance sheets, statements of earnings, retained earnings, and cash flows. This is the standard type of report issued for publicly traded companies. The auditor’s standard unqualified report can also cover a single year only. The Molson Inc. report contains a number of important elements.
Title  Auditing standards require that the report be entitled “Auditor's Report.”

Addressee  The audit report is addressed to the individual or group that engaged the auditor. In the normal situation, the report is addressed to the entity's shareholders.

Introductory Paragraph  The introductory paragraph contains three important facts. First, it states that an audit was conducted and indicates which financial statements are covered by the audit report. Second, it contains a statement that the financial statements are the responsibility of management. Third, it identifies the auditor's responsibility—to express an opinion on the financial statements.
Scope Paragraph  The second, or scope, paragraph communicates to the users, in very general terms, what an audit entails. In addition to indicating that the audit was conducted in accordance with Canadian generally accepted auditing standards, it emphasizes the fact that the audit provides only reasonable assurance that the financial statements contain no material misstatements. The scope paragraph also discloses that an audit involves examining evidence on a test basis, an assessment of accounting principles used and significant estimates, and an overall evaluation of financial statement presentation. The overall evaluation is in terms of the agreed-upon criteria. In Exhibit 2–1, GAAP are the criteria used for the fairness of the financial statements.

Opinion Paragraph  The third paragraph contains the auditor’s opinion concerning the fairness of the financial statements based on the audit evidence. Two important phrases contained in this paragraph require further explanation. First, the phrase “present fairly . . . in accordance with Canadian generally accepted accounting principles” is the wording used by the auditor to comply with the fourth reporting standard. Second, the
opinion paragraph also contains the phrase “in all material respects.” As mentioned earlier, this phrase is included in the report to stress the concept of materiality.

Name of the Auditor This is the manual or printed signature of the CA firm.

Date of Report Generally, the auditor’s report is dated as of the date on which the auditor has completed all significant auditing procedures. The audit report date indicates to the user the last day of the auditor’s responsibility for the review of significant events that have occurred after the date of the financial statements.

In the remaining sections, departures from an unqualified audit report and other types of audit reports are covered briefly so that the reader will understand the auditor’s reporting options when a standard unqualified report is not appropriate. Chapter 18 provides detailed coverage, including examples of the other types of reports.

There are three basic reasons why an auditor may be unable to express an unqualified opinion (see Figure 2–3):

1. A departure from GAAP. The financial statements are prepared using an accounting principle that is not in conformity with GAAP. For example, if the client does not include overhead costs in inventory, the inventory account is valued using an accounting principle that is not in accordance with GAAP.

2. Scope limitation. A scope limitation results from a lack of evidence such as an inability to conduct an audit procedure considered necessary. For example, if the client had an equity investment in a foreign affiliate and the auditor is unable to obtain audited financial statements for the affiliate, the auditor does not have sufficient appropriate evidence to determine the amount of equity income or the reported amount of the investment account.

3. The auditor is not independent. The auditor must be independent of the entity being audited in order to comply with the general standard and the Code of Professional Conduct. For example, if an auditor had a material financial interest in or performed managerial functions for the entity, he or she would not be independent of the entity.

Other Types of Audit Reports

The auditor can assume different degrees of responsibility for the financial statements. In a sense, auditing standards provide for a graded set of audit reports. There are three types of audit reports other than unqualified:

1. Qualified. The auditor’s opinion is qualified for either a scope limitation or a departure from GAAP with material consequences, but the overall financial statements present fairly. With a qualified report, the opinion paragraph is modified by the words “except for.”
2. **Adverse.** The auditor’s opinion states that the financial statements do not present fairly in accordance with GAAP because the departure affects the overall financial statements. In this case, the departure from GAAP is so significant that the overall financial statements may not be fairly presented.

3. **Denial.** When issuing a denial, the auditor states that he or she cannot give an opinion on the financial statements because of a lack of sufficient appropriate evidence to form an opinion on the overall financial statements. In this case, the scope limitation is so significant that the overall financial statements may not be fairly presented.

The choice of which audit report to issue depends on the condition and the materiality of the departure (see Figure 2–3).

**REVIEW QUESTIONS**

2-1 The independent auditor normally uses GAAP as a benchmark to measure management’s reporting of economic activity and events. The auditor’s report states that “the financial statements . . . present fairly . . . in accordance with generally accepted accounting principles.” In making this statement, what judgments does the auditor make concerning GAAP?

2-2 Briefly describe what is meant by the Strategic Systems Approach to auditing.

2-3 How do management assertions relate to the financial statements? To audit objectives?

2-4 What are the auditor’s responsibilities for errors and fraud? For illegal acts?

2-5 Describe what is meant by the statement that “due care requires that the auditor exercise professional scepticism.”

2-6 Why are ethical behaviour and independence so vital to the audit function?

2-7 What is meant by client business risk, and why is it important for the auditor to properly assess this risk?

2-8 Define materiality. How is this concept reflected in the auditor’s report?

2-9 Define audit risk. How is this concept reflected in the auditor’s report?

2-10 Describe what is meant by the relevance and reliability of audit evidence.

2-11 Briefly describe why on most audit engagements an auditor tests only a sample of transactions that occurred.

2-12 What is the purpose of establishing quality control policies for new client acceptance?

2-13 What types of inquiries about a prospective client should an auditor make to third parties?

2-14 Who is responsible for initiating the communication between the predecessor and successor auditors? What type of information should be requested from the predecessor auditor?
2-15 What is the purpose of the fourth reporting standard?

2-16 Identify the elements of the auditor's standard unqualified report.

2-17 What three important facts are contained in the introductory paragraph of the standard unqualified audit report?

2-18 What is the significance of the audit report date?

2-19 Identify the conditions that result in a departure from an unqualified audit report.

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.

2-20 Prior to beginning the field work on a new audit engagement in which a CA does not possess expertise in the industry in which the client operates, the CA should
a. Reduce audit risk by lowering the preliminary levels of materiality.
b. Design special substantive tests to compensate for the lack of industry expertise.
c. Engage financial experts who are familiar with the nature of the industry.
d. Obtain a knowledge of matters that relate to the nature of the entity's business.

2-21 Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's
a. Awareness of the consistency in the application of generally accepted accounting principles between periods.
b. Evaluation of all matters of continuing accounting significance.
c. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
d. Understanding as to the reasons for the change of auditors.

2-22 Which of the following, if material, would be fraud?
a. Mistakes in the application of accounting principles.
b. Clerical mistakes in the accounting data underlying the financial statements.
c. Misappropriation of an asset or groups of assets.
d. Misinterpretations of facts that existed when the financial statements were prepared.

2-23 According to the CICA Handbook section on misstatements, which of the following would be classified as an error?
a. Misappropriation of assets for the benefit of management.
b. Misinterpretation by management of facts that existed when the financial statements were prepared.
c. Preparation of records by employees to cover a fraudulent scheme.
d. Intentional omission of the recording of a transaction to benefit a third party.

2-24 The auditor's report should be dated as of the date on which the
a. Report is delivered to the client.
b. Field work is completed.
2-25 An auditor’s responsibility to express an opinion on the financial statements is
a. Implicitly represented in the auditor’s standard report.
b. Explicitly represented in the opening paragraph of the auditor’s standard report.
c. Explicitly represented in the scope paragraph of the auditor’s standard report.
d. Explicitly represented in the opinion paragraph of the auditor’s standard report.

2-26 For an entity’s financial statements to be presented fairly in accordance with generally accepted accounting principles, the principles selected should
a. Be applied on a basis consistent with those followed in the prior year.
b. Be approved by the Auditing Standards Board.
c. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
d. Match the principles used by most other entities within the entity’s particular industry.

2-27 An auditor may not issue a qualified opinion when
a. A scope limitation prevents the auditor from completing an important audit procedure.
b. The auditor’s report refers to the work of a specialist.
c. An accounting principle at variance with generally accepted accounting principles is used.
d. The auditor lacks independence with respect to the audited entity.

2-28 The management of Hill Company has decided not to account for a material transaction in accordance with GAAP. In setting forth its reasons in a note to the financial statements, management has argued that due to unusual circumstances the financial statements presented in accordance with GAAP would be misleading. The auditor does not agree with management’s treatment. The auditor’s report should contain a(n)
a. Qualified opinion.
b. Denial.
c. Adverse opinion.
d. Unqualified opinion with a separate explanatory paragraph.

2-29 Analysis is a technique that is often used in the planning phase of an audit. In what other phases of the audit could the auditor use analysis?
a. The testing phase.
b. The final review phase.
c. Analysis can be used in all phases of the audit.
d. Analysis is not useful in any other phase of the audit.

(CGAC, adapted)
The use of standardized wording has been the subject of considerable debate among auditors. Which of the following is the strongest argument in favour of using standardized wording?

a. It facilitates the international harmonization of auditing standards.

b. Standardized wording is not confusing to readers of the auditor's report.

c. It is more informative than a non-flexible standard.

d. The type of opinion is less likely to be misinterpreted by readers when standardized wording is used.

(CGAC, adapted)

**PROBLEMS**

2-31 Sheri Shannon was recently hired by the CA firm of Honson & Hansen. Within two weeks, Sheri was sent to the first-year staff training course. The instructor asked her to prepare answers for the following questions:

a. How is audit evidence defined?

b. How does evidence relate to assertions or audit objectives, and to the audit report?

c. What characteristics of evidence should an auditor be concerned with when searching for and evaluating evidence?

2-32 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. John has asked you, his trusted assistant, to prepare an outline for his speech. He suggests that you answer the following:

a. List and describe the various phases of an audit.

b. Describe how the results of work completed in certain phases provide feedback to earlier completed phases. Give an example.

c. 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?

2-33 The auditor’s standard report consists of an “introductory” paragraph describing the financial statements and management and auditor responsibilities; a “scope” paragraph describing the nature of the examination; and an “opinion” paragraph expressing the auditor’s opinion. In some circumstances the auditor’s standard report is modified by changing the wording of one or more of the paragraphs included in the report and/or adding one or more explanatory paragraphs.

For this question, assume the auditor is independent and has expressed an unqualified opinion on the prior year’s financial statements.
Required:
Identify the circumstances necessitating modification of the auditor’s standard report. For each circumstance, indicate the type of opinion that would be appropriate. Organize the answer as indicated in the following example:

<table>
<thead>
<tr>
<th>Circumstances</th>
<th>Types of Opinion</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. The financial statements are materially affected by a departure from generally accepted accounting principles.</td>
<td>1. The auditor should express a qualified opinion or an adverse opinion.</td>
</tr>
</tbody>
</table>

[9] 2-34 The following auditors’ report was drafted by Moore, a staff accountant of Tyler & Tyler, CAs, at the completion of the audit of the financial statements of Park Publishing Company, Inc., for the year ended September 30, 2002. The report was submitted to the engagement partner, who reviewed the audit working papers and properly concluded that an unqualified opinion should be issued. In drafting the report, Moore knew that Tyler & Tyler had previously audited the financial statements for the year ended September 30, 2001, and expressed an unqualified opinion.

Independent Auditor’s Report
To the Board of Directors of Park Publishing Company, Inc.:

We have audited the accompanying balance sheet of Park Publishing Company, Inc., as of September 30, 2002, and the related statements of income and cash flows for the year ended then. These financial statements are the responsibility of the company’s management.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are fairly presented. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a basis for determining whether any material modifications should be made to the accompanying financial statements.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Park Publishing Company, Inc., as of September 30, 2002, and the results of its operations and its cash flows for the year then ended in conformity with generally accepted accounting principles.

Tyler & Tyler, CAs
November 5, 2002

Required:
Identify the deficiencies in the auditors’ report as drafted by Moore. Group the deficiencies by paragraph and in the order in which the deficiencies appear. Do not redraft the report.

(AICPA, adapted)
BioPharm, Inc., is a biotechnology company that is solely involved in research and development of antibodies for various diseases. Once an antibody has been developed, BioPharm contracts with large pharmaceutical companies to manufacture and distribute the antibodies. BioPharm’s licensing agreements provide that the company will receive royalties based on a percentage of product sales.

Your firm has audited BioPharm since it went public five years ago. Johan Splice, the company’s controller, has contacted you about accounting for a transaction under which the company would sell to Big Drugs, Inc., the right to receive a portion of the future royalties on its new antibody. Big Drugs provided BioPharm with R&D financing two years ago. Under the agreement, Big Drugs would pay BioPharm $3 million in 2000 and another $2.5 million in 2001 for the right to receive 5 percent of the royalties received by BioPharm on sales of the antibody during 2002 to 2007. The agreement also specifies that if the cumulative payments exceed $25 million, the royalty rate will drop from 5 percent to 1 percent.

BioPharm projects that Big Drugs will earn a 28 percent return on its investment. The agreement does not require BioPharm to guarantee any royalties, and, if the new antibody is replaced by a better treatment before 2002, Big Drugs will receive no payments. The agreement is noncancellable, there is no minimum guaranteed amount, and Big Drugs has no recourse against BioPharm.

BioPharm’s only requirement under the agreement is to defend the related patents against infringements.

**Required:**
How should BioPharm account for the proceeds of this transaction in 1999?

**DISCUSSION CASES**

The opinion paragraph of the standard auditor’s report uses the phrase “present fairly in accordance with GAAP.” However, the idea that following GAAP produces fairness in reporting has been questioned by some. The Handbook recognizes this potential dilemma by stating “the auditor should exercise professional judgment as to the appropriateness of the selection and application of principles to the particular circumstances of an entity and as to the overall effect on the financial statements of separate decisions made in their preparation.”

**Required:**

a. Provide an example of an accounting practice that you feel might cause a conflict between reporting according to GAAP and fair presentation.

b. What other sources of information might the auditor consult in attempting to resolve this conflict.

(CICA, adapted)
It has been suggested that the audit report of future years might look something like the following:

The accompanying balance sheet of XYZ Company as of December 31, 2002 and the related statements of earnings, retained earnings, and cash flows for the year then ended, including the notes, were prepared by XYZ Company’s management, as explained in the report by management.

In our opinion, those financial statements, in all material respects, present the financial position of XYZ Company as at December 31, 2002 and the results of its operations and changes in financial position for the year then ended in accordance with Canadian generally accepted accounting principles appropriate in the circumstances.

We audited the financial statements and the accounting records and documents supporting them in accordance with generally accepted auditing standards. Our audit included a study and evaluation of the company’s accounting system and the controls over it. We obtained sufficient evidence through a sample of the transactions and other events reflected in the financial statement amounts and analysis of the information presented in the statements. We believe our auditing procedures were adequate in the circumstances to support our opinion.

Based on our study and evaluation of the accounting system and the controls over it, we concur with the description of the system and controls in the report by management. Nevertheless, in the performance of most control procedures, errors can result from personal factors. Also, control procedures can be circumvented by collusion or overridden. Furthermore, projection of any evaluation of internal accounting control to future periods is subject to the risk that changes may cause procedures to become inadequate and the degree of compliance with them to deteriorate.

We reviewed the information appearing in the annual report other than the financial statements, compared it to the statements, and found no material disagreement between them.

We reviewed the process used by the company to prepare the quarterly information released during the year. Our reviews were conducted each quarter (or times as explained). (Any other information reviewed such as replacement cost data would be identified here also.) Our reviews consisted primarily of enquiries of management, analysis of financial information, and comparisons of that information to information and knowledge about the company obtained during our audits and were based on our reliance on the company’s internal control system. Any adjustments or additional disclosures that we recommended have been reflected in the information.

We reviewed the company’s policy statement on employee conduct described in the report by management, and reviewed and tested the related controls and internal audit procedures. While no controls or procedures can prevent or detect all individual miscon-
duct, we believe the controls and internal audit procedures have been appropriately designed and applied.

We met with the audit committee of XYZ Company sufficiently often to inform it of the scope of our audit and to discuss any significant accounting or auditing problems encountered and any other services provided to the company.

Test, Check & Co.
Chartered Accountants
Canada, March 1, 2003

**Required:**
Contained in the above audit report is an implied level of responsibility for auditors and/or an implied duty to report the discharge of that responsibility different from that presently existing for auditors in Canada. Discuss.
Do you agree or disagree with such an expanded style of report? Explain your position.
(CICA, adapted)

**INTERNET ASSIGNMENTS**

2-38 Visit EarthWear Clothiers’ website (www.mcgrawhill.ca/college/messier/earthwear) and become familiar with the type of information contained there.

2-39 Willis & Adams are the auditors of EarthWear. Visit Willis & Adams’ website (www.mcgrawhill.ca/college/messier/willisandadams) and become familiar with the information contained there.

2-40 Use one of the Internet search engines to do the following:

a. Visit the websites of Rogers Communications (www.rogers.ca) (listed on the TSE), Microsoft (www.microsoft.com) (listed on NASDAQ), and Nortel (www.nortel.com) (cross-listed on both the TSE and NASDAQ) and review their financial statements, including auditors’ reports. Prepare a brief analysis of their similarities and differences.

b. Search the Web for the website of a non-Canadian company and review its financial statements, including its auditor’s report. For example, BMW’s website (www.bmw.com) allows a visitor to download the financial statements as a pdf file. The auditor’s report on BMW’s financial statements is based on German auditing standards.

c. Compare the standard Canadian report with the audit report for the non-Canadian company from part (b). Prepare a brief analysis of their similarities and differences.