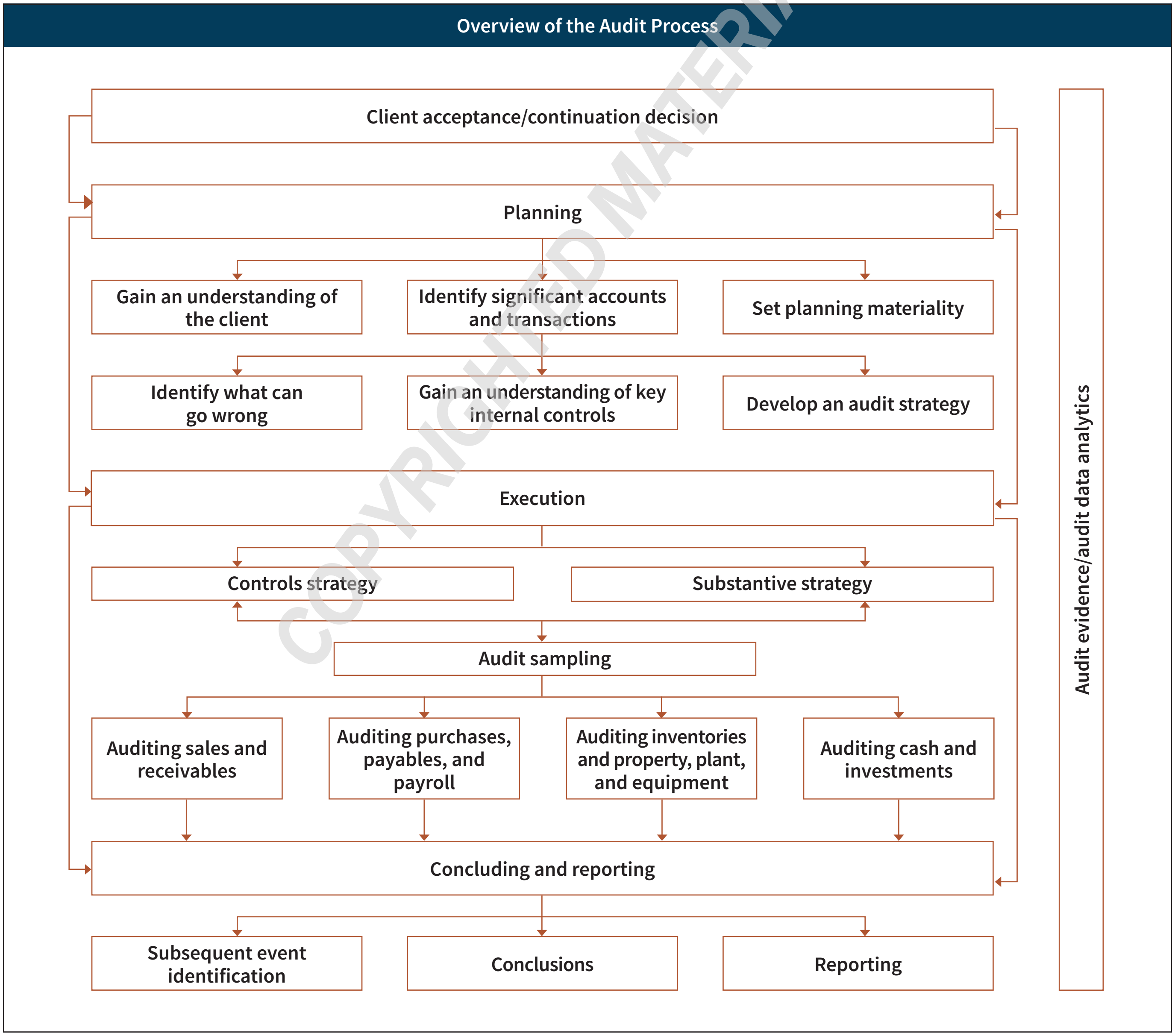
Introduction and Overview of Audit and Assurance



LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
After studying this chapter, you should be able to: **1** Define an assurance engagement	**1.1** Auditing and Assurance Defined	Standards addressed in each learning objective are as follows: CSAE 3000 *Attestation Engagements Other than Audits or Reviews of Historical Financial Information*
2 Explain why there is a demand for audit and assurance services	**1.2** Demand for Audit and Assurance Services **1.2.1** Financial statement users **1.2.2** Sources of demand for audit and assurance services **1.2.3** Theoretical frameworks **1.2.4** Demand in a voluntary setting	
3 Differentiate between types of assurance services	**1.3** Different Assurance Services **1.3.1** Financial statement audits **1.3.2** Compliance audits **1.3.3** Performance audits **1.3.4** Comprehensive audits **1.3.5** Internal audits **1.3.6** Corporate social responsibility (CSR) assurance	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CAS 610 *Using the Work of Internal Auditors* CSAE 3000 *Attestation Engagements Other than Audits or Reviews of Historical Financial Information* CSAE 3001 *Direct Engagements*
4 Explain the different levels of assurance	**1.4** Different Levels of Assurance **1.4.1** Reasonable assurance **1.4.2** Limited assurance **1.4.3** No assurance	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CSRE 2400 *Engagements to Review Historical Financial Statements* CSRS 4200 *Compilation Engagements* CAS 700 *Forming an Opinion and Reporting on Financial Statements* CAS 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
5 Outline different audit opinions	**1.5** Different Audit Opinions	CAS 700 *Forming an Opinion and Reporting on Financial Statements* CAS 705 *Modifications to the Opinion in the Independent Auditor's Report*

LEARNING OBJECTIVES	CHAPTER OUTLINE	CANADIAN AUDITING AND ASSURANCE STANDARDS
		CAS 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
6 Differentiate between the roles of the preparer and the auditor, and discuss the different firms that provide assurance services	**1.6** Preparers and Auditors **1.6.1** Preparer responsibility **1.6.2** Auditor responsibility **1.6.3** Assurance providers	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards*
7 Identify the different regulators, legislation, and regulations surrounding the assurance process	**1.7** The Role of Regulators and Regulations **1.7.1** Regulators, standard setters, and other bodies **1.7.2** Legislation **1.7.3** Regulation	CAS 220 *Quality Control for an Audit of Financial Statements* CSQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance Engagements*
8 Describe the audit expectation gap	**1.8** The Audit Expectation Gap	CAS 200 *Overall Objectives of the Independent Auditor, and the Conduct of an Audit in Accordance with Canadian Auditing Standards* CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

Cloud 9 Integrated Case

This book is designed to provide students with the opportunity to learn about auditing by using a practical, problem-based approach. Each chapter begins with some information about an audit client—Cloud 9 Ltd. (Cloud 9). The chapter then provides the underlying concepts and background information needed to deal with this client's situation and the problems facing its auditor. As students work through the chapters, they gradually build up their knowledge of auditing by studying how the contents of each chapter are applied to Cloud 9. The end-of-chapter exercises and problems also provide students with the opportunity to study other aspects of Cloud 9's audit, in addition to applying the knowledge gained in the chapter to other practical examples.

Cloud 9 Inc., a listed company in Canada, is looking to expand. McLellan's Shoes is seen as a potential target.

In 2000, Ron McLellan starts a business to manufacture and retail customized basketball shoes. Ron calls his business McLellan's Shoes. Ron borrows from the bank to start the business, using his house as security, and over the years he works very hard to establish a profitable niche in the highly competitive sport shoe market. Ron is able to repay the bank in 2005, before a recession hit. As he watches retail businesses struggle to stay open, he is glad to have the extra cash available to invest in creative marketing and product development to maintain solid sales.

As the business grows, Ron's wife and three adult children start to work for him, with responsibility for administration, marketing and sales, production, and distribution. By the early 2010s, Ron's business employs 20 people full-time, most of whom work in production. There are also several casual employees and part-time staff in the retail outlet, particularly during busy periods.

In February 2012, Ron receives a call from Chip Masters, the senior vice-president of Cloud 9 Inc. Chip expresses an interest in buying McLellan's Shoes. Ron is getting tired, and his children are starting to fight among themselves about who is going to take over from their father. Ron has had enough, but he does not want Chip to know that. He asks if Chip is ready to talk about the price. Chip says he is, but first he needs to see the audited financial statements for McLellan's Shoes.

Ron asks for some time. He tells Chip that he needs to talk to his family and will get back to him. When Ron puts the phone down he immediately rings his friend from the golf club, Ernie Black, who is a professional accountant. For years, Ernie has been quietly suggesting to Ron that his business affairs need attention. Ron is skilled at making deals and working hard, but he has never bothered with sophisticated financial arrangements. He has never had a formal set of financial statements prepared for McLellan's Shoes. Ron is in a panic—he wants to sell McLellan's Shoes, but what is he going to do about Chip's request for audited financial statements?

Chapter Preview

The purpose of this chapter is to provide an overview of audit and assurance services. We begin by defining assurance and audit engagements. We discuss the reasons why there is a demand for audit and assurance services. We also introduce some of the assurance and audit terms that will be used throughout the text. We then go on to differentiate between the various types of assurance services a practitioner may provide. The assurance engagements explained in this chapter include financial statement audits, compliance audits, performance audits, comprehensive audits, and internal audits. We also discuss the emerging area of assurance of corporate social responsibility disclosures. We then provide an overview of the different levels of assurance that can be provided when conducting assurance procedures. The levels of assurance discussed in the chapter include reasonable, limited, and no assurance engagements.

Next, we provide a brief overview of the different audit opinions that an auditor can arrive at after completing an audit. An auditor can provide either an unmodified or a modified audit opinion. Unmodified or modified opinions can include an emphasis of matter paragraph, which is intended to draw the reader's attention to a specific matter. They can also include key audit matters, where auditors communicate issues that were important during the audit. If a modified opinion is used, the auditor has the choice of three types of modifications: qualified, adverse, or a disclaimer of opinion. These concepts are explained further in this chapter.

The roles of the financial statement preparer and auditor are explained and contrasted. An overview of the different firms that provide assurance services is then given. That section contains details about both accounting and consulting firms and the different services they provide. An overview of assurance regulators and their regulations is provided. The audit expectation gap is explained in the last section of the chapter.

1.1 Auditing and Assurance Defined

LEARNING OBJECTIVE 1

Define an assurance engagement.

assurance engagement an engagement performed by an auditor or consultant to enhance the reliability of the subject matter

An assurance engagement is defined as "an engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria" (CSAE 3000 C12). Thus, an **assurance engagement** is an engagement where a practitioner, such as a financial statement auditor, is engaged to issue a written conclusion on a subject matter for which a responsible party is accountable to intended users. Intended users are the people for whom the assurance provider prepares the report (for example, the shareholders). The responsible party is the person or organization (for example, the company) responsible for the preparation of the subject matter (for example, the financial statements). The triangle in **figure 1.1** illustrates the three parties needed for an assurance engagement.

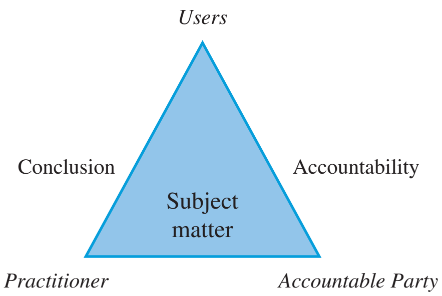


FIGURE 1.1 Parties involved in an assurance engagement

As illustrated in the triangle in figure 1.1, there must be an accountability relationship where a person or organization is responsible to the users for the subject matter. The practitioner gathers evidence and assesses the subject matter against criteria or benchmarks, and then provides a written report that concludes on the subject matter.

While the audit of a company's financial statements is one of the most common types of assurance engagements, it is not the only type of assurance engagement. Later in this chapter, section 1.3 provides a description of some of the different types of assurance services.

Cloud 9 Integrated Case

Chip Masters has asked Ron McLellan for audited financial statements of McLellan's Shoes. Ron has heard about tax audits, efficiency audits, and financial statement audits. Are they all the same thing? Ernie explains to Ron that there are several services that people call "audits" that are different from financial statement audits. However, all these services, including financial statement audits, can be defined as assurance engagements.

When you are acquiring a new skill, it is often necessary to become familiar with new terminology. **Table 1.1** presents a number of key assurance and audit terms to introduce you to the language of auditing.

TABLE 1.1 **Key assurance and audit terms**

Term	Definition
applicable financial reporting framework	The financial framework chosen by management to prepare a company's financial statements. For example, an applicable framework for a reporting issuer would be International Financial Reporting Standards (IFRS). An applicable framework for a private enterprise could be Accounting Standards for Private Enterprises (ASPE), or it could be IFRS.
assertions	Statements made by management regarding the recognition, measurement, and presentation and disclosure of items in the financial statements.
audit evidence	Information used by the auditor to support the audit opinion.
audit file	The file where the evidence and documentation of the work performed are kept as a permanent record to support the opinion issued.
audit plan	The list or description of audit procedures to be performed.
audit risk	The risk that the auditor may express an inappropriate opinion. This means the auditor may indicate that the financial statements are not materially misstated when in fact they are.
financial statements	A structured representation of historical financial information, including the required disclosures.
independent auditor's report	The auditor's formal expression of opinion on whether the financial statements are in accordance with the applicable financial reporting framework.
internal control	The processes implemented and maintained by management to help the entity achieve its objectives.
material	An amount or disclosure that is significant enough to make a difference to a user. For example, if a company reports a profit of $100,000 and the auditor finds an error resulting in an overstatement of net income by $10, this probably wouldn't affect an investor's decision. However, if the auditor finds an error overstating revenue by $50,000, or 50 percent of the profit, this likely would affect the user's decision and would therefore be considered material.
sufficient and appropriate evidence	The quantity (sufficiency) and quality (appropriateness) of the evidence collected by the auditor.

(*continued*)

TABLE 1.1 Key assurance and audit terms (*continued*)

Term	Definition
unmodified opinion	The auditor's opinion concluding that the financial statements are fairly presented. (Also called an "unqualified opinion.")
working papers	Paper or electronic documentation of the audit created by the audit team as evidence of the work completed.

Before You Go On

1.1.1 Who are the three parties involved in an assurance engagement?

1.1.2 What might an assurance provider express a conclusion about?

1.1.3 What is an assurance engagement?

1.2 Demand for Audit and Assurance Services

LEARNING OBJECTIVE 2

Explain why there is a demand for audit and assurance services.

In this section, we will provide an overview of the key financial statement users and their requirements. This is followed by a description of why these users may demand an audit of the financial statements. Next, three theoretical frameworks that have been used to encapsulate these sources of demand are described. Finally, the demand for assurance services in a voluntary setting is explored.

1.2.1 Financial Statement Users

Financial statement users include current and potential investors (shareholders if the entity is a company), suppliers, customers, lenders, employees, governments, and the general public. Each of these groups will read the financial statements for a slightly different reason. Each group of users and their reasons for reading a company's financial statement is described below, and is illustrated in **figure 1.2**.

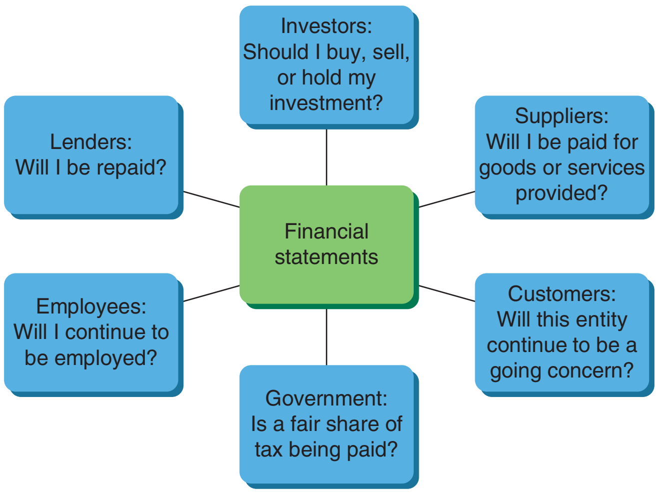


FIGURE 1.2 Financial statement users

Investors

In the case of a company, investors generally read the financial statements to determine whether they should invest in or buy, hold, or sell shares in the entity being reported on. They are interested in the return on their investment and are concerned that the entity will remain a going concern into the foreseeable future. Investors may also be interested in the capacity of the entity to pay a dividend. Prospective investors read financial statements to determine whether they should buy shares in the entity.

Suppliers

Suppliers may read the financial statements to determine whether the entity can pay them for goods supplied. They are also interested in whether the entity is likely to remain a going concern (that is, it is likely to continue to be a customer of the supplier) and continue to be able to pay its debts as and when they fall due.

Customers

If customers rely on the entity for their business, they may read the financial statements to determine whether the entity is likely to remain a going concern.

Lenders

Lenders may read the financial statements to determine whether the entity can pay the interest and principal on their loans as and when they fall due.

Employees

Employees may read the financial statements to determine whether the entity can pay their wages or salaries and other benefits (for example, vacation pay). They may also be interested in assessing the future stability and profitability of the entity, as this affects their job security.

Governments

Governments may read the financial statements to determine whether the entity is complying with regulations and paying a fair amount of taxation given its reported earnings, and to gain a better understanding of the entity's activities. An entity in receipt of government grants may provide a copy of its financial statements when applying for a grant and when reporting on how grant funds have been spent.

The General Public

The general public may read the financial statements to determine whether they should associate with the entity (for example, as a future employee, customer, or supplier) and to gain a better understanding of the entity, what it does, and its plans for the future.

1.2.2 Sources of Demand for Audit and Assurance Services

Financial statement users and their needs, as outlined in the previous section, are many and varied. There are a number of reasons why some or all of these users would demand audited financial statements. The primary reason is to reduce **information risk**, which is the risk that users will rely on incorrect information to make a decision. The causes of information risk include remoteness, complexity, competing incentives, and reliability. Each of these concepts is now explained.

information risk the risk that users will rely on incorrect information to make a decision

Remoteness

Most financial statement users do not have access to the entity under review. This makes it difficult to determine whether the information contained in the financial statements is a fair presentation of the entity and its activities for the relevant period.

Complexity

Most financial statement users do not have the accounting and legal knowledge to enable them to assess the complex accounting and disclosure choices being made by the entity.

Competing Incentives

Management has an incentive to disclose the information contained in the financial statements in a way that helps them achieve their own objectives—for example, to present their performance in the best possible light. Users may find it difficult to identify when management is presenting biased information.

Reliability

Financial statement users are concerned with the reliability of the information contained in the financial statements. As they use that information to make decisions that have real consequences (financial and otherwise, such as assessing the future viability of the company), it is very important that users are able to rely on the facts contained in the financial statements.

An independent third-party review of the information contained in the financial statements by a team of auditors, who have the knowledge and expertise to assess the fair presentation of the information being presented by the preparers, aids users with all of these issues. Auditors have access to entity records, so they are not remote. They are trained accountants and have detailed knowledge about the complex technical accounting and disclosure issues required to assess the choices made by the financial statement preparers. Independent auditors have no incentives to aid the entity in presenting its results in the best possible light. They are concerned with ensuring that the information contained in the financial statements is reliable and free from any significant (material) misstatements (error or fraud).

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Ron tells Ernie that he has no remote users, such as shareholders or lenders, and his business is not very complex. He is the owner and the manager of McLellan's Shoes and therefore has no competing incentives. For all these reasons, he has never felt the need to purchase an audit to assure users of the reliability of his business's financial information. Ernie agrees, but points out that there is now a user who is very interested in the reliability of the financial information—Chip Masters.

1.2.3 Theoretical Frameworks

The reasons for demanding audit and assurance services outlined in the previous section have led to the development of three theoretical frameworks that have been used to explain why audits occurred prior to regulations requiring that they be done, why users may demand an audit from a certain type of firm (for example, an international or an industry specialist firm), and why users may demand assurance of voluntarily disclosed information (for example, environmental reports). The three theories are agency theory, the information hypothesis, and the insurance hypothesis. Each is described in turn.

Agency Theory

When an individual is an owner-manager of their own business, there are no competing incentives. The owner (principal) and manager (agent) are one. When an owner hires a manager to run the business on their behalf, potential conflicts arise. The manager has an incentive to provide favourable results. If there is one owner, they can easily monitor the activities of the manager. When there are several owners (such as shareholders of a large company), it is difficult for the owners to monitor the activities of the management. Agency theory tells us that, due to the remoteness of the owners from the entity, the complexity of items included in the financial statements, and competing incentives between the owners and managers, the owners (principals) have an incentive to hire an auditor (incur a monitoring cost) to assess the fair presentation of the information contained in the financial statements prepared by their managers (agents).

Information Hypothesis

Financial statement users require access to high-quality information to make a variety of decisions. That information is used to determine whether to hold or sell shares in the entity, whether to lend money to the entity, what rate of interest to charge the entity on money lent, and so on. The greater the perceived quality of the information contained in the financial statements, the more likely it will be relied upon by the users of that information. The information hypothesis tells us that, due to the demand for reliable, high-quality information, various user groups, including shareholders, banks, and other lenders, will demand that financial statements be audited to aid their decision-making.

Insurance Hypothesis

Investors take on a risk when buying shares. If the entity fails, investors could lose the money invested. According to the insurance hypothesis, an audit is one way for investors to insure against at least part of their loss should the company they invest in fail. As auditors are required to take out professional indemnity insurance policies, they are seen as having "deep pockets" (that is, access to money), should an investor be able to prove that audit failure was to blame, at least in part, for a loss. The insurance hypothesis tells us that investors will demand that financial statements be audited as a way of insuring against some of their loss should their investment fail.

Cloud 9 Integrated Case

Cloud 9 is considering buying McLellan's Shoes from Ron. In effect, it is considering investing in the business. If the business fails, the shareholders of Cloud 9 will lose their money. The new investors have incentives that are in competition with Ron's. If Ron purchases an audit, he is providing assurance to the potential new investors about the fair presentation of the financial statements. The audit also increases the perceived reliability of the information in the financial statements. For example, the outsiders know that Ron will have to convince an auditor of the appropriateness of the reporting decisions he is making.

Purchasing an audit is also a way of taking insurance against any possible loss by creating the opportunity for investors to recover their investment from the auditor. In reality, the auditor is not guaranteeing the success of the business, only providing reasonable assurance that the financial statements comply with the relevant laws and standards and give a fair presentation of the business's financial position and performance. There is little chance of a successful legal action against an auditor unless it can be established that the auditor failed to perform to a reasonable standard.

1.2.4 Demand in a Voluntary Setting

In addition to the audit of company financial statements, assurance providers (including auditors and consultants) provide other assurance services (as outlined in section 1.3). The theories outlined above are now being used to understand more about the demand for assurance of corporate social responsibility (CSR) disclosures, including environmental, sustainability, and carbon emissions reports.

It is becoming more common for companies to voluntarily disclose CSR information in their annual reports, on their websites, and in separate stand-alone reports. This trend toward increased disclosures has been in response to stakeholder (shareholder, lender, employee, customer, supplier, and public) demand that companies be more accountable for their impact on the environment and on society. Stakeholders are concerned about more than just profits and returns on shareholder funds. They want to know what impact companies are having on our environment and what actions are being taken by those companies to reduce that impact.

Stakeholders are concerned about the reliability of environmental and other CSR disclosures. Just as the provision of these disclosures is voluntary, so is the assurance. Companies are not required to have their environmental and other CSR disclosures assured, yet several companies do. Assurance is provided to meet user demands for high-quality, reliable information and to demonstrate a high level of corporate responsibility.

Before You Go On

1.2.1 Who are the main users of company financial statements?

1.2.2 Why might financial statement users demand an audit?

1.2.3 What are the three most common theories used to explain the origins of the demand for audit and assurance services?

1.3 Different Assurance Services

LEARNING OBJECTIVE 3

Differentiate between types of assurance services.

In this section, we provide an overview of the different types of assurance services that an assurance practitioner can provide. Common types of assurance engagements are financial statement audits, compliance audits, performance audits, comprehensive audits, and internal audits. We will also briefly consider assurance on corporate social responsibility (CSR) disclosures. Each will now be explained in turn.

1.3.1 Financial Statement Audits

According to CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards,* the objective of a **financial statement audit** is for the auditor to express an opinion about whether the financial statements are prepared in all material respects in accordance with a financial reporting framework (CAS 200, para. 11). Within a Canadian context, this means that the financial statements have been prepared in accordance with Canadian generally accepted accounting principles (GAAP) and any relevant legislation, such as the Canada Business Corporations Act.

financial statement audit an audit that provides reasonable assurance about whether the financial statements are prepared in all material respects in accordance with the financial reporting framework

This means that, when a set of financial statements has been audited, the information presented has been verified by an independent auditor. To do this, the auditor methodically gathers evidence to corroborate the financial information presented by management. At the end of an audit engagement, the auditor issues a report indicating whether the financial information is fairly presented in accordance with the financial reporting framework. This lends credibility to the information.

listed entity an entity whose shares or debt are listed on a stock exchange

fair presentation the consistent and faithful application of accounting standards when preparing the financial statements

The Canadian Securities Administrators (CSA) requires **listed entities** to publish audited financial statements annually. It is the auditor's responsibility to form an opinion on the fair presentation of the financial statements. **Fair presentation** refers to the consistent and faithful application of the accounting standards. In fulfilling their role, the auditor must be independent of the company audited and exercise due professional care.

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Ron believes that his business has good, reliable financial records. Ron's wife helps him keep tight control of the cash and other assets, and together they prepare some simple reports on a regular basis. Ron believes he knows exactly what is happening in the business and monitors the business's cash flow and profit very closely. However, he has not prepared financial statements that comply with Canadian generally accepted accounting principles (GAAP). Is this a problem? Ernie explains to Ron that some businesses must apply the accounting standards. For example, if a company requires audited financial statements to meet regulatory requirements or as a condition of a loan agreement, then the financial statements must comply with Canadian GAAP.

Process of a Financial Statement Audit

An audit is a systematic process. It involves the gathering of evidence in a logical fashion to substantiate the balances and disclosures in the financial statements. All audits should follow the same process to ensure that professional standards are met. Regardless of the size or complexity of the entity, auditing principles remain the same. Some engagements may be riskier than others, so the amount of work performed and the time spent may vary, but the sequence to be followed is the same for all audits.

The first step in this sequence is the risk assessment phase. This involves performing an overall risk assessment. The auditor documents an understanding of the business, its environment, and its processes to determine where the greatest risks may be. The auditor then devises an overall audit strategy, taking these risks into consideration. This allows the auditor to plan when to perform the "fieldwork" (the work to be done at the client's premises), who will do it, and what exactly needs to be done. Tasks are usually divided by business cycle or financial statement groupings (for example, purchasing cycle; cash; property, plant, and equipment). The financial statement accounts related to each cycle are divided into sections. For each section, there should be an "audit working paper program" that lists the procedures to be performed for that area.

During the risk response phase, the auditor typically works at the client's premises. When the auditor is not a sole practitioner, and carries out the engagement as part of a team, staff members are assigned sections to complete, which generally involves obtaining information, assessing it, and having discussions with the client's staff regarding systems, procedures, and clarification as required. As the work is done, it is documented in the audit working paper file (which may be electronic or paper). The documentation is done through the use of narrative, memos, or schedules with audit "ticks" (common conventions used by auditors to indicate the work performed). The audit programs are "signed off" or initialled by audit members once completed. Each completed section is then reviewed by a more senior auditor, as work must be properly supervised.

Once the fieldwork has been completed, the auditor leaves the client's premises; however, there remain a number of completion procedures to be done. Once all of the required procedures have been performed, the completed file and financial statements go to the partner responsible for the audit for review. If the partner believes there is sufficient and appropriate evidence in the audit file, and the financial statements appear fairly stated, they will approve and issue an unmodified audit opinion on the financial statements.

Limitations of a Financial Statement Audit

An audit is an assurance engagement performed to increase the confidence of financial statement users. Therefore, an audit is conducted to enhance the reliability and credibility of the information in the financial statements. However, it is not a guarantee that the financial statements are free from fraud and error.

The limitations of an audit result from the nature of financial reporting, the nature of audit procedures, and the need for the audit to be conducted within a reasonable period of time and at a reasonable cost (CAS 200).

"The nature of financial reporting" refers to the use of judgement when preparing financial statements, because of the subjectivity required when arriving at accounting estimates. Judgement is also required when selecting and applying accounting methods. For example, judgements and estimates are used when determining whether to use FIFO (first-in, first-out) or weighted average for inventory costing, as well as when assessing inventory obsolescence.

"The nature of audit procedures" refers to the reliance on evidence provided by the client and its management. If an auditor does not have access to all the information relevant to the audit, there is a limitation in the scope of the audit. If the auditor is unaware of this situation, they may arrive at an inappropriate conclusion based on incomplete facts. Evidence may be withheld or modified by perpetrators of fraud. It can be difficult for an auditor to determine whether fraud has occurred and documents altered, as those committing fraud generally hide evidence. Sampling may be used when testing transactions and account balances. If a sample is not representative of all items available for testing, an auditor may arrive at an invalid conclusion.

"The timeliness and cost of a financial statement audit" refers to the pressure an auditor faces to complete the audit within a certain time frame at a reasonable cost. While it is important that auditors do not omit procedures in an effort to meet time and cost constraints, they may be under some pressure to do so. This pressure will come from clients wanting to issue their financial statements by a certain date, from clients refusing to pay additional fees for additional audit effort, and from within the audit firm, where there are pressures to complete all audits on a timely basis to avoid incurring costs that may not be recovered. By taking the time to plan the audit properly, an auditor can ensure that adequate time is spent where the risks of a significant error or fraud are greatest.

1.3.2 Compliance Audits

compliance audit an audit to determine whether the entity has conformed with regulations, rules, or processes

A **compliance audit** involves gathering evidence to ascertain whether the person or entity under review has followed the applicable rules, policies, procedures, laws, and regulations. There are a number of examples of compliance audits. A tax audit is used to determine whether an individual or company has completed a tax return in accordance with the Income Tax Act. Within an organization, management may specify that certain processes be followed when completing a function. For example, a company may have policies and procedures for the hiring of new staff. In that case, the organization's internal auditors may be called upon to determine whether employees are following the specified processes appropriately.

1.3.3 Performance Audits

performance audit an assessment of the economy, efficiency, and effectiveness of an organization's operations

Performance audits are concerned with the economy, efficiency, and effectiveness of an organization's activities. Economy refers to the cost of inputs, including wages and materials. Efficiency refers to the relationship between inputs and outputs; specifically, efficiency refers to the use of the minimum amount of inputs to achieve a given output. Finally, effectiveness refers to the achievement of certain goals or the production of a certain level of outputs. From an organization's perspective, it is important to perform well across all three dimensions and not allow one to dominate. For example, if buying cheap inputs results in an inefficient production process, efficiency may be seen to be sacrificed to achieve economic goals.

Performance audits are generally conducted by an organization's internal auditors, or they may be outsourced to an external audit firm. Performance audits are sometimes referred to as value for money audits, operational audits, or efficiency audits. Professional Environment 1.1 explains how the Office of the Auditor General of Canada carries out performance audits of various federal government programs and agencies.

1.1 Professional Environment Performance Audits as a Public Service

The Office of the Auditor General of Canada (OAG) is the internal auditor of the Canadian government. It is responsible for performing financial and performance audits for federal government departments and agencies, most Crown corporations, and many other federal organizations.

The OAG performs between 25 to 30 performance audits a year. While the OAG reports to Parliament, the reports issued are available to the public. The OAG states that "a performance audit is an independent, objective and systematic assessment of how well government is managing its activities, responsibilities and resources. Performance audits contribute to a public service that is effective and a government that is accountable to Parliament and Canadians." Audits are selected based on a risk analysis performed by the OAG. High-risk areas are those that use significant taxpayer dollars or threaten the health and safety of Canadians.

In 2016, one performance audit report issued was related to preventing and detecting fraud in the Canadian citizenship program. "This audit examined whether Immigration, Refugees and Citizenship Canada detected and prevented fraud in adult citizenship applications to ensure that only applicants who met selected eligibility requirements were granted Canadian citizenship." This program was selected for audit because citizenship fraud is very costly to Canadian taxpayers as it results in people fraudulently receiving the benefits of citizenship.

The audit report concluded that the responsible government department did not adequately ensure that the citizenship criteria were met. It was found that processes were not being applied consistently and information was not being shared between government departments to ensure that informed decisions were being made. The performance audit report included several recommendations as to how the citizenship criteria should be better applied. For each recommendation, the government department issued a written response, indicating how the recommendations would be implemented. Through this process, the OAG contributes to the economy and effectiveness of the Canadian government.

Q: Audits are not only limited to audits of financial information. How important is it to have performance audits within government agencies and why?

Sources: Office of the Auditor General of Canada, "What We Do," www.oag-bvg.gc.ca/internet/English/au_fs_e_371.html; Office of the Auditor General of Canada, 2016 Spring Reports, "Report 2—Detecting and Preventing Fraud in the Citizenship Program."

1.3.4 Comprehensive Audits

A **comprehensive audit** may encompass elements of a financial statement audit, a compliance audit, and a performance audit. For example, an auditor may report on whether an entity has met its efficiency targets. Comprehensive audits most commonly occur in the public sector, where compliance with various regulations is examined as part of the financial statement audit.

comprehensive audit an audit that encompasses a range of audit and audit-related activities, such as a financial statement audit, performance audit, and compliance audit

1.3.5 Internal Audits

Internal audits are conducted to provide assurance about various aspects of an organization's activities. The internal audit function is typically conducted by employees of the organization being audited, but can be outsourced to an external audit firm. As such, the function of internal audit is determined by **those charged with governance** and management within the organization. While the functions of internal audits vary widely from one organization to another, they are often concerned with evaluating and improving risk management, internal control procedures, and elements of the governance process. The internal audit function often conducts performance audits, compliance audits, internal control assessments, and reviews. Many internal auditors are members of the Institute of Internal Auditors (IIA), an international organization that provides guidance and standards to aid internal auditors in their work. When conducting a financial statement audit, the external auditor may consider the work done by the internal auditors (CAS 610 *Using the Work of Internal Auditors*).

internal audit an independent service within an entity that generally evaluates and improves risk management, internal control procedures, and elements of the governance process

those charged with governance generally the board of directors, and may include management of an entity, concerned with evaluating and improving risk management, internal control procedures, and elements of the governance process

1.3.6 Corporate Social Responsibility (CSR) Assurance

Corporate social responsibility (CSR) reporting is voluntary. However, it is becoming more widespread. CSR disclosures include environmental, employee, and social reporting. Some organizations choose to have their CSR disclosures assured by an independent assurance provider. The assurance of CSR disclosures can be carried out by both auditors and specialist **consulting firms**. As these disclosures include non-financial as well as financial information, the skill set required to conduct these assurance services is quite broad.

Whether a company chooses to provide additional voluntary environmental disclosures or not, an auditor must still consider the impact of environmental issues on a client's financial statements when conducting the financial statement audit. However, as investors demand more relevant information in this area, further guidance is expected.

corporate social responsibility (CSR) a range of activities undertaken voluntarily by a corporation; CSR disclosures include environmental, employee, and social reporting

consulting firms non-audit firms that provide assurance services on non-financial information, such as corporate social responsibility and environmental disclosures

Cloud 9 Integrated Case

Ron is not concerned about internal audits—his business is too small for a separate internal audit function. He is also not worried about CSR reporting or compliance and performance audits. His priority at the moment is to close the deal with Chip Masters, and he still does not know what he has to do about the audit.

Before You Go On

1.3.1 What are the three elements of a performance audit?

1.3.2 What is the objective of a financial statement audit?

1.3.3 What are the most common tasks of the internal audit function?

1.4 Different Levels of Assurance

LEARNING OBJECTIVE 4

Explain the different levels of assurance.

In this section, we describe the different levels of assurance that a practitioner can provide when conducting assurance procedures. An assurance practitioner can provide reasonable assurance, limited assurance, or no assurance. When providing reasonable and limited assurance, the practitioner's report is addressed to the party requesting assurance (for example, a company's shareholders). When an assurance practitioner performs a non-assurance engagement, a report on the findings is addressed to management or to those charged with governance. The differences between reasonable, limited, and no assurance are now explained.

1.4.1 Reasonable Assurance

reasonable assurance assurance that provides high but not absolute assurance on the reliability of the subject matter

The objective of a **reasonable assurance** engagement is to gather sufficient evidence upon which to form a positive expression of an opinion regarding whether the information being assured is presented fairly. This means that the auditor has done adequate work to report with reasonable certainty that the information being assured is, or is not, reliable. This does not reflect absolute assurance, as an auditor can never be 100 percent certain that there are no errors or omissions. For example, an auditor is in the position to say whether in their opinion the financial statements are in accordance with relevant laws and accounting standards and they present fairly the financial position of the reporting entity. Auditors can make such a positive statement only if they are reasonably sure that the evidence gathered is sufficient and appropriate. The audit opinion will depend upon the auditor's findings while conducting the audit. A brief overview of the different opinions that an auditor may form when conducting a financial statement audit is provided in the next section of this chapter. Reasonable assurance is the highest level of assurance provided; again, note that it is high but not absolute assurance. The audit of a company's financial statements is one example of a reasonable assurance engagement. CAS 700 *Forming an Opinion and Reporting on Financial Statements* provides guidance on the form and elements of the audit report.

As illustrated in **figure 1.3**, the audit report includes the following:

- The report begins with the audit opinion and an identification of the financial statements that have been audited.
- It is followed by a basis of opinion, which provides an explicit statement about the auditor independence and ethical requirements.
- The audit report may include "key audit matters," where auditors communicate issues that were important in the current audit. According to CAS 701, key audit matters include areas of higher assessed risk of material misstatement, areas that involve significant judgement where there is high uncertainty around estimations, and the effect of significant events on the audit (CAS 701, para. 9). The reporting of key audit matters is mandatory only if required by law or regulation. After December 15, 2020, key audit matters are required for audits for entities listed on the Toronto Stock Exchange, except for certain investment funds.
- Where clients include other information with their audit report, such as an MD&A (management's discussion and analysis), the auditor is required to make a statement in the audit report regarding this information.

FIGURE 1.3 **Example of an audit report**

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INDEPENDENT AUDITOR'S REPORT

To the Shareholders of Skyward Inc.,

Report on the Audit of the Consolidated Financial Statements

Opinion

We have audited the consolidated financial statements of Skyward Inc. and its subsidiaries (the Group), which comprise the consolidated statement of financial position as at December 31, 2023, and the consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying consolidated financial statements present fairly, in all material respects, the consolidated financial position of the Group as at December 31, 2023, and its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRSs).

Provides the opinion and identifies the entity and the title of the financial statements under audit, including the disclosures and accounting policies.

Basis for Opinion

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

Indicates the audit was conducted in accordance with auditing standards, and makes an explicit statement about the auditor's independence and compliance with ethical standards.

Key Audit Matters

Key audit matters are those matters that, in our professional judgment, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

For listed entities, key matters of significance.

[Description of each key audit matter in accordance with CAS 701.]

Other Information

Management is responsible for the other information. The other information comprises the information, other than the financial statements and our auditor's report thereon, in the Annual Report.

Our opinion on the financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

Other Information explains the auditor responsibilities when the audited financial statements are included with other documents, such as the MD&A.

In connection with our audit of the financial statements, our responsibility is to read the other information identified above and, in doing so, consider whether the other information is materially inconsistent with the financial statements or our knowledge obtained in the audit, or otherwise appears to be materially misstated.

We obtained the Annual Report prior to the date of this auditor's report. If, based on the work we have performed on this other information, we conclude that there is a material misstatement of this other information, we are required to report that fact in this auditor's report. We have nothing to report in this regard.

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

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

Management's responsibility for the financial statements and internal control.

(continued)

Statement that those responsible for governance are responsible for overseeing financial reporting.

Summarizes that an audit provides reasonable, not absolute, assurance whether the financial statements are free from fraud or error.

Auditor's responsibility to: assess risk of material misstatement, understand internal controls, evaluate the overall financial statements including accounting policies and estimates, and conclude on management's appropriateness of going concern.

Highlights the auditor's requirement to communicate with those responsible for governance regarding scope and timing of audit, significant audit findings, and independence.

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

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

Auditor's Responsibilities for the Audit of the Consolidated Financial Statements

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

As part of an audit in accordance with Canadian generally accepted auditing standards, we exercise professional judgment and maintain professional skepticism throughout the audit. We also:

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

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

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

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

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

Toronto, Canada

March X, 2024

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FIGURE 1.3 **Example of an audit report (*continued*)**

- This is followed by a paragraph summarizing management's responsibilities for the financial statements, internal control, and for the assessment of the going concern assumption. It also indicates that those responsible for governance are responsible for overseeing financial reporting.
- The report then concludes with the auditor's responsibilities, which includes assessing the risk of material misstatement, understanding internal controls, assessing the overall financial statements including estimates, and concluding on the appropriateness of management's use of the going concern assumption.

Note that in figure 1.3, part of the auditor's responsibilities is shaded. This shaded wording may instead be reported in an appendix to the report, as long as the report includes a reference to the location of the appendix. It may also be reported on a website, as long as a description of the website is provided in the report, and this is permitted by law, regulation, or national auditing standards.

1.4.2 Limited Assurance

The objective of a **limited assurance** engagement is to perform sufficient procedures and gather sufficient evidence to support the practitioner's conclusion. This means that the practitioner has done adequate work to report whether or not anything came to their attention that would lead them to believe that the information is not prepared in accordance with the applicable financial framework. The practitioner is not required to conduct detailed testing when undertaking a limited assurance engagement. The practitioner is required to at least do enough work so that the report enhances the user's confidence about the information. This means that practitioners do not need to obtain as much evidence or perform as many procedures as when they make a positive statement.

limited assurance the level of assurance obtained where engagement risk is reduced to an acceptable level and the evidence gathered is at least sufficient for the practitioner to conclude and provide a level of assurance that is likely to enhance the intended users' confidence about the financial statements

The limited assurance engagement for a company's historical financial statements is called a **review engagement**. A review engagement may be requested when the client requires some assurance over the financial statements but does not require an audit level of assurance. For example, a lender of a small business may not want to approve a loan based on financial statements with no assurance, but it may not require the same level of assurance that an audit would provide.

review engagement engagement in which the practitioner does adequate work to provide limited assurance

When conducting a review engagement, a practitioner obtains an understanding of the entity and identifies where material misstatements are likely. The practitioner then performs primarily inquiry and analytical procedures on material financial statement items and items where a risk of material misstatement has been determined to exist.

Guidance on the form and elements of the review engagement report is provided in CSRE 2400 *Engagements to Review Historical Financial Statements*. An example of a review engagement report is provided in **figure 1.4**. The report explicitly states that management is responsible for the preparation and fair presentation of the financial statements, and the practitioner is responsible for complying with generally accepted standards for review engagements. The report also states that the procedures performed are less than that of an audit and therefore an audit opinion is not expressed. Finally, the review engagement report concludes that the practitioner was not aware of any matter that made them believe that the financial statements were not fairly stated.

1.4.3 No Assurance

no assurance what results when a practitioner completes a set of tasks requested by the client and reports factually on the results of that work to the client

An assurance provider may perform other services for clients for which **no assurance** is provided. In such circumstances, an assurance provider must ensure when reporting to users that they make clear that they are merely reporting the activities that they have performed (and in some engagements, their findings) and are not providing assurance. An example of an engagement where no assurance is provided is a **compilation engagement**, where a practitioner compiles the financial information provided by the client and arranges it into a set of financial statements. The financial statements must include disclosure with respect

compilation engagement engagement that provides no assurance, where the practitioner compiles the financial information in accordance with a basis of accounting disclosed in the financial statements

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INDEPENDENT PRACTITIONER'S REVIEW ENGAGEMENT REPORT

To the Board of Directors of Janeway Ltd.

We have reviewed the accompanying financial statements of Janeway Ltd. that comprise the balance sheet as at December 31, 2023, and the statements of income, retained earnings and cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements

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

Practitioner's Responsibility

Our responsibility is to express a conclusion on the accompanying financial statements based on our review. We conducted our review in accordance with Canadian generally accepted standards for review engagements, which require us to comply with relevant ethical requirements.

A review of financial statements in accordance with Canadian generally accepted standards for review engagements is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less in extent than, and vary in nature from, those performed in an audit conducted in accordance with Canadian generally accepted auditing standards. Accordingly, we do not express an audit opinion on these financial statements.

Conclusion

Based on our review, nothing has come to our attention that causes us to believe that the financial statements do not present fairly, in all material respects, the financial position of Janeway Ltd. as at December 31, 2023, and the results of its operations and its cash flows for the year then ended in accordance with Canadian accounting standards for private enterprises.

Toronto, Canada — "W&S Partners, LLP"
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March X, 2024 — Licensed Public Accountants

FIGURE 1.4 Example of a review engagement report

Source: CPA Canada, CPA Handbook, CSRE 2400

to the basis of accounting used to prepare the financial statements. For example, an entity is required to disclose if the financial information is prepared on a cash or on an accrual basis. When accepting the engagement, if a compilation engagement is to be provided to a third-party user, then CSRS 4200, *Compilation Engagements*, requires the practitioner to ensure that the third-party user is able to obtain additional information from the entity and has agreed to the basis of accounting to be used in preparing the financial statements. If these two conditions are not met, the practitioner should not accept or conduct the engagement.

After accepting an engagement, CSRS 4200 requires the practitioner to obtain an understanding of the business, its operations, and its accounting system to the level needed to conduct the engagement. The practitioner should ensure management understands any assumptions made so management is able to accept responsibility for the financial statements.

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COMPILATION ENGAGEMENT REPORT

To Management of StyleWear Inc.

On the basis of information provided by management, we have compiled the balance sheet of StyleWear Inc. as at December 31, 2023, the statement of income and retained earnings for the year then ended, and Note 1, which describes the basis of accounting applied in the preparation of the compiled financial information, and other explanatory information ("financial information").

Management is responsible for the accompanying financial information, including the accuracy and completeness of the underlying information used to compile it and the selection of the basis of accounting.

We performed this engagement in accordance with Canadian Standard on Related Services (CSRS) 4200, *Compilation Engagements*, which requires us to comply with relevant ethical requirements. Our responsibility is to assist management in the preparation of the financial information.

We did not perform an audit engagement or a review engagement, nor were we required to perform procedures to verify the accuracy or completeness of the information provided by management. Accordingly, we do not express an audit opinion or a review conclusion, or provide any form of assurance on the financial information.

Readers are cautioned that the financial information may not be appropriate for their purposes.

Toronto, Canada
February X, 2024.

"W&S Partners, LLP"
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FIGURE 1.5 **Example of a Compilation Engagement Report**

Source: CPA Canada Handbook – Assurance, 2020, Chartered Professional Accountants of Canada

The practitioner should also format the financial statements, check them for mathematical accuracy, and read them to ensure they are not misleading.

The report issued for a compilation engagement is called a **Compilation Engagement Report** and it includes a description of both management's and the practitioner's responsibilities. The Compilation Engagement Report explicitly states that no assurance is being provided. An example of the report for a fictional company is in **figure 1.5**.

Table 1.2 summarizes the differences among the three types of engagements.

Compilation Engagement Report the communication issued when the practitioner performs a compilation engagement

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As Ernie explains the differences between reasonable and limited assurance, Ron wonders if Chip will accept a review, rather than an audit, of the financial statements. If he will, it will be much easier and cheaper for Ron. However, Ron also realizes that Chip would not get as much assurance from a review as he would get from an audit. Ron thinks Chip would know the difference between an audit and a review; because he asked for an audit, Chip must need the additional assurance it provides.

TABLE 1.2 Types of engagements

Characteristic	Audit	Review	Compilation
Objective	To reduce the assurance engagement risk to an acceptably low level so that a positive opinion can be provided. Reasonable assurance means a high, but not absolute, level of assurance.	To reduce the assurance engagement risk to an acceptable level to allow the practitioner to conclude and express limited assurance in that nothing has come to their attention.	To compile a set of financial statements based on information provided, including disclosure with respect to the basis of accounting used to prepare the financial statements.
Procedures	Sufficient appropriate evidence is obtained as part of a systematic process that includes: • obtaining an understanding of the assurance engagement circumstances • assessing risks • responding to assessed risks • performing further evidence-gathering procedures using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures, and inquiry	Sufficient appropriate evidence is obtained by: • obtaining an understanding of the entity and identifying where material misstatements are likely • performing primarily inquiry and analytic procedures to address high-risk areas and to address all material items in the financial statements	Performance requirements include: • obtaining a knowledge of the business, the accounting systems, and the policies used to prepare the financial statements as needed to conduct the engagement • discussing with management the assumptions the auditor helped make in preparing the financial statements • reading the financial statements to consider if they are misleading • formatting the financial statements and checking the mathematical accuracy
Financial reporting framework	Must be in accordance with Canadian GAAP or other appropriate financial reporting framework.	Must be in accordance with Canadian GAAP or other appropriate financial reporting framework.	GAAP not required but must include a note to disclose the basis of accounting used to prepare the financial statements.
Level of assurance	High assurance	Limited assurance	No assurance
Report	Independent Auditor's Report	Independent Practitioner's Review Engagement Report	Compilation Engagement Report
Cost and time	Most time-consuming, highest cost	May take less time, as less work required; lower cost	Least amount of work, lowest cost

Before You Go On

1.4.1 What are the main differences between reasonable and limited assurance engagements?

1.4.2 What is the level of assurance required for an annual financial statement for a reporting issuer?

1.4.3 What level of assurance does a compilation engagement provide?

1.5 Different Audit Opinions

LEARNING OBJECTIVE 5

Outline different audit opinions.

unmodified opinion a clean audit opinion; the auditor concludes that the financial statements are fairly presented

emphasis of matter what results when an auditor issues an unmodified audit opinion when there is a significant issue that is adequately disclosed and there is a need to draw the attention of the user to it in the audit report

The purpose of this section is to present a very brief overview of the different types of audit opinions an auditor can arrive at when completing an audit.

The most common audit report includes an unmodified opinion. An **unmodified opinion** is also known as a clean opinion. The audit report in figure 1.3 is an example of such a report. Auditors arrive at this type of opinion when they believe that the financial statements are not materially misstated and that they present fairly the financial position of the company, and that the information provided is in accordance with Canadian GAAP.

An audit report may have an unmodified opinion and include an **emphasis of matter** paragraph. An emphasis of matter paragraph draws the attention of the reader to an issue that

TABLE 1.3 Audit opinion modifications

Nature of the matter giving rise to the modification	*Auditor's judgement about the pervasiveness of the effects or possible effects on the financial statements*	
	Material but not pervasive	*Material and pervasive*
Financial statements are materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Source: CAS 705 *Modifications to the Opinion in the Independent Auditor's Report*, para. Al.

the auditor believes has been adequately and accurately explained in a note to the financial statements. The purpose of the paragraph is to ensure that the reader pays appropriate attention to the issue when reading the financial statements. The audit report remains unmodified and users of the financial statements can still rely on the information contained in the financial statements (CAS 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*).

All other audit reports are modified. There are three types of modifications, shown in **table 1.3** (CAS 705 *Modifications to the Opinion in the Independent Auditor's Report*).

The first is called a **qualified opinion** and is issued when the auditor believes that "except for" the effects of a matter that is explained in the audit report, the financial statements can be relied upon by the reader. A qualified opinion is used when the matter of concern can be identified, quantified, and explained in the audit report. In this case, the matter of concern is material but not pervasive to the financial statements. In this context, "pervasive" refers to misstatements that are not confined to individual accounts or elements of the financial statements, or, if confined, the misstatements affect an extensive portion of the financial statements or there are missing disclosures that are vital to a user's understanding of the financial statements.

More serious matters require either an **adverse opinion** or a **disclaimer of opinion**. An adverse opinion is appropriate if the auditor has evidence that identified misstatements, individually or in the aggregate, are material and pervasive to the financial statements. A disclaimer of opinion is used when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and concludes that the possible effects on the financial statements could be material and pervasive. Although these opinions are used in different circumstances, in both instances the matter or matters of concern are so material and pervasive to the financial statements that the auditor cannot issue a qualified, "except for" opinion.

qualified opinion an "except for" opinion provided where there is a material scope limitation or a material (significant) misstatement not pervasive to the overall financial statements

adverse opinion opinion provided when the auditor concludes that there is a pervasive material misstatement in the financial statements

disclaimer of opinion opinion provided when the impact of a scope limitation is so extreme that an auditor is unable to obtain sufficient appropriate evidence to base an opinion

Cloud 9 Integrated Case

Ron worries that an auditor might not be able to give an unmodified opinion on his business's financial statements. The whole point of getting an audit would be to give Chip sufficient assurance that the financial statements give a true and fair view of his business's financial position and performance, and thus agree to pay a good price for the business. If the auditor gives a disclaimer of opinion or an adverse opinion, Chip could either change his mind about the business or offer only a very low price because he can't be sure that the business is as profitable and as solvent as Ron claims. Even getting a qualified opinion would be serious. Ernie assures Ron that disclaimers are extremely rare; in fact, he has never seen one. Adverse opinions are also rare, and if Ron's belief about his good financial records and tight control over assets is well founded, then there should not be any major problems.

Before You Go On

1.5.1 What are the different types of unmodified audit opinions?

1.5.2 What are the different types of modified audit opinions?

1.5.3 What type of audit opinion is unmodified and modified?

1.6 Preparers and Auditors

LEARNING OBJECTIVE 6

Differentiate between the roles of the preparer and the auditor, and discuss the different firms that provide assurance services.

In this section, we explain and contrast the different responsibilities of financial statement preparers and auditors. We provide details of the role that each group plays in ensuring that the financial statements are a fair representation of the company in question. Following this discussion, there is an overview of the different firms that provide assurance services.

A complete set of financial statements includes the balance sheet (statement of financial position), income statement (statement of comprehensive income), statement of cash flows, statement of changes in equity, and the required disclosures. It is the responsibility of those charged with governance (generally the board of directors and management) to prepare the financial statements. They must ensure that the information included in the financial statements is fairly presented and complies with Canadian accounting standards and interpretations. According to CAS 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Canadian Auditing Standards*, those charged with governance are responsible for:

- identifying the financial reporting framework to be used in the preparation and presentation of their financial statements
- reporting, establishing, and maintaining internal controls that are effective in preventing and detecting material misstatements finding their way into the financial statements
- selecting and applying appropriate accounting policies and making reasonable accounting estimates

1.6.1 Preparer Responsibility

It is the responsibility of those charged with governance to ensure that the information contained in their financial statements is relevant, reliable, comparable, understandable, and fairly presented. Each of these concepts is now discussed.

Relevant

The information included in the financial statements should be relevant to the users of that report. Information is relevant if it has an impact on the decisions made by users regarding the performance of the entity. Users require information that helps them evaluate past, present, and future events relating to the entity. They are interested in evaluating past decisions made by management and predicting whether the entity will remain viable (that is, a going concern) into the future. Users can use current information to estimate future share price movements, like dividend payments, and the ability of the entity to meet its immediate obligations.

Reliable

The information included in the financial statements should be reliable to the users of those statements. Information is reliable when it is free from material misstatements (errors or fraud). If users perceive that the information presented is unreliable, for whatever reason, the financial statements cannot be used to make the types of decisions outlined above. The information must be unbiased; it must not be presented in such a way as to influence the user's decision-making process. An independent audit of the financial statements is one method of improving the reliability of the financial statements.

Comparable

The information included in the financial statements should be comparable through time. Users need to be able to trace an entity's performance to identify any trends that may influence their perception of how well the entity is doing. Users also need to be able to benchmark the performance of the entity against other similar organizations to assess its relative performance. To enable such comparisons, information must be presented consistently across time and across entities. Any changes in accounting policies must be clearly disclosed so that appropriate adjustments can be made. Consistent application of Canadian generally accepted accounting principles by all entities over time aids these comparisons.

Understandable

The information included in the financial statements should be understandable. Users need to understand the information presented in order to make appropriate decisions. The financial statement disclosures should provide additional details to aid in the interpretation of the accounting information provided and they should be appropriately placed based on their significance. The disclosures must be clear and concise, and phrased in such a way as to impartially inform users to aid their decision-making.

Fairly Presented

The information included in the financial statements should be fairly presented. "Presented fairly" or "truth and fairness" refers to the consistent and faithful application of the accounting standards or an applicable framework when preparing the financial statements.

It is the responsibility of the auditor to form an opinion on the fair presentation or the truth and fairness of the financial statements. In doing so, the auditor will assess the accounting policies selected by those charged with governance of the entity. Specifically, the auditor will evaluate whether those accounting policies are consistent with the financial reporting framework used by the entity. The auditor will also consider the accounting estimates made by management and those charged with governance to determine whether the estimates are reasonable. The auditor will assess the relevance, reliability, comparability, and understandability of the information presented in the financial statements and the adequacy of the disclosures.

1.6.2 Auditor Responsibility

When undertaking an audit, the auditor should use professional scepticism, professional judgement, and due care. Each of these concepts is now defined and explained.

Professional Scepticism

Professional scepticism is an attitude adopted by the auditor when conducting the audit. It means that the auditor remains independent of the entity, its management, and its staff when completing the audit work. In a practical sense, it means that the auditor maintains a questioning mind and thoroughly investigates all evidence presented by the client. The auditor must seek independent evidence to corroborate information provided by the client and must be suspicious when evidence contradicts documents held by the client or inquiries made of client personnel (including management and those charged with governance). It means the auditor should assess evidence critically and remain alert for fraud.

Professional Judgement

Professional judgement relates to the level of expertise, knowledge, and training that an auditor uses while conducting an audit. An auditor must utilize their judgement throughout the audit. For example, an auditor must determine the reliability of an information source and decide on the sufficiency and appropriateness of evidence gathered, the procedures to be used in testing, and an appropriate sample size.

Due Care

Due care refers to being diligent while conducting an audit, applying technical and statute-backed standards, and documenting each stage in the audit process.

1.6.3 Assurance Providers

Assurance services are provided by accounting and other consulting firms. The largest accounting firms in Canada are known collectively as the "Big-4." The firms that make up the Big-4 are Deloitte, EY, KPMG, and PricewaterhouseCoopers (PwC). These four firms operate internationally and dominate the assurance market throughout the world. There were once eight international firms, but after a series of mergers and the collapse of Arthur Andersen, the Big-8 became the Big-4. These four firms dominate the audits of Canada's largest companies.

The next tier of accounting firms is known as the national accounting firms. The firms in this tier have a significant presence nationally and most have international affiliations. National firms in Canada include BDO, Grant Thornton, and MNP. These firms service medium-sized and smaller clients.

The next tier of accounting firms is made up of regional and local accounting firms. These firms service clients in their local areas and range in size from single-partner firms to several-partner firms with professionally qualified and trained staff.

Most of these accounting firms provide non-assurance (or non-audit) services as well as assurance (or audit) services. Non-assurance services include management consulting, mergers and acquisitions, insolvency, tax, and accounting services. The code of professional conduct specifies a number of requirements that restrict an accounting firm from providing non-audit services to its audit clients. These rules were established to increase the transparency of the extent of services being provided by an accounting firm to its audit clients after the collapse of several high-profile companies, including Enron and WorldCom (in the United States). The collapse of Arthur Andersen (previously an international accounting firm) raised concerns that the provision of non-audit services to an audit client could affect the auditor's independence and objectivity.

Accounting firms are not the only providers of assurance services. A number of consulting firms provide assurance services primarily in areas of corporate social responsibility, including some combination of environmental issues, carbon emissions, community engagement, charitable activities, and employee welfare as well as disclosures in other areas. Consulting firms employ staff with a range of expertise, including engineers, accountants, sociologists, scientists, and economists.

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Ernie stresses to Ron that any financial statements prepared for McLellan's Shoes are Ron's responsibility, even if they are audited. The auditor has to be sceptical about the claims made by Ron in the financial statements. These claims include, for example, that the assets shown on the balance sheet exist and are valued correctly, and that the balance sheet contains a complete list of the business's liabilities. In other words, the auditor is not just going to believe whatever Ron tells him or her. Auditors must gather evidence about the financial statements before they can give an audit opinion. Ernie also explains to Ron that, because his business is relatively small, he has a choice between large and small audit firms. Very large companies would be expected to select a larger audit firm because often smaller firms may be too small to maintain their independence effectively. If a small audit firm audits a large company, it is open to the criticism that it will not be sufficiently sceptical because it does not want to lose the fees from that client. A large audit firm has many other clients, so the fees from any one client are a relatively small part of its revenue. Ron likes the idea that the smaller audit firms may be less costly.

Before You Go On

1.6.1 A financial statement must be relevant and reliable. What do these terms mean in this context?

1.6.2 What three characteristics should an auditor have when conducting an audit?

1.6.3 What are non-audit services?

1.7 The Role of Regulators and Regulations

LEARNING OBJECTIVE 7

Identify the different regulators, legislation, and regulations surrounding the assurance process.

In this section, we discuss the regulators and regulations that have an impact on the audit process.

1.7.1 Regulators, Standard Setters, and Other Bodies

The accounting profession in Canada is primarily self-regulated; however, it does rely on legislation to some extent. Currently, a number of organizations have an impact on the auditing profession, either directly or indirectly. They include the Auditing and Assurance Standards Board (AASB), the Canadian Securities Administrators (CSA) and the various provincial securities commissions, the Canadian Public Accountability Board (CPAB), and the Chartered Professional Accountants of Canada or CPA Canada (which integrated the former Canadian Institute of Chartered Accountants, Certified General Accountants Association of Canada, and, Society of Management Accountants of Canada).

Auditing and Assurance Standards Board (AASB)

The purpose of the Canadian AASB is to serve the public interest by setting high-quality auditing and assurance standards.[1] To accomplish this, the AASB adopted the International Standards on Auditing (ISAs), which are issued by the International Auditing and Assurance Standards Board (IAASB). The ISAs have been redrafted by the IAASB and placed in a "clarity" format to improve the consistency of application worldwide. The Canadian version of the ISAs is now referred to as the Canadian Auditing Standards (CASs). In addition to issuing the CASs, the AASB is responsible for issuing the Canadian Standards for Assurance Engagements (CSAEs), as well as the Canadian review engagement and compilation engagement standards. Some CSAEs cover assurance related to non-financial issues, as discussed in Professional Environment 1.2.

1.2 Professional Environment — Assurance Engagements on Carbon Emissions Information

Many companies now present CSR information in their annual reports or in separate corporate sustainability reports. In some cases, the reports include information about carbon emissions. However, the reporting and assurance of these reports is voluntary and largely unregulated, raising concerns about the quality of the information. One of these concerns is that the information being provided in CSR reports is not sufficiently quantitative, particularly with respect to carbon emissions data.

To address some of these concerns, Canada issued a Canadian Standard on Assurance Engagements, CSAE 3410 *Assurance Engagements on Greenhouse Gas Statements*, based on the international assurance standard, ISAE 3410 *Assurance Engagements of Greenhouse Gas Statements.* The standard stipulates an auditor's responsibilities in identifying, assessing, and responding to the risks of material misstatement when engaged to report on greenhouse gas (GHG) statements. It sets out requirements and guidance on the work to be performed and the reporting responsibilities for both reasonable and limited assurance engagements. Unlike in financial statement audits, the standard does not mandate certain types of procedures (such as inquiry and analytical procedures) as the primary means of obtaining evidence. This requirement recognizes that GHG information is not capable of being subject to the rigour of a double-entry bookkeeping system and is susceptible to different risks than historical financial information. In addition, the nature of assurance engagements on GHG statements can vary greatly. Auditing carbon emissions information creates new challenges for auditors and has the potential to change what it means to be an "auditor" in the twenty-first century.

Q: What concerns should an auditor have when approached to audit information other than financial information?

Canadian Securities Administrators (CSA)

In Canada, securities regulation falls under provincial jurisdiction. However, securities regulators from across the provinces and territories have joined together to form the CSA. The CSA is a voluntary umbrella organization with the objective of improving, coordinating, and harmonizing regulation of the Canadian capital markets.[2] Part of its mandate is to regulate listed entity disclosure requirements. As such, it requires the annual filing of audited financial statements in accordance with Canadian GAAP, which in Canada is now IFRS for listed entities. It also requires that the CEOs and CFOs of reporting issuers certify that the annual financial statements are fairly presented. In addition, the CSA issues staff notices to provide reporting issuers with guidance on various issues, such as environmental disclosures.

Canadian Public Accountability Board (CPAB)

CPAB was incorporated in 2003 under the Canada Corporations Act. It was formed by the CSA, Canadian Institute of Chartered Accountants, and Office of the Superintendent of Financial Institutions with the objective of promoting high-quality audits. The CSA requires that auditors of reporting issuers register and be members in good standing with CPAB. To be a member in good standing, a firm must pass a CPAB inspection, which includes a review of the firm's compliance with its quality control policies and a sample of engagement files for compliance with professional standards.

Toronto Stock Exchange (TSX)

The TSX is the largest stock exchange in Canada. It aims to help listed companies raise funds, provide opportunities for investors to build wealth, and enable buyers and sellers to transact with confidence. In order to remain listed on the TSX, a company must meet the requirements of the Securities Act of Ontario, the relevant provincial securities acts, and the CSA. Companies listed on the TSX must file all required documents through the SEDAR (System for Electronic Document Analysis and Retrieval) electronic filing system.

Chartered Professional Accountants of Canada (CPA Canada)

CPA Canada is the national body of the accounting profession in Canada, with members working in public practice, industry, academia, and government.

Becoming a CPA requires completion of an extensive training program, which combines study and mentored work experience with a focus on technical competence and skills. The successful completion of a rigorous professional exam is required before a CPA designation is conferred.

1.7.2 Legislation

In Canada, a company can be incorporated under either federal or provincial jurisdiction. If a company is incorporated federally, then it must follow the statutes of the Canada Business Corporations Act (CBCA) (excluding banks and insurance and trust companies). The CBCA calls for audited financial statements for federally incorporated companies that are listed on Canadian stock exchanges. The CBCA statutes also require that these financial statements be in accordance with Canadian generally accepted accounting principles, and audits must be conducted in accordance with Canadian generally accepted auditing standards as defined by the CPA Canada Handbook. In addition, the CBCA regulates auditor independence, auditor appointment, and auditor access to information and company records.

1.7.3 Regulation

Auditing standards are issued by the Auditing and Assurance Standards Board (AASB) in Canada. The standards provide minimum requirements and guidance for auditing and assurance engagements. These standards, comprising the Canadian Auditing Standards (CASs), constitute Canadian generally accepted auditing standards (GAAS), and apply to all audits of historical financial information where audit assurance is provided. They are based on the International Standards for Auditing (ISAs); however, they may be modified to comply with Canadian legal or regulatory environments. As noted earlier in the chapter, review engagements of financial statements and other historical financial information are guided by Other Canadian Standards—Review Engagements. The Other Canadian Standards—Assurance Engagements other than Audits or Reviews of Financial Statements and Other Historical Financial Information (CSAEs) are the engagement standards that apply to other assurance engagements not related to historical financial information, such as compliance engagements. These standards provide general and specific guidance for assurance engagements other than audits and reviews of historical financial information, such as the effectiveness of internal controls, where either reasonable or limited assurance is provided. Assurance engagements that comply with the CSAEs are also in compliance with Canadian GAAS. The Canadian Standard on Quality Control (CSQC 1) applies to audits and reviews of financial statements and other assurance engagements. This standard specifies quality control requirements for firms providing audit, review, and assurance services. Other Canadian Standards—Related Services provide guidance on related services, including compilation engagements.[3] **Figure 1.6** provides an overview of the CPA Canada Handbook – Assurance.

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Ernie explains that, in general, the regulators and regulations that apply to companies are not relevant to McLellan's Shoes. However, any auditor Ron engages would be also performing company audits and would be a member of a professional accounting body. The auditor would apply the auditing and accounting standards that are relevant to an audit engagement when auditing a small business. The auditor would apply strict professional standards to Ron's audit and should perform the audit to a reasonable standard.

Before You Go On

1.7.1 What is CPA Canada?

1.7.2 What is the AASB and what is its role?

1.7.3 What are the main functions of the CSA?

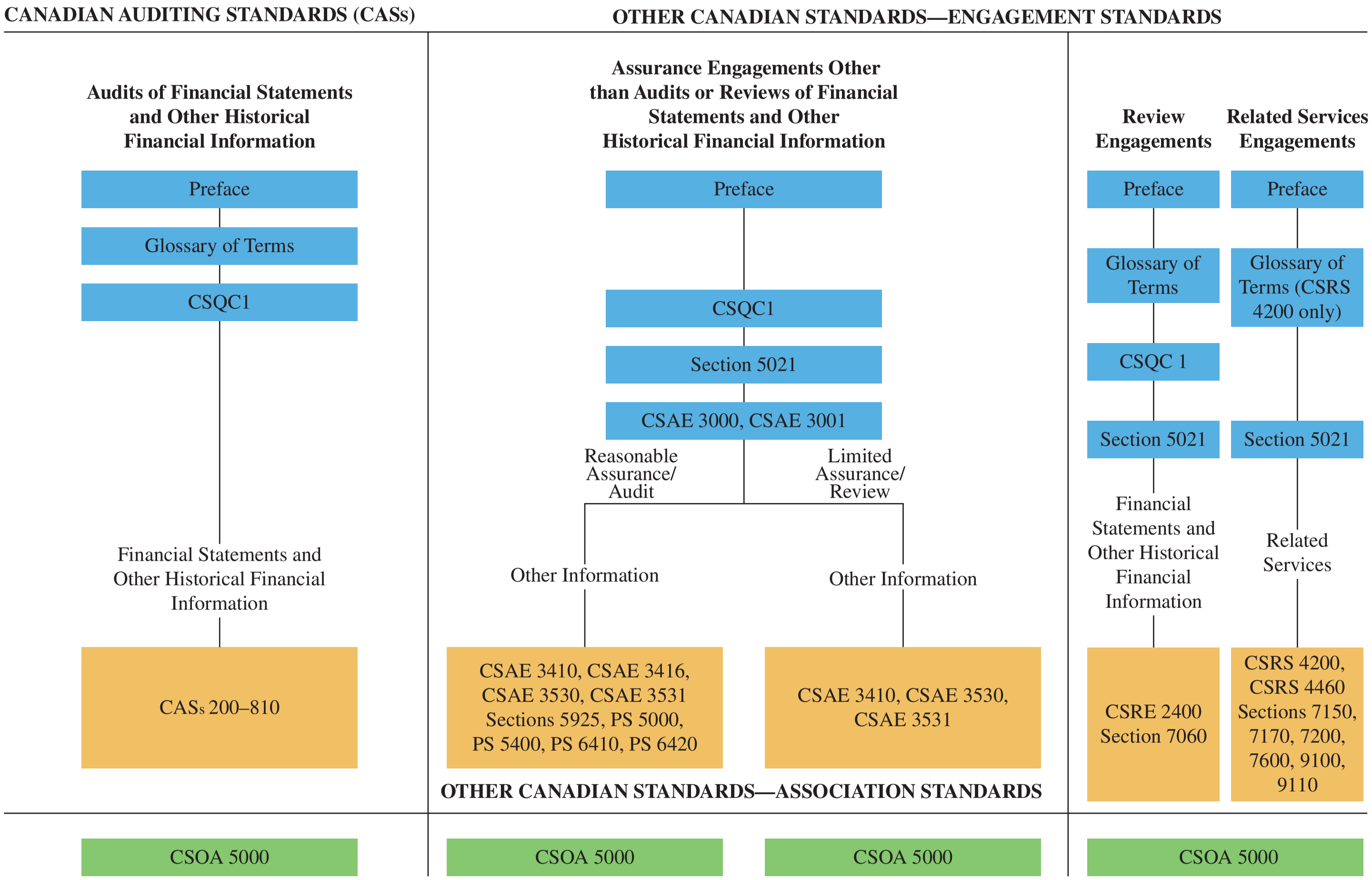

FIGURE 1.6 **Overview of the Assurance Handbook, Appendix 4**

Source: Chartered Professional Accountants of Canada. "Overview of the Assurance Handbook." *CPA Canada Handbook – Assurance*, Part I, *Preface to the CPA Canada Handbook – Assurance*, Copyright © 2020, Chartered Professional Accountants of Canada. References to the CPA Canada Handbook are reprinted with permission from the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the author and/or publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

1.8 The Audit Expectation Gap

LEARNING OBJECTIVE 8

Describe the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial statement users. The gap occurs when user beliefs do not align with what an auditor has actually done. In particular, the gap is caused by unrealistic user expectations, such as:

- The auditor is providing complete assurance.
- The auditor is guaranteeing the future viability of the entity.
- An unqualified (clean) audit opinion is an indicator of complete accuracy.
- The auditor will definitely find any fraud.
- The auditor has checked all transactions.

The reality is that:

- An auditor provides reasonable assurance.
- The audit does not guarantee the future viability of the entity.
- An unqualified opinion indicates that the auditor believes that there are no material (significant) misstatements (errors or fraud) in the financial statements.
- The auditor will assess the risk of fraud and conduct tests to try to uncover any fraud, but there is no guarantee that they will find fraud, should it have occurred.
- The auditor tests a sample of transactions.

The audit expectation gap is represented in **figure 1.7**.

The audit expectation gap can be reduced by:

- auditors performing their duties appropriately, complying with auditing standards, and meeting the minimum standards of performance that should be expected of all auditors
- peer reviews of audits to ensure that auditing standards have been applied correctly
- auditing standards being reviewed and updated on a regular basis to enhance the work being done by auditors
- education of the public

Auditor performance	⟵ Expectation gap ⟶	Financial statement reader's expectations
Auditor performance impacted by: • Auditing standards • Ethical standards • Regulations • Legislation • Firm policy and procedures		Financial statement reader's expectations impacted by: • Audit firm's reputation • Audit firm's independence • Reader's knowledge of auditing • Economic conditions

FIGURE 1.7 **Audit expectation gap**

- enhanced reporting to explain what processes have been followed in arriving at an audit (reasonable assurance) or a review (limited assurance) opinion (significant improvements have been introduced by standard setters improving assurance reporting)
- assurance providers reporting accurately the level of assurance being provided (reasonable, limited, or none)

As described in this chapter, financial statement users rely on audited financial statements to make a variety of decisions. They use the statements to assess the performance of the company, the appropriateness of the remuneration paid to management, the adequacy of dividends declared, and the likely future viability of the company. Following the corporate collapses of the early 2000s (for example, Enron and WorldCom), user confidence in auditors and audited financial statements hit a low. In Canada and the United States, increased regulation was imposed on the auditing profession. The United States passed the Sarbanes-Oxley Act (SOX) and created the Public Company Accounting Oversight Board (PCAOB). These organizations focus on corporate governance and accounting and audit regulations. In Canada, increased regulation resulted in the creation of the Canadian Public Accountability Board (CPAB). The standard setters have also responded to public demands that auditors pay greater attention to the risk that a material fraud may occur. CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires that auditors consider the risk of material fraud in every audit. The auditor must assess the risk that a material fraud could occur and gauge the adequacy of the client's system of internal control to prevent or detect such a fraud. If the auditor is not satisfied with the client's system of internal control, its audit procedures must be designed to aid in the detection of any material suspected frauds.

While highlighting the importance of considering fraud in every audit, standard setters also point out that the primary responsibility for fraud prevention and detection remains with management and those charged with governance (CAS 240, para. 4). They also emphasize the inherent limitation of any audit, making fraud detection less than certain (CAS 240, para. 5).

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Ron believes that Chip Masters would know what an audit can provide and what it cannot, because Chip is an experienced vice-president of a large international company. He would deal with auditors on a regular basis. Ron thanks Ernie for his time. Ernie has helped him to understand that preparing more detailed financial statements and engaging an auditor to perform a financial statement audit would not be as bad as he first thought. Ron now understands why Ernie thinks audits are valuable, and not just another business expense. If Chip thinks that Ron's financial statements are more credible with an audit, then it is likely that he will be prepared to pay a higher price for Ron's business.

Before You Go On

1.8.1 Define the audit expectation gap.

1.8.2 What causes the audit expectation gap?

1.8.3 What can be done to reduce the audit expectation gap?

Summary

1 Define an assurance engagement.

An assurance engagement involves an assurance provider arriving at an opinion about some information being provided by their client to a third party. A financial statement audit is one type of assurance engagement. This engagement involves an auditor arriving at an opinion about the fair presentation of the financial statements. The audit report is addressed to the shareholders of the company being audited, but other users may read the financial statements. Learning about auditing and assurance requires an understanding of auditing and assurance terminology, including terms such as audit risk, materiality, internal controls, listed entity, and assertions.

2 Explain why there is a demand for audit and assurance services.

Financial statement users include investors (shareholders), suppliers, customers, lenders, employees, governments, and the general public. These groups of users demand audited financial statements because of their remoteness from the entity, accounting complexity, their incentives competing with those of the entity's managers, and their need for reliable information on which to base decisions. The theories used to describe the demand for audit and assurance services are agency theory, the information hypothesis, and the insurance hypothesis.

3 Differentiate between types of assurance services.

Assurance services include financial statement audits, compliance audits, performance audits, comprehensive audits, internal audits, and assurance on corporate social responsibility (CSR) disclosures.

4 Explain the different levels of assurance.

The different levels of assurance include reasonable assurance, which is the highest level of assurance, limited assurance, and no assurance. Reasonable assurance is provided in an audit of a company's financial statements. Limited assurance is provided in a review of a company's financial statements. No assurance is provided in a compilation engagement.

5 Outline different audit opinions.

An auditor can issue an unmodified opinion, also known as a clean report, or an unmodified opinion with an emphasis of matter paragraph. Alternatively, a modified opinion may be issued as a qualified, an adverse, or a disclaimer of opinion.

6 Differentiate between the roles of the preparer and the auditor, and discuss the different firms that provide assurance services.

It is the responsibility of a company's governing body to ensure that its financial statements are relevant, reliable, comparable, understandable, and true and fair. It is the responsibility of the auditor to form an opinion on the fair presentation of the financial statements. In doing so, the auditor must maintain professional scepticism and utilize professional judgement and due care.

The firms that provide assurance services include the Big-4 international firms, the national firms (with international links), local and regional firms, and consulting firms that tend to specialize in assurance of CSR and environmental disclosures.

7 Identify the different regulators, legislation, and regulations surrounding the assurance process.

Regulators of the assurance process include the Auditing and Assurance Standards Board (AASB), Canadian Securities Administrators (CSA) and the various provincial securities commissions, and the Canadian Public Accountability Board (CPAB). Relevant legislation includes the Canada Business Corporations Act (CBCA). CPA Canada is the professional accounting body in Canada, responsible for the Chartered Professional Accountant (CPA) designation.

8 Describe the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial statement or other users. The gap occurs when user beliefs do not align with what an auditor has actually done.

Key Terms

Adverse opinion 1-21
Applicable financial reporting framework 1-5
Assertions 1-5
Assurance engagement 1-4
Audit evidence 1-5
Audit file 1-5
Audit plan 1-5
Audit risk 1-5
Compilation engagement 1-17
Compilation Engagement Report 1-19
Compliance audit 1-12
Comprehensive audit 1-13
Consulting firms 1-13
Corporate social responsibility (CSR) 1-13
Disclaimer of opinion 1-21
Emphasis of matter 1-20
Fair presentation 1-10
Financial statement audit 1-10
Financial statements 1-5
Independent auditor's report 1-5
Information risk 1-7
Internal audit 1-13
Internal control 1-5
Limited assurance 1-17
Listed entity 1-10
Material 1-5
No assurance 1-17
Performance audit 1-12
Qualified opinion 1-21
Reasonable assurance 1-14
Review engagement 1-17
Sufficient and appropriate evidence 1-5
Those charged with governance 1-13
Unmodified opinion 1-6, 1-20
Working papers 1-6

Self-Test Questions

Answers can be found in *WileyPLUS*.

1.1 The parties relevant to an assurance engagement are:

a. assurance practitioner, users, responsible party.

b. assurance practitioner, responsible party, subject matter.

c. assurance practitioner, users, criteria.

d. assurance practitioner, subject matter, criteria.

1.2 Agency theory explains that audits are demanded because conflicts can arise between:

a. managers and owners.

b. managers and agents.

c. owners and principals.

d. auditors and owners.

1.3 The insurance hypothesis means:

a. managers must take insurance.

b. owners must take insurance.

c. an audit acts as insurance.

d. none of the above.

1.4 Performance audits are useful because:

a. they include an internal audit.

b. they are concerned with the economy, efficiency, and effectiveness of an organization's activities.

c. they involve gathering evidence to ascertain whether the entity under review has followed the rules, policies, procedures, laws, or regulations with which it must conform.

d. none of the above.

1.5 The function of internal audit is determined by:

a. the external auditor.

b. the Institute of Internal Auditors.

c. those charged with governance and management.

d. the government.

1.6 Reasonable assurance means:

a. the auditor disclaims responsibility for the audit opinion.

b. an adverse audit report.

c. the auditor has done adequate work to report whether or not anything came to their attention that would lead them to believe that the information being assured is not fairly presented.

d. the auditor has gathered sufficient and appropriate evidence to form a positive expression of opinion regarding the financial statements.

1.7 An auditor disclaims responsibility when:

a. the users cannot rely on the financial statements.

b. the audit opinion is unqualified and unmodified.

c. the auditor is unable to obtain sufficient evidence about a potentially material and pervasive matter.

d. the audit opinion is unqualified and the auditor includes a paragraph in the audit report to emphasize something important.

1.8 Those charged with governance have a responsibility to ensure that the information in financial statements is:

a. relevant and reliable.

b. comparable and understandable.

c. fairly presented.

d. all of the above.

1.9 The purpose of the Auditing and Assurance Standards Board is:

a. to set high-quality auditing and assurance standards.

b. to regulate capital markets.

c. to promote high-quality audits.

d. to set the educational requirements for the Chartered Professional Accountant designation.

1.10 The audit expectation gap occurs when:

a. auditors perform their duties appropriately and satisfy users' demands.

b. user beliefs do not align with what an auditor has actually done.

c. peer reviews of audits ensure that auditing standards have been applied correctly and the standards are at the level that satisfies users' demands.

d. the public is well educated about auditing.

Review Questions

1.1 What does "assurance" mean in the financial reporting context? What qualities must an "assurer" have in order for you to feel that their statement has high credibility?

1.2 Compare the financial statement users and their needs for a large listed public company with those of a sports team (for example, a football team).

1.3 What are the limitations of an audit?

1.4 Who would request a performance audit? Why?

1.5 Are internal auditors independent? Which internal auditor would be more independent: an internal auditor who reports to the chief financial officer (CFO) of the company, or an internal auditor who reports to the audit committee?

1.6 What does reasonable assurance mean?

1.7 What is an emphasis of matter paragraph? When do you think an auditor would use it?

1.8 What are the auditor's responsibilities?

1.9 Describe the audit expectation gap. What causes the gap?

1.10 Explain the system of reviewing the quality of audits performed by listed company auditors.

Professional Application Questions

Basic Moderate Challenging

1.1 Assurance engagement **Basic** **LO 1**

Bravo Bags is a luggage retailer that operates out of a shopping mall. As required by the landlord, Bravo Bags has hired Brad Pope, CPA, to provide a report to the landlord as to whether Bravo Bags has met the requirements of its lease agreement in terms of reporting the store's sales information.

Required

Discuss how this engagement meets the requirements of an assurance engagement.

1.2 Demand for assurance **Basic** **LO 2**

In 2002 the audit firm Arthur Andersen collapsed following charges brought against it in the United States relating to the failure of its client, Enron. Some other clients announced that they would be dismissing Arthur Andersen as their auditor before it was clear that Arthur Andersen would not continue.

Required

Using the theories outlined in this chapter on the demand for audits, give some reasons why these clients took this action.

1.3 Assurance providers **Basic** **LO 2, 6**

Most audit firms maintain a website that explains the services offered by the firm and provides resources to their clients and other interested parties. The services offered by most firms include both audit and non-audit services.

Required

a. Find the websites for (1) a Big-4 audit firm and (2) a national audit firm. Compare them on:

- **i.** the range of services provided
- **ii.** geographic coverage (that is, where their offices are located)
- **iii.** staff numbers and special skills offered
- **iv.** industries in which they claim specialization
- **v.** publications and other materials provided to their clients or the general public
- **vi.** marketing message

b. In times of economic recession, would you expect the demand for audits to increase or decrease? Would you expect clients to shift from large (Big-4) auditors to national auditors or from national auditors to Big-4 auditors? Why or why not?

Questions 1.4 and 1.5 are based on the following case.

Securimax Limited has been an audit client of KFP Partners for the past 15 years. Securimax is based in Waterloo, Ontario, where it manufactures high-tech armour-plated personnel carriers. Securimax often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialized, and Securimax does business only with nations that have a recognized, democratically elected government. Securimax maintains a highly secure environment, given the sensitive and confidential nature of its vehicle designs and its clients.

Clarke Field has been the engagement partner on the Securimax audit for the past five years.

The board of Securimax is considering changing from an audit engagement to a review engagement and has approached Clarke to discuss the implications of this change. Clarke suggests that KFP could perform the review engagement.

Securimax's financial year end is December 31.

1.4 Types of assurance engagements **Moderate** **LO 1**

Required

What is a review engagement? Why would a review be appropriate for a set of financial statements for Securimax?

1.5 Audit expectation gap **Moderate** **LO 8**

Required

Discuss the expectation gap that could exist for the audit of Securimax. Consider the existence of any special interests of the users of Securimax's financial statements.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, May 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

1.6 Performance and compliance audits **Challenging** **LO 3**

Fellowes and Associates Chartered Professional Accountants is a successful mid-tier accounting firm with a large range of clients across Canada. In April 2023, Fellowes and Associates gained a new client, Health Care Holdings Group (HCHG), which owns 100 percent of the following entities:

- Shady Oaks Centre, a private treatment centre
- Gardens Nursing Home Ltd., a private nursing home
- Total Laser Care Limited (TLCL), a private clinic that specializes in the laser treatment of skin defects

The year end for all HCHG entities is June 30.

TLCL owns two relatively old laser machines used in therapy. Recently, staff using these machines have raised concerns that they have adverse impacts on patients.

TLCL wishes to purchase a new, more technologically advanced machine. The Ministry of Health has agreed to fund half the purchase price on the basis that TLCL follows the ministry's "Guidelines for Procurement of Medical Equipment" when purchasing the machine. The Ministry of Health has engaged the provincial Auditor General to check that TLCL has met the terms of the funding agreement.

Required

Discuss the relevant criteria against which the Auditor General will check TLCL's compliance with the terms of the funding agreement.

Source: Adapted from the Institute of Chartered Accountants Australia's CA Program's *Audit and Assurance Exam*, December 2008. Provided courtesy of Chartered Accountants Australia and New Zealand.

1.7 Types of engagements and reports **Moderate** **LO 1, 4**

Building-On-Line (BOL) is an online retailer that has been selling high-end home building products to construction contractors for several years. It was started by Jack Tosic, once a contractor himself, who wanted to find a way to supply home building products to the construction market at lower costs. Jack started BOL and began selling home building products over the Internet. Because it did not have any retail locations, BOL was able to charge its customers lower prices for higher-end products than its competitors.

In recent years, Jack has tried to diversify and expand the business by taking advantage of the technology structure it has had in place. BOL expanded into the consumer retail market with the goal of becoming a home remodelling marketplace, offering a wider variety of products to a wider range of customers. In order to enter this market, the company had to further lower its prices, squeezing already low margins. This resulted in declining profitability and, at times, cash flow issues.

To help with its cash flow problems, BOL has recently asked the bank for a loan. The loan would be used to support the day-to-day operations of the business and to allow BOL to continue to invest in its IT infrastructure. After speaking with the bank manager, Jack has learned the bank appears to have some reservations in lending BOL any money. The bank is aware of BOL's declining profitability and in order to approve the loan, the bank will require a set of financial statements from a CPA. The bank has not indicated the type of engagement it might require. While Jack has seen financial statements before, the bank has suggested it may require some type of report to be attached to the financial statements. Jack wonders what type of reports might be available and what they might say.

Required

a. Compare and contrast the three common types of engagements a CPA may perform in this case.

b. Explain to Jack the various report options and what is included in each report.

c. What type of report do you think would be most appropriate in this case?

d. If the bank requires an audit, discuss how this meets the definition of an assurance engagement.

[1]**1.8** Types of assurance engagements **Moderate** **LO 4**

DDD Motor Sales Inc. is privately owned. It wants to expand its business and has approached its bank for a loan. DDD wants the funds to purchase additional inventory and will be able to provide excellent security to the bank. The bank has agreed that, since DDD can provide good security for the loan, an external audit will not be required. The bank manager has insisted that DDD hire a firm of professional accountants to examine DDD's financial records and provide some level of assurance.

Required

a. What type of engagement is required? Explain your answer.

b. Assume that DDD contracts with Cicak & Jones, CPAs, to perform the required services. What is the title of the report or communication that Cicak & Jones will prepare?

c. Identify the types of procedures Cicak & Jones will be required to conduct.

1.9 Audit opinions **Moderate** **LO 1, 5**

Required

What type of audit report would be appropriate in each of the following scenarios? Explain.

a. There is uncertainty relating to a pending exceptional litigation matter that is adequately disclosed in the notes.

b. The client's records are inadequate and the auditor is unable to obtain sufficient appropriate evidence.

c. There is a GAAP departure concerning a highly material item.

d. The client will not allow the auditor to contact the client's legal counsel.

e. The client's accounting records have been destroyed.

f. There is a material misstatement in the client's inventory account. The misstatement is deemed to be material but not pervasive to the financial statements.

g. Inventories are misstated. The misstatement is deemed to be material and pervasive to the financial statements.

[2]**1.10** Types of audit opinions **Moderate** **LO 5**

Situation 1

The accounting firm of Aschari and Di Tomaso was engaged to perform an audit of the financial statements of Pammenter Inc. During the audit, Pammenter's senior managers refused to give the auditors the information they needed to confirm any of the accounts receivable. As a result, Aschari and Di Tomaso were not able to confirm the accounts receivable balance. However, they did not encounter any other problems during the audit.

Situation 2

The accounting firm of Jovanovic and St. Pierre has discovered, during its audit of Robson Chemicals Inc., that the client is being sued for $3 million. Allegedly, one of its products exploded and severely injured a customer. In the firm's discussion with Robson's lawyers, Jovanovic and St. Pierre ascertained that it is very likely that Robson will indeed have to pay this entire amount when the lawsuit is resolved. To provide for this, Robson's chief financial officer has included information relating to the lawsuit in the notes to its financial statements, but did not otherwise reflect it in its financial statements.

Required

For each of the independent situations presented above:

a. state what type of audit opinion should be issued

b. explain your reasoning

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[2] Adapted with permission of the Chartered Professional Accountants of Canada, Toronto, Canada. Any changes to the original material are the sole responsibility of the publisher and have not been reviewed or endorsed by the Chartered Professional Accountants of Canada.

1.11 Different audit opinions **Basic** **LO 5, 6**

C. D. Hodgson and Associates Chartered Professional Accountants audited the financial statements of Tallender Company, a sporting goods retailer. As with all of his firm's audits, Carl Hodgson conducted the Tallender audit in accordance with generally accepted auditing standards, and, therefore, wrote a standard unqualified opinion in his audit report.

On Saturday afternoon, just as he was about to write the audit opinion relating to this audit, Carl received an emergency telephone call from his wife regarding an accident involving their only child. He had to leave the office immediately and was not sure when he would be able to return. Since the only other person in the office at the time was a junior accountant, Khaled Nersesian, who had also worked on the audit, Carl handed him the completed financial statements and working papers and asked him to make sure it was appropriate to issue an unqualified opinion.

Required

What should Khaled Nersesian take into consideration in deciding whether an unqualified opinion is appropriate for Tallender Company?

1.12 The audit expectation gap **Moderate** **LO 1, 2, 8**

Certek Technologies Inc. is a biotechnology company whose shares traded on a major Canadian stock exchange. Over the 22 months following its initial public offering in May 2009, Certek's share price rose an astounding 1,350 percent. In mid-March 2011, Certek's share price began to decline. Then, in April 2011, the share price plummeted when it was announced that Certek had stopped all research activities on its major projects due to unsatisfactory scientific results. You, a CPA, are sitting with some friends who make the following comments:

Ruby: I lost a bundle on the Certek shares. The price went up with every press release. It seemed like the company was going to solve every medical problem in the world. I thought the auditors had a responsibility to investors and the capital markets for information released to the public.

Omid: I don't understand how audited financial statements are the least bit useful. Certek was investing huge amounts of money in researching new pharmaceutical products, yet the financial statements provided no information on whether its research would develop into viable products. Couldn't the auditors take some responsibility for evaluating the research that companies are doing?

Required

a. What is the auditor's responsibility for information released to the public?

b. Discuss Omid's comment with reference to the expectation gap.

c. What can auditors do to reduce the expectation gap?

Source: Adapted from the Uniform Final Exam (UFE), CPA Canada, Paper 2, 2000.

1.13 Audit reports **Basic** **LO 3, 4, 5, 6, 8**

A sample audit report is provided in figure 1.3 in this chapter. A sample review engagement report is provided in figure 1.4.

Required

a. What is the auditor's responsibility as determined in the audit report?

b. Find the lines in the audit report that express the auditor's opinion. Is it an unqualified or modified audit opinion?

c. Find the lines in the review report that express the auditor's conclusion. Is it an audit opinion? Is it a positive or negative statement?

d. Make a list of the other differences between the audit report and the review report.

1.14 Being an auditor **Basic** **LO 4, 5, 8**

You have recently graduated from university and have started work with an audit firm. You meet an old school friend, Kim, for dinner—you haven't seen each other for several years. Kim is surprised that you are now working as an auditor, because your childhood dream was to be a ballet dancer. Unfortunately, your knees were damaged in a fall and you can no longer dance. The conversation turns to your work and Kim wants to know how you do your job. Kim cannot understand why an audit is not a guarantee that the company will succeed. Kim also thinks that company managers will lie to you in order to protect themselves, and as an auditor, you would have to assume that you cannot believe anything a company manager says to you.

Required

- **a.** Write a letter to Kim explaining the concept of reasonable assurance, and how reasonable assurance is determined. Explain why an auditor cannot offer absolute assurance.
- **b.** Explain in the letter to Kim the concept of "professional scepticism" and how it is not the same as assuming that managers are always trying to deceive auditors.

Case Study—Cloud 9

Ron McLellan established his business, McLellan's Shoes, in 2000. Ron keeps records and his wife helps him prepare basic accounting records. As McLellan's Shoes has no outside owners, Ron has never seen the need to have his books audited.

When Chip Masters from Cloud 9 Inc. expressed an interest in buying McLellan's Shoes in 2012, Ron was asked to provide audited financial statements. Ron discussed his concerns about having an audit with his friend Ernie Black. Ernie is concerned that Ron may forget their conversations and has asked you to prepare a summary of the issues listed below for Ron.

Required

- **a.** What are the main differences between a financial statement audit, a review engagement, and a compilation engagement?
- **b.** What is the difference between reasonable assurance and limited assurance?
- **c.** Why would Chip ask Ron to have the financial statements for McLellan's Shoes audited rather than reviewed?
- **d.** What factors should Ron consider when selecting an accounting firm to complete the McLellan's Shoes audit?

Research Question 1.1

Chong and Pflugrath conducted a study of different audit report formats and their effects on the audit expectation gap. They investigated whether report length (long or short), the location of the audit opinion (at the start or the end), and plain language (instead of technical language) affect shareholders' and auditors' perceptions of the audit. They surveyed a sample of shareholders and auditors and concluded that the responses indicate that different report formats have only minor effects on the audit expectation gap.[4]

Required

- **a.** In your view, what should be contained in an audit report that conveys realistic explanations of the auditor's role and the assurance provided by the audit report?
- **b.** Do you believe that auditors are correct in dismissing users' expectations as "unrealistic"? Should auditors be trying to meet these expectations by rethinking their role and changing their approach?

Research Question 1.2

Required

Access the CPA Canada Handbook and locate the following:

- **a.** What number is the CAS for audit documentation?
- **b.** How many sections are there to each CAS?
- **c.** What is the name of CSAE 3000?
- **d.** What numbers relate to review engagements?
- **e.** Where specifically can the required wording for the Compilation Engagement Report be found?

Notes

1. Financial Reporting & Assurance Standards Canada, "Auditing and Assurance Standards Board." Accessed June 2, 2014. www.frascanada.ca/auditing-and-assurance-standards-board/.

2. Canadian Securities Administrators, "Who We Are." Accessed June 2011. www.securitiesadministrators.ca.

3. Ethical standards are also important regulations concerning auditors. These are discussed in detail in chapter 2 of this book.

4. K. M. Chong and G. Pflugrath, "Do Different Audit Report Formats Affect Shareholders' and Auditors' Perceptions?" *International Journal of Auditing* 12, 2008, pp. 221–41.