

Chapter 1: The Demand for an Auditing and Assurance Profession

## **Chapter 1**

### **The Demand for an Auditing and Assurance Profession**

#### **Audit Challenge 1-1: Assessing Privacy Practices**

1. Hospital data could be obtained from numerous sources: for example, unshredded documentation from garbage bins, reports or files taken home by employees to work on, reports left lying around on a doctor's desk or nurse's station. Poor security practices, such as weak passwords, passwords written on paper and stored under keyboards, or out of date firewalls (enabling hackers to access the hospital system) could also provide access to hospital data.
2. Auditors should know the requirements of Canada's privacy legislation, the nature of control systems for manual and automated information systems, have awareness of best practices for security and privacy. Someone on the audit team should also be able to assess technical matters such as the functioning of firewalls, routers, data communications, and other security software in use by the hospital.
3. Internal auditors (with the CIA) designation, and qualified accountants (CA, CGA, CMA) should be skilled in control systems. Team members on the audit should also have skills in information technology (perhaps with the CISA designation).

#### **Review Questions**

**1-1** You will be looking at his accounting records (evidence) and evaluating and collecting information about those records. Your evaluation process will be done using relatively standard audit procedures (part of GAAS – generally accepted auditing standards). Your objective is to compare the evidence (his accounting records) to the financial statements that he has prepared (which will become information available to others, such as the Canada Revenue Agency). To help you evaluate his records (the evidence) you will use criteria (GAAP – generally accepted accounting principles). You are able to add value to the financial statements because you are an independent professional qualified accountant.

**1-2** To do an audit, there must be information in a verifiable form and some standards (criteria) by which the auditor can evaluate the information. Examples of established criteria include generally accepted accounting principles, and the *Income Tax Act*. Determining the degree of correspondence between information and established criteria is determining whether a given set of information is in accordance with the established criteria using audit procedures that conform with GAAS – generally accepted auditing standards. The information for Glickle Ltd.'s tax return is the corporate tax returns filed by the company. The criteria are the *Income Tax Act* and all interpretations. For the audit of Glickle Ltd.'s financial statements, the information is the financial statements being audited and the established criteria are generally accepted accounting principles and generally accepted auditing standards.

**1-3** The primary evidence the Canada Revenue Agency auditor will use in the audit of Glickle Ltd.'s tax return includes all available documentation and other information available in

Glickle's office or from other sources. For example, when the auditor examines taxable income, a major source of information will be bank statements, the cash receipts journal, and deposit slips. The auditor is likely to emphasize unrecorded receipts and revenues. For expenses, major sources of evidence are likely to be cancelled cheques, vendors' invoices, and other supporting documentation.

**1-4** This apparent paradox arises from the distinction between the function of auditing and the function of accounting.

The accounting function is the process of recording, classifying, and summarizing economic events to provide relevant information to decision makers.

The rules of accounting are the criteria used by the auditor for evaluating the presentation of economic events for financial statements and he or she must therefore have an understanding of generally accepted accounting principles (GAAP), as well as generally accepted auditing standards (GAAS).

The accountant need not, and frequently does not, understand what auditors do, unless he or she is involved in doing audits, or has been trained as an auditor.

**1-5** The auditor could provide an audit of the financial statements, an attestation report on internal control over the financial statements, or a variety of special assurance engagements. For example, a WebTrust or SysTrust report could be prepared for transactions made via the hospital's secure web site or with respect to the quality of information systems used to process prescription medication. If there are leased premises on the hospital grounds, the auditor could provide a review engagement report with respect to common area costs for use by the tenants of the premises. Other examples are possible.

**1-6**

	<b>Audits of Financial Statements</b>	<b>Compliance Audits</b>	<b>Operational Audits</b>
<b>Purpose</b>	To determine whether the financial statements are presented in accordance with GAAP	To determine whether the client is following specific procedures set by higher authority	To evaluate whether operating procedures are efficient and effective
<b>Users of Audit Report</b>	Different groups for different purposes—mainly outside entities	Authority setting down procedures, internal or external	Management of organization
<b>Nature</b>	Highly standardized	Not standardized, very specific, often very subjective, but usually objective	Highly non-standardized

<b>Performed By:</b>			
<b>Public Accountant</b>	Almost universally	Occasionally	Frequently
<b>Government Auditors</b>	Occasionally	Frequently	Frequently
<b>Canada Revenue Agency Auditors</b>	Never	Universally	Never
<b>Internal Auditors</b>	Never, although they might review them for management	Frequently	Frequently

**1-7** Five specific examples of operational audits that could be conducted by an internal auditor in a manufacturing company are:

- Examination of employee time cards and personnel records to determine if sufficient information is available to maximize the effective use of personnel.
- Review the processing of sales invoices to determine if it could be done more efficiently.
- Review the acquisitions of goods, including costs to determine if they are being purchased at the lowest possible cost considering the quality needed.
- Review and evaluate the efficiency of the manufacturing process.
- Review the processing of cash receipts to determine if they are deposited as quickly as possible.

Other examples are possible.

**1-8** Audit services could be: financial statement audit. Other attestation services could be reviews of the personal financial statements of individual lawyers for inclusion with their tax returns. Attestation services could include a report on sales revenue for submission to a landlord (to adjust lease payments), or a report that provides assurance on the quality of accounts receivable for a bank holding a loan with the firm. Other examples are possible.

**1-9** Many clients are using e-commerce to conduct their business transactions, so an auditor needs to be familiar with such technologies when conducting the financial statement audit. Also, the auditor may be called upon to conduct a special engagement, such as a WebTrust engagement, where knowledge of e-commerce technologies are required to effectively conduct the engagement.

**1-10** The accounting organizations in Canada are:

The Canadian Institute of Chartered Accountants (CICA), whose members are chartered accountants (CAs). CAs are licensed to perform audits in all provinces and also are employed in government, industry, and education.

The Certified General Accountants Association of Canada (CGAAC), whose members are certified general accountants (CGAs). CGAs perform audits in most provinces and are employed in government, industry, and education.

The Society of Management Accountants of Canada (SMAC), whose members are certified management accountants (CMAs). CMAs are primarily employed in government, industry, and education, and may also be licensed as PAs.

The Institute of Internal Auditors (IIA) includes members who may have a certified internal auditor (CIA) designation. Members are primarily in internal auditing but also in other positions in government, industry, and education.

The Information Systems Audit and Control Association (ISACA) requires members to pass an examination and have relevant work experience before receiving a CISA (Certified Information Systems Auditor). Members are primarily in internal auditing but also in other positions in government, industry, and education.

Roles of these organizations include:

The CICA is the organization that sets accounting and auditing standards that have been given quasi-legal status by legislative acts such as the *Canada Business Corporations Act* and by the provincial securities administrators.

All three of the CICA/CGAAC/SMAC conduct research and publish materials on many different subjects related to accounting, auditing, management advisory services, and taxes. The organizations also prepare and grade the CA, CGA, and CMA accounting examinations, respectively, and provide continuing education to their members. Finally, the organizations set out professional standards regulating the professional conduct of their members.

The IIA and CISA perform similar standard setting, research and examination administration functions for their members.

**1-11** The major differences in the scope of audit responsibilities are:

- Public accountants perform audits in accordance with generally accepted auditing standards of published financial statements prepared in accordance with generally accepted accounting principles.
- Government auditors from the auditor generals (federal or provincial) perform compliance or operational (value-for-money) audits in order to assure the Parliament that the expenditure of public funds is in accordance with its directives and the law and is done with efficiency, economy and effectiveness. They also do financial statement audits of Crown Corporations, or sub-contract this work to external public accountants.
- Canada Revenue Agency auditors perform compliance audits to enforce the federal tax laws as defined by Parliament, interpreted by the courts, and regulated by the *Income Tax Act*.
- Internal auditors perform compliance or operational audits in order to assure management or the board of directors that controls and policies are properly and consistently developed, applied and evaluated.

**1-12** Assuming a bank is deciding to make a loan to a business, the bank will charge a rate of interest determined primarily by the following three factors:

- *Risk-free interest rate.* This is approximately the rate the bank could earn by investing in Canadian treasury bills for the same length of time as the business loan.
- *Business risk.* This risk reflects the possibility that the business will not be able to repay its loan because of economic or business conditions such as a recession, poor management decisions, or unexpected competition in the industry.
- *Information risk.* This risk reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements.

Auditing has no effect on either the risk-free interest rate or business risk. However, auditing can significantly reduce information risk.

- *Conduct:* employs a professional staff of sufficient size to provide a broad range of expertise. Continuing education is supported. The firm promotes a professional, independent attitude and competence among its professional staff. Consultation among professional staff is encouraged.

## Discussion Problems

**1-13** a. The following parts of the definition of auditing are related to the narrative:

(1) Virms is being asked to issue a report about qualitative and quantitative information relating to trucks. The trucks are therefore the quantifiable information with which the auditor is concerned.

(2) There are three criteria which must be evaluated and reported by Virms: Existence of the trucks on the night of June 30, physical condition of each truck, and fair market value of each truck.

(3) Susan Virms will *accumulate* and *evaluate* four basic types of *evidence*:

- *Count the trucks* to determine their existence.
- *Use registration documents* held by Charon for comparison to the serial number on each truck to determine ownership.
- *Examine the trucks* to determine each truck's physical condition.
- *Examine the current blue book* to determine the fair market value of each truck.

(4) Susan Virms, public accountant, appears qualified as a *competent, independent person*. She is a public accountant, and she spends most of her time auditing used automobile and truck dealerships and has extensive specialized knowledge about used trucks that is consistent with the nature of the engagement.

(5) The *report results* are to include:

- which of the 20 trucks are parked in Regional's parking lot the night of June 30
- the condition of each truck, using established guidelines
- the fair market value of each truck using the current blue book for trucks

- b. The only parts of the audit which will be difficult for Virms are:
- Evaluating the condition, using the guidelines of poor, good, and excellent. It is highly subjective to do so. If she uses a different criterion than the blue book, the fair market value will not be meaningful. Her experience will be essential in using this guideline.
  - Determining the fair market value, unless it is clearly defined in the blue book for each condition.

- 1-14** a. The interest rate for the loan that requires a review report is lower than the loan that did not require a review because of lower information risk. A review report provides moderate assurance to financial statement users, which lowers information risk. An audit report provides further assurance and lower information risk. As a result of reduced information risk, the interest rate is lowest for the loan with the audit report.
- b. Given these circumstances, Vial-tek should select the loan from Second National Bank that requires an annual audit. In this situation, the additional cost of the audit is less than the reduction in interest due to lower information risk. The following is the calculation of total costs for each loan:

LENDER	PA SERVICE	COST OF PA SERVICES	ANNUAL INTEREST	ANNUAL LOAN COST
Existing loan	None	0	\$ 142,500	\$ 142,500
First National Bank	Review	\$ 12,000	\$ 127,500	\$ 139,500
Second National Bank	Audit	\$ 20,000	\$ 112,500	\$ 132,500

**1-14 (continued)**

- c. Vial-tek should select the loan from First National Bank due to the higher cost of the audit and the reduced interest rate for the loan from First National Bank. The following is the calculation of total costs for each loan:

LENDER	PA SERVICE	COST OF PA SERVICES	ANNUAL INTEREST	ANNUAL LOAN COST
Existing loan	None	0	\$ 142,500	\$ 142,500
First National Bank	Review	\$ 12,000	\$ 120,000	\$ 132,000
Second National Bank	Audit	\$ 25,000	\$ 112,500	\$ 137,500

- d. Vial-tek may desire to have an audit because of the many other positive benefits that an audit provides. The audit will provide Vial-tek's management with assurance about annual financial information used for decision-making purposes. The audit may detect errors or fraud, and provide management with information about the effectiveness of controls. In addition, the audit may result in recommendations to management that will improve efficiency or effectiveness.
- e. The auditor must have a thorough understanding of the client and its environment, including the client's e-commerce technologies, industry, regulatory and operating environment, suppliers, customers, creditors, and business strategies and processes. This thorough analysis helps the auditor identify risks associated with the client's strategies that may affect whether the financial statements are fairly stated. This strategic knowledge of the client's business often helps the auditor identify ways to help the client improve business operations, thereby providing added value to the audit function.

- 1-15 a. & b**
1. (1) Audit of historical financial statements
  2. (2) An attestation service other than an audit service; or
  - (3) An assurance service that is not an attestation service (*WebTrust* developed from the AICPA Special Committee on Assurance Services, but the service meets the criteria for an attestation service.)
  3. (2) An attestation service other than an audit service
  4. (2) An attestation service other than an audit service
  5. (2) An attestation service other than an audit service
  6. (2) An attestation service that is not an audit service (Review services are a form of attestation, but are performed according to Review Standards.)
  7. (2) An attestation service other than an audit service
  8. (2) An attestation service other than an audit service
  9. (3) An assurance service that is not an attestation service

Justification for these decisions is based upon the type of report to be issued and the criteria used.

**1-16 a.** The services provided by Consumers Union are very similar to assurance services provided by PA firms. The services provided by Consumers Union and assurance services provided by PA firms are designed to improve the quality of information for decision makers. PAs are valued for their independence, and the reports provided by Consumers Union are valued because Consumers Union is independent of the products tested.

b. The concepts of information risk for the buyer of an automobile and for the user of financial statements are essentially the same. They are both concerned with the problem of unreliable information being provided. In the case of the auditor, the user is concerned about unreliable information being provided in the financial statements. The buyer of an automobile is likely to be concerned about the manufacturer or dealer providing unreliable information.

c. The four causes of information risk are essentially the same for a buyer of an automobile and a user of financial statements:

- *Remoteness of information* It is difficult for a user to obtain much information about either an automobile manufacturer or the automobile itself without incurring considerable cost. The automobile buyer does have the advantage of possibly knowing other users who are satisfied or dissatisfied with a similar automobile.
- *Biases and motives of provider* There is a conflict between the automobile buyer and the manufacturer. The buyer wants to buy a high quality product at minimum cost whereas the seller wants to maximize the selling price and quantity sold.
- *Voluminous data* There is a large amount of available information about automobiles that users might like to have in order to evaluate an automobile. Either that information is not available or too costly to obtain.
- *Complex exchange transactions* The acquisition of an automobile is expensive and certainly a complex decision because of all the components that go into making a good automobile and choosing between a large number of alternatives.

d. The three ways users of financial statements and buyers of automobiles reduce information risk are also similar:

- *User verifies information for him or herself* That can be obtained by driving different automobiles, examining the specifications of the automobiles, talking to other users, and doing research in various magazines.
- *User shares information risk with management* The manufacturer of a product has a responsibility to meet its warranties and to provide a reasonable product. The buyer of an automobile can return the automobile for correction of defects. In some cases a refund may be obtained.
- *Examine the information prepared by Consumer Reports* This is similar to an audit in the sense that independent information is provided by an independent party. The information provided by *Consumer Reports* is comparable to that provided by a PA firm that audited financial statements.



## Professional Judgment Problems

**1-17** The PA firm for the Internet company described in this problem could address these customer concerns by performing a WebTrust attestation engagement. The WebTrust assurance service was created by the profession to respond to the growing need for assurance resulting from the growth of business transacted over the Internet.

Relevant principles for each of the customer concerns noted in the problem are as follows:

- processing integrity for: Accuracy of product descriptions and adherence to stated return policies
- online privacy and security for: credit card and other personal information
- online privacy and security for: selling information to other companies
- availability for: system failure

**1-18** a. The operational efficiency of the sales department could be assessed by a qualified accountant (which could include a PA, internal auditor, or other qualified accountant), while the other departments could be assessed by qualified accountants together with a qualified researcher and manufacturing consultant. Skills present should be familiarity with best business practices in the industry and functional area under audit, as well as skills in information technology, research and development, and production development and management.

b. The auditors may have difficulty developing criteria to conduct the audit (unless there are standard best practices available for the industry), which will make the engagement more judgmental. They may also have difficulty writing the report, since such audits are unique, and the report will need to be custom-written for the engagement.

## Case

**1-19** a. First, you the student. Then, the faculty member and the school (as school reputation rests upon the quality of the student). Other stakeholders could be recipients of the grades in the future, such as other schools where the student has applied as a Masters student, or professional associations where grades are submitted to obtain credit for having taken courses.

b. To answer this question, we must consider that students are likely to report grades that are too low, but may not report grades that are too high. So, grades that are too high are at most risk of being incorrect.

c. The instructor could double check grades as they are recorded. Also, preliminary grades with a detailed breakdown could be posted for students to review. On the assumption that all work is returned to students and that they are informed the grades for each portion of their work, the student should check to ensure that the grades are recorded correctly by the instructor.

d. Auditing the grades would be asking for a detailed breakdown and a comparison to the source records. This is known as reperformance, since the work done by the instructor is repeated.

Instructor's Solutions Manual for *Auditing*, C11e (Arens/Elder/Beasley/Splettstoesser-Hogeterp)

### **Ongoing Small Business Case: Thinking about CondoCleaners.com**

**1-20** Jim and Cecilia have worked with a variety of businesses, and learned about good quality and poor quality documentation methods and internal control systems. This knowledge will help them design their own systems should they decide to set up a business. They have also learned assessment techniques for evaluating documents and comparing them to the reported results in the financial statements. These assessment techniques will help them to assess suppliers and customers (for example for credit worthiness), and to develop clear reports for potential customers. As part of their work, they will have had to communicate their needs and the results of their findings, improving their communication skills. These skills will help them work with employees or outsiders when developing their own business.

### **Internet Research Problem**

**1-21** Answers to these questions will vary depending upon the research conducted by students.