Audit and Assurance Primer

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Table of Contents

PRIMER

INTRODUCTION

The Audit and Assurance Primer provides the foundation for understanding audit and assurance. The Primer will cover basic audit concepts such as audit standards, engagement procedures, different types of risk, testing, and audit reports.

PART 1: BASIC CONCEPTS OF ASSURANCE

This part of the Primer begins with a discussion of the basic concepts of an assurance engagement. It also introduces the audit opinion, the audit report, and the different types of assurance engagements that an auditor can provide. This is followed by a discussion of the common misconceptions that the public has regarding the auditor's role. The Primer then explains auditing standards and regulations, and discusses the rules of professional conduct, ethical standards, and legal considerations for auditors.

Basic concepts of assurance

Assurance engagements are contracts in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users, other than the responsible party, about the outcome of the evaluation or measurement of a subject matter against criteria.

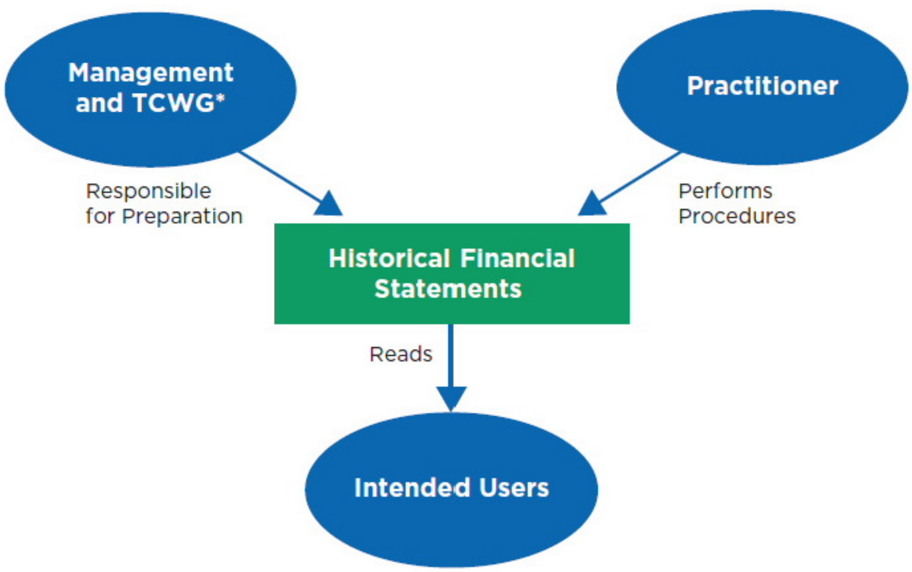
Many of the same considerations and stages apply to any assurance engagement. The most common assurance engagement is the audit of financial statements.

Financial statement audit

An external financial statement audit is one example of an assurance engagement. Per Section 200, paragraph 3, of the *CPA Canada Handbook – Assurance*, the purpose of an audit is "*to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial statements are presented fairly, in all material respects, or give a true and fair view in accordance with the framework. An audit conducted in accordance with CASs and relevant ethical requirements enables the auditor to form that opinion.*" Canadian Auditing Standards (CASs) dictate the work the auditor should undertake to express this opinion, regardless of the applicable financial reporting framework. These standards will be discussed in more detail in Topic 1.2.

Parties in a financial statement audit engagement

There are three main parties in a financial statement audit engagement as shown in the following diagram:



*TCWG = Those charged with governance

Management and those charged with governance: Responsible for the **preparation and fair presentation** of the financial statements in accordance with the applicable financial reporting framework. Those charged with governance are typically the board of directors, and for public companies, this includes an audit committee.

Practitioner: As outlined in the *CPA Canada Handbook – Assurance*, CAS 200, paragraph 11, the overall objectives of the auditor are:

> *(a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error,*

thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and

(b) To report on the financial statements, and communicate as required by the CASs, in accordance with the auditor's findings.

Intended users: The users read the financial statements and the auditor's report and use them for their intended purpose (for example, a bank may use the statements to assess the financial health of the company before providing financing). An assurance engagement enhances the users' confidence about the financial statements.

The economic purpose of an audit

Companies are required to produce financial statements to reduce the information gap between the shareholders and management to a reasonable level. An external financial statement audit is an independent examination of a company's financial statements that results in an opinion on whether the financial statements give a fair view of the entity to the shareholders. The primary purpose of the audit is to add credibility to the financial statements.

The audit opinion

As discussed above, one of the key objectives of the auditor is to express an opinion on the fairness of the financial statements. As per CAS 200, paragraph 11:

> *In conducting an audit of financial statements, the overall objectives of the auditor are:*
>
> *(a) To obtain* ***reasonable assurance*** *about whether the financial statements as a whole are free from* ***material misstatement****, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with* ***an applicable financial reporting framework****; and*
>
> *(b) To report on the financial statements, and communicate as required by the CASs, in accordance with the auditor's findings.*

Behind this responsibility are **three fundamental concepts** that must be considered to understand the value of the audit opinion: (i) reasonable assurance, (ii) material misstatement, and (iii) applicable financial reporting framework.

Reasonable assurance

An opinion indicating that the financial statements give a fair view provides **reasonable assurance** that the financial statements are free from material misstatement. As per CAS 200, paragraph 13(m), reasonable assurance "*in the context of an audit of financial statements, [is] a high, but not absolute, level of assurance.*"

Therefore, a financial statement audit is not a guarantee that the financial statements are 100% correct. The auditor seeks to obtain sufficient appropriate evidence, to be able to provide a high level of assurance that the financial statements are free from material misstatements.

Material misstatement

Companies are required to prepare financial statements that present fairly, in all material respects, the company's financial performance and position. As per CAS 200, paragraph 13(i), a misstatement is defined as:

> *A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.*

The external auditor must then give their opinion on whether the financial statements are indeed presented fairly in all material respects.

An applicable financial reporting framework

As per CAS 200, paragraph 13(a), the auditor needs to check "*whether the financial reporting framework* (for example, ASPE, IFRS, or any other applicable reporting framework) *adopted by management is acceptable in view of the nature of the entity and the objective of the financial statements or that is required by law or regulation."*

The auditor's report

The auditor's opinion is expressed in a document called the Independent Auditor's Report. This report is addressed to the company's shareholders (for profit-oriented companies) or the board (for not-for-profit organizations) and is included in the annual report for listed companies, along with the audited financial statements.

Types of assurance engagements

While a financial statement audit is the most common type of assurance engagement, examples of non-financial statement assurance engagements include the following:

- environmental audits (including audits of greenhouse gas emissions)
- audits of internal controls
- taxation audits
- fraud investigations/forensic audits
- data audits

The expectations gap

The auditor's role is defined by standards. However, it is common for the general public to misunderstand the scope of an auditor's work. This difference between the understanding that the public has about the auditor's responsibilities and the actual defined responsibilities of the auditor is often referred to as the expectations gap. For example, a common misconception is that the auditor guarantees that the financial statements are 100% correct. In fact, the auditor expresses an opinion on the financial statements that provides reasonable assurance. Auditing standards permit the auditor to undertake an audit on a sample basis. Moreover, financial reporting and financial statement audit involve an individual's judgment. Therefore, there is always a risk that the auditor will not detect all material misstatements in the financial statements.

Other common misconceptions are as follows:

- The auditor is responsible for the internal controls of the company.
- The auditor is responsible for detecting all instances of fraud.
- The auditor prepares and produces the financial statements.
- The auditor is responsible for checking compliance with all laws and regulations.
- The auditor provides aid and advice to management.
- The auditor assesses the effectiveness and adequacy of the client's operations and management.

Auditing standards and regulations

The accounting profession and regulatory bodies go to great lengths to ensure the credibility of audit work. In Canada, the Auditing and Assurance Standards Board (AASB), an independent board of CPA Canada, has established CASs, which were adapted from the International Standards on Auditing developed by the International Auditing and Assurance Standards Board. CPA Canada publishes the audit and assurance standards developed by the AASB, which sets the auditing and assurance standards followed by public accountants in Canada (both private and public sector standards). CASs are found in the *CPA Canada Handbook – Assurance*.

For statutory audits (that is, financial statement audits required by law), the auditor must be registered with one of the registered supervisory bodies (such as a provincial CPA body). The rules of this body require that the audit be conducted in accordance with the auditing standards, guidance, and quality standards issued by the AASB.

Two organizations have been created to help with the accountability and oversight of financial reporting and auditing in Canada: the Canadian Public Accountability Board and the Auditing and Assurance Standards Oversight Council.

Rules of professional conduct, ethical standards, and legal considerations

Rules of professional conduct

The auditor provides a service to the shareholders. For that service to be of value, the auditor's work must be credible. Credibility is a fundamental concept of auditing and relates to whether users of financial statements will rely on an auditor's report. Credibility encompasses the following qualities: competence, independence, integrity, and ethics.

In Canada, in order to audit, an accountant must work as a registered public accountant, have an accounting designation, and meet provincial licensing requirements with respect to audit knowledge and training. All public accountants must follow the rules of professional conduct of their registered accounting body.

The Public Trust Committee oversees the ethical standards of the CPA profession in Canada and promotes national harmonization of the profession's self-regulatory policies and practices. To obtain a copy of the rules of professional conduct, visit the website of your CPA provincial or regional body.

The rules of professional conduct provide ethical standards based on five key principles:

- objectivity
- integrity and due care
- professional competence
- confidentiality
- professional behaviour

Ethical standards

There are many different ethics frameworks in use in Canada, but the following categories cover the basic principles and essential rules with which auditors are required to comply in any audit of financial statements:

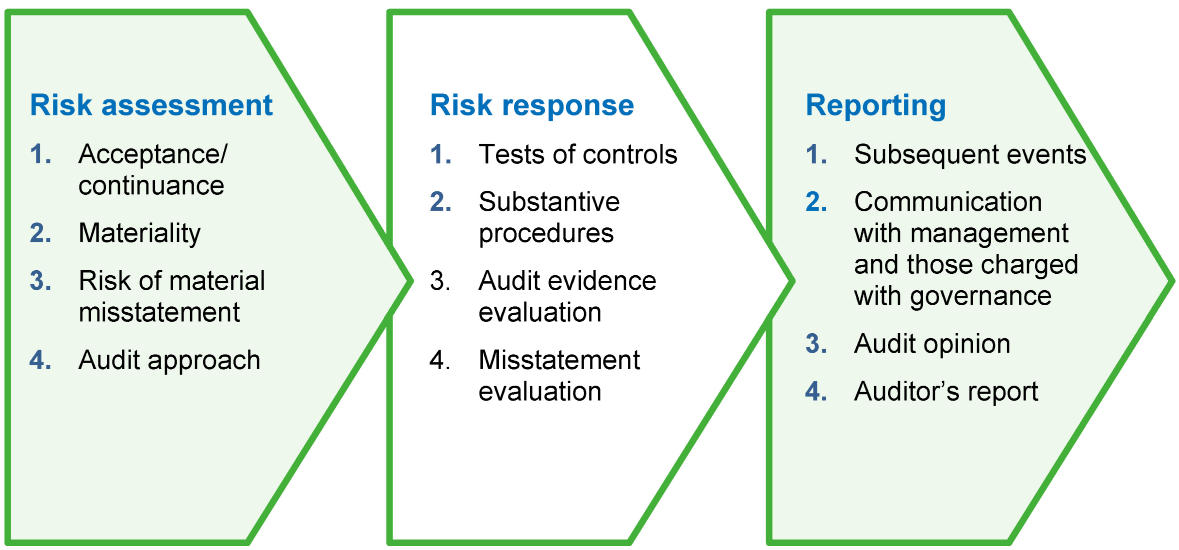
1. Integrity, objectivity, and independence
2. Financial, business, employment, and personal relationships
3. Long association with the audit engagement
4. Fees, remuneration and evaluation policies, litigation, gifts, and hospitality
5. Non-audit services provided to audit clients

Legal considerations

In addition to their statutory responsibilities, rules of professional conduct, and ethical standards, auditors must adhere to their responsibilities laid down in common law. A significant area of common law that affects the auditing profession is the case law that has defined the concept of auditor negligence, which means the auditor has not performed the audit with reasonable skill, care, and caution. Negligence refers to a situation where a party suffers loss or damage as a consequence of another party's carelessness.

The audit approach

The following is an overview of the actual process of conducting an audit.



As shown, there are three phases in the audit process. Although the diagram shows the process moving from assessment to response to reporting, it is important to remember that the auditor must continually reassess previous components as they learn more information that could be critical to the engagement.

Different activities occur within each phase of the audit process.

Practice questions

1. Multiple-choice questions:

    i. Which of the following statements is true?

    a) Any professional accountant who holds a CPA designation can be an auditor.
    b) Any professional accountant who holds a CPA designation and works in the private sector can be an auditor.
    c) Any professional accountant who holds a CPA designation and has proper audit knowledge and training can be an auditor.

d) Any professional accountant who holds a CPA designation, has proper audit knowledge and training, meets provincial licensing requirements, and works in the public sector can be an auditor.

Solution

Option d) is **correct**. To be an auditor in Canada, the professional accountant must meet all the criteria outlined above.

Option a) is incorrect. In Canada, additional criteria are required to be an auditor. Holding a CPA designation is not enough. The professional accountant must work in the public sector, have proper knowledge and training, and be licenced with their provincial professional organization.

Option b) is incorrect. The professional accountant must work in the public sector, not the private sector. They must also have proper knowledge and training, and be licenced with their provincial professional organization.

Option c) is incorrect. The professional accountant must work in the public sector and be licenced with their provincial professional organization in order to be an auditor.

ii. The differences between what the public believes and what the actual responsibilities of the auditor are, are referred to as the expectations gap. Which of the following is a common misconception of the responsibilities?

a) Management is responsible for the internal controls of the company.
b) Those charged with governance provide aid and advice to management.
c) Management prepares and produces the financial statements.
d) The auditor is responsible for detecting all instances of fraud and error.

Solution

Option d) is **correct**. It is a common misconception that the auditor is responsible for identifying all instances of fraud and error. While the auditor does perform fraud risk procedures and will test for errors, they are not providing an absolute guarantee on their opinion on the financial statements.

Option a) is incorrect. It is management's responsibility to monitor the internal controls of the company. The misconception is that it is the auditor's responsibility to implement the internal controls of the company.

Option b) is incorrect. It is the responsibility of those charged with governance (for example, board of directors) to provide advice and aid to management; the common misconception is that this is the responsibility of the auditors.

Option c) is incorrect. It is management's responsibility to prepare the financial statements. The misconception is that it is the auditor's responsibility to prepare them.

2. Sarah, a CPA, and her sister Mary have been presented an investment opportunity with their mutual friend Thomas. The investment requires $20,000 from each sister. Thomas has provided the sisters with audited financial statements. Mary says the following to Sarah: "I think this is a great opportunity, and we should accept Thomas's proposal especially since he has provided us with audited financial statements; the statements will be 100% accurate."

   Required:

   Discuss whether Mary's statement is correct. Use the CPA Way methodology in the analysis.

   Solution

   Mary's comment is not correct. According to the CPA Way, it is important to *assess the situation*; an audit is not a guarantee from the auditor that the financial statements are 100% correct. In *analyzing the major issues*, we know that the auditor is only expressing an opinion, with reasonable assurance, on the financial statements, that is, whether they have been fairly presented and are free from material misstatements. Further, an audit examines the financial statements on a sample basis, and the CPA applies professional judgment on estimates. Therefore, there is always a risk that the auditor will not detect all material misstatements. Sarah should *conclude and advise* her sister Mary that the audit is not an absolute guarantee but rather an assurance engagement that adds credibility to the financial statements by providing reasonable assurance that they have been fairly presented and are free from material misstatements.

PART 2: RISK ASSESSMENT PHASE

In Part 2 we discuss completing the first phase of the audit process — the risk assessment phase — in conducting a financial statement audit, starting with a discussion of the client acceptance and continuance procedures for prospective and recurring audit clients.

Client acceptance and continuance

Prior to accepting a new audit engagement, the audit firm must perform acceptance procedures to assess the risks to the firm that would arise from being associated with the new client (acceptance risks).

If the engagement is for an existing client, the audit firm performs continuance procedures to assess continuance risks. For existing clients, the audit firm should still complete a risk assessment annually to identify changes in circumstances that may impact the client's risk profile.

In evaluating acceptance and continuance risks, the audit firm will examine the following factors:

a) **Identify and assess the engagement risks** — The auditor must consider whether the firm has the competence, capabilities, and resources to undertake a new engagement from a prospective or recurring client. Policies and procedures for the acceptance and continuance of engagements must ensure that the firm:

- Is competent to perform the engagement and has the capabilities, including time and resources, to do so.
- Can comply with relevant ethical requirements that include integrity, objectivity, professional competence, confidentiality, and professional behaviour.
- Considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity.

b) **Establish the engagement preconditions** — The auditor should accept or continue an audit engagement only when the basis upon which it is to be performed has been agreed upon. It is important to establish preconditions to confirm there is an understanding between the auditor and the client's management (including those charged with governance) of the terms of the audit engagement.

c) **Obtain a signed engagement letter** — The engagement letter outlines the terms of the engagement and confirms the obligations of both the client and the practitioner. This reduces the risk of misunderstandings occurring during the engagement and provides evidence to protect the parties in the event of a dispute.

d) **Obtain evidence about opening balances** — The objective of the auditor with respect to opening balances is to obtain sufficient appropriate audit evidence about whether opening balances contain misstatements that materially affect the current period's financial statements, and whether appropriate accounting policies reflected in the opening balances have been consistently applied in the current period's financial statements.

e) **Communicate with the predecessor auditor** — The auditor is to communicate with the predecessor auditor, who may alert the prospective auditor to management integrity issues that occurred in the past. Another reason to communicate with the predecessor auditor is to ask whether there are any other reasons not to accept the engagement, such as fee disputes, disagreements with accounting policies, and identified or suspected non-compliance with laws and regulations.

Materiality

The overall objective of the auditor is to obtain reasonable assurance about whether the financial statements are free from material misstatement to enable the auditor to express an opinion on the financial statements. Materiality is the threshold above which missing or incorrect information in financial statements is considered to have an impact on the decision-making of users.

Audit materiality

CAS 320 *Materiality in Planning and Performing an Audit* defines materiality as follows:

- It influences the economic decisions of users.
- It is affected by the size or nature of a misstatement, or a combination of both.
- It is relevant to the common information needs of users as a group.

Therefore, items can be material by **value (quantitatively)** or **nature (qualitatively)**. Although a misstatement could be quantitatively small, the error could be considered qualitatively material due to its nature. For example, inaccuracies caused by management fraud are likely to matter to users, regardless of the size of the misstatement.

If an omission or misstatement is not material, then according to this definition it is not relevant because it will not affect any of the decisions that are likely to be made by the shareholders or other users. Thus, setting materiality helps auditors decide which items to examine during the audit.

The purpose of audit planning

An audit must be properly thought out and planned to ensure it is properly executed and that sufficient, appropriate evidence is obtained. This section will look at how an auditor should plan audit work for a risk-based audit.

An external audit involves managing a series of conflicting objectives. The shareholders want the audit to be effective (that is, to highlight any irregularities in the financial statements). At the same time, they want this service to be efficient (that is, provided without delaying the publication of the information that is being audited and without running up an enormous audit bill). Auditors have responded to these pressures by developing a risk-based approach to auditing. This is designed to provide the highest-quality evidence in a given time or for a given fee while ensuring that sufficient, appropriate evidence is collected on which the audit opinion can be based. In short, the risk-based approach to auditing means the auditor does more audit testing on areas of the financial statements that have an increased risk of misstatement. That is why applying this approach requires an understanding of the underlying business.

An audit must be planned to ensure that it is properly executed and that sufficient, appropriate evidence is obtained. This Primer will look at how an auditor should plan audit work for a risk-based audit.

In addition to helping the auditor organize the engagement so that it is efficient and effective, planning for an audit will allow the auditor to ensure the following:

- Attention is devoted to important areas.
- Potential problems are identified at an early date.
- Staff members with the right skills and experience are assigned to the engagement.
- The review and supervision of the work done can be effectively co-ordinated.
- The work of experts can be co-ordinated.

Audit planning will vary in its extent and complexity depending on the client and on the auditor's experience from previous years.

Identifying the risks of material misstatement through understanding the entity and its environment

The risk of material misstatement (RMM) is the risk that the financial statements of an organization have been misstated to a material degree. RMM is composed of inherent risk and control risk. Inherent risk is the susceptibility of an assertion to misstatement because of error or fraud, before considering controls. Control risk is the risk of misstatement not being prevented or detected by a reporting entity's internal controls. RMM is assessed by auditors at the following two levels:

- At the *assertion level*. Relates to a particular account or balance for a particular assertion.
- At the *overall financial statement level*. Relates to the financial statements as a whole. This risk is more likely when there is a possibility of fraud.

In order to fully identify and evaluate the RMM, CAS 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* requires the auditor to obtain said understanding, including an understanding of the entity's internal control.

Risk assessment techniques

The auditor must use a variety of techniques to gather the information that is used to assess risk. The point of gathering information and assessing risk at the planning stage is to direct the auditor to areas of potential misstatement.

These techniques include the following:

- inquiries of management and others within the entity
- observation and inspection
- analytical procedures — planning phase

Audit risk model

The auditor obtains reasonable assurance by acquiring sufficient appropriate audit evidence in order to reduce audit risk to an acceptably low level. Audit risk is the risk that the auditor expresses an inappropriate audit opinion on the financial statements due to a failure to find an existing material misstatement. Audit risk is a function of the RMM and detection risk.

Audit risk model

Audit risk can be defined using the following formula:

Audit risk (AR) = Inherent risk (IR) × Control risk (CR) × Detection risk (DR)

- Inherent risk is the likelihood that the financial statements are misstated before considering internal control (that is, assuming that the client has no internal controls).
- Control risk is the likelihood that misstatements due to inherent risk will not be prevented, or detected and corrected by the client's internal controls.

Therefore, RMM (the likelihood that the financial statements are misstated after considering internal control and before the audit) = IR × CR.

- Detection risk is the likelihood that the auditor will not detect existing misstatements in the financial statements.
- Audit risk is the risk that an auditor will issue an unmodified report due to the auditor's failure to detect a material misstatement.

Audit approach — developing a response to assessed risks

Once risk assessment procedures have been carried out, materiality has been established, and potential RMM have been identified, auditing standards require the auditor to then design and implement responses to those risks. The response to assessed risks is also known as the **audit approach**. This is still part of the risk assessment phase of the audit process.

The **audit approach** is a high-level indication of how audit evidence will be collected. The approach is then used by the auditor to guide the specific control tests and substantive tests that should be performed.

CAS 330 *Auditor's Responses to Assessed Risks* outlines the procedures the auditor should take in relation to significant risks.

An overall response will address an RMM that has arisen at the financial statement level:

- Where the RMM relate to fraud, the response to these risks is outlined in CAS 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*.
- Where the RMM relate to going concern, the response is outlined in CAS 570 *Going Concern*.
- Where the risks relate to a weak control environment, the typical response is to place no reliance on controls and use a fully substantive audit approach.

Responses at the assertion level require further audit procedures whose nature, timing, and extent are responsive to the risk of misstatement in that assertion. Such audit procedures include the following:

- testing the operating effectiveness of controls, where relevant
- substantive procedures

Practice questions

1. Multiple-choice questions:

   i. Which of the following is an acceptance risk that should be considered in accepting a new audit client?

      a) The auditor has a close personal relationship with the audit client.
      b) The auditor has the necessary skills and knowledge of the client's industry.
      c) The auditor has prepared a budget to show the expected level of fees that will cover the costs to complete the audit and be profitable to the auditor.
      d) The predecessor auditor discloses their relationship with the new audit client that ended due to the predecessor auditor's retiring.

Solution

Option a) is **correct**. The auditor's close personal relationship with the client impairs their ability to be independent and objective. This is a violation of CASs and is therefore an acceptance risk, as the auditor would not be in compliance with standards and regulations.

Option b) is incorrect. This is not an acceptance risk, as the auditor has the necessary skills and knowledge to complete the engagement.

Option c) is incorrect. The auditor has shown that the expected level of fees is appropriate and will not impact perceived or actual independence.

Option d) is incorrect. The predecessor auditor has given no indication that management has exhibited any irregular or illegal behaviour that would be cause for concern in accepting the new audit client.

ii. Which of the following is included in the definition of materiality found in CAS 320 *Materiality in Planning and Performing an Audit*?

a) It influences the economic decisions of users.
b) It is based solely on quantitative factors affecting the audit risk.
c) It is affected only by the size of the misstatement. The nature of the misstatement is not considered.
d) It is relevant to the specific information needs of a particular user of financial statements.

Solution

Option a) is **correct**. Misstatements, including omissions, are considered material if they, individually or in aggregate, could reasonably be expected to influence the economic decisions of users.

Option b) is incorrect. This is not included in the definition of materiality. Materiality should be based on both quantitative and qualitative factors. In addition, audit risk is a function of the RMM. Therefore, materiality helps determine the level of audit testing to reduce audit risk.

Option c) is incorrect. Materiality is affected by the size or nature of the misstatement, or a combination of both.

Option d) is incorrect. The possible effect of misstatements on specific individual users is not considered.

2. Company XYZ is a private manufacturing company started in 20X1 and owned by three brothers in the Wong family. Company XYZ has been profitable since its first year of operation and has consistently had steady growth. The Wong family has approached their local bank for a $2 million loan to finance an expansion project on a new factory. As part of the loan application review process, the bank has asked for audited financial statements for the most recent year end. Company XYZ has approached your accounting firm to perform the required audit, as it has never completed a financial statement audit. The audit partner went to university with the eldest Wong brother.

   Required:

   What acceptance factors should your accounting firm as the auditor examine when determining whether Company XYZ should be taken on as a new client? Use the CPA Way methodology.

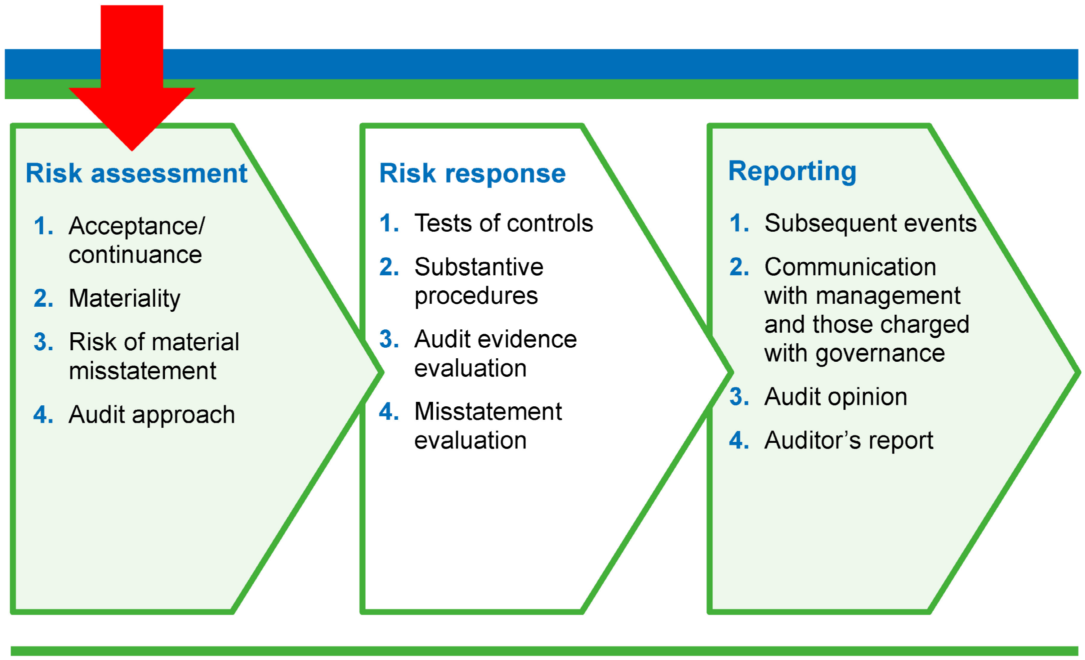
   Solution

   According to the CPA Way, it is important to *assess the situation*. Following are some of the steps that the auditor should complete to determine if there are any specific risk factors relating to accepting a new audit engagement:

   - **Assess capabilities and resources.** Does our firm have the necessary skills to complete the audit of a manufacturing company?
   - **Comply with ethical requirements.** Are there are independence issues with our firm's taking on the audit of Company XYZ, since the partner and the eldest Wong brother went to university together? The audit firm needs to assess how close their personal relationship is and whether it impacts the partners' ability to be objective.
   - **Assess the integrity of those charged with governance and management, as well as the principal owners.** The auditors will need to assess the Wong family and assess whether there are any concerns with management's integrity and how any concerns may impact the audit engagement.
   - **Communicate with the predecessor auditor.** Communication with the predecessor auditor is not required, as Company XYZ has never been audited.
   - **Establish the engagement preconditions.** Company XYZ and the auditor will need to agree on the details of the audit, such as the period to be audited and the reporting framework (IFRS or ASPE) against which Company XYZ is to be assessed. Moreover, the auditor must be satisfied that management understands and has agreed to its responsibilities.

PART 3: AUDIT APPROACH

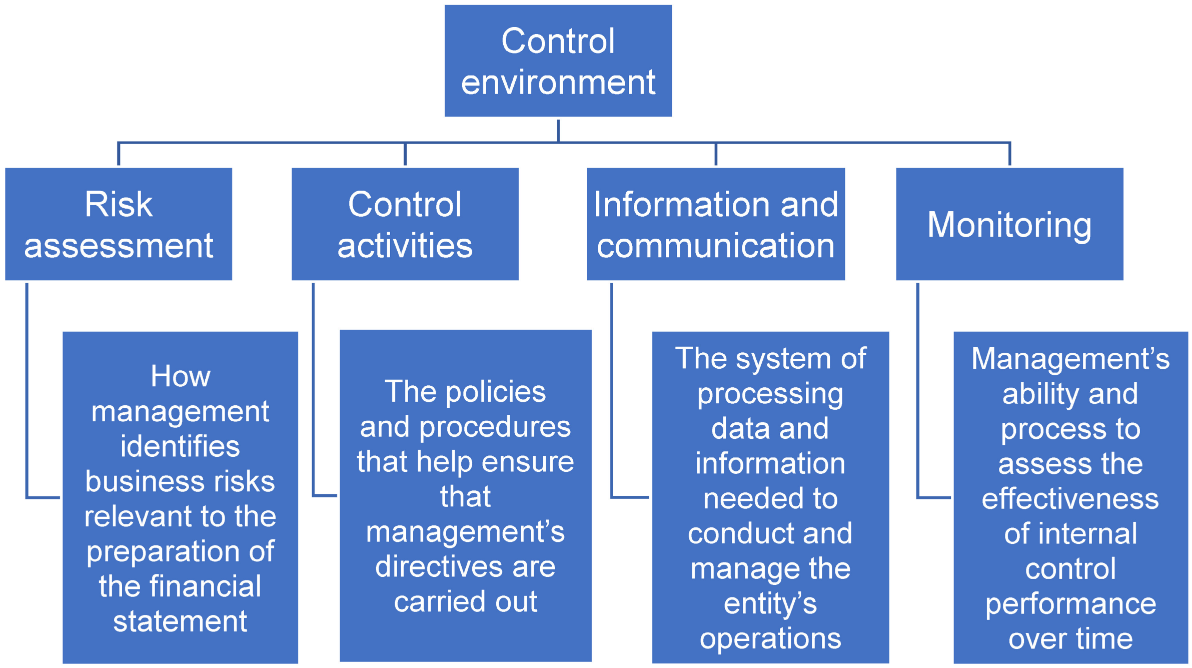
Part 3 continues to focus on the risk assessment phase and discusses the auditor's approach to understanding the internal control systems of the entity and how this determines the audit approach.



Introduction to internal controls

Recall from Part 2 that control risk is the likelihood that the misstatements due to inherent risk will not be prevented or detected by the client's internal controls. To assess the control risk of the audit, the auditor will examine the internal controls of the audit client. Internal control is the system of policies and procedures put into place to ensure that a company meets business objectives. There are five elements of internal control: control environment, risk assessment, control activities, information and communication, and monitoring. The auditor must consider each of these components when assessing the internal control system within an entity and consider how each component may affect the audit.

Elements of the control environment



What are control activities?

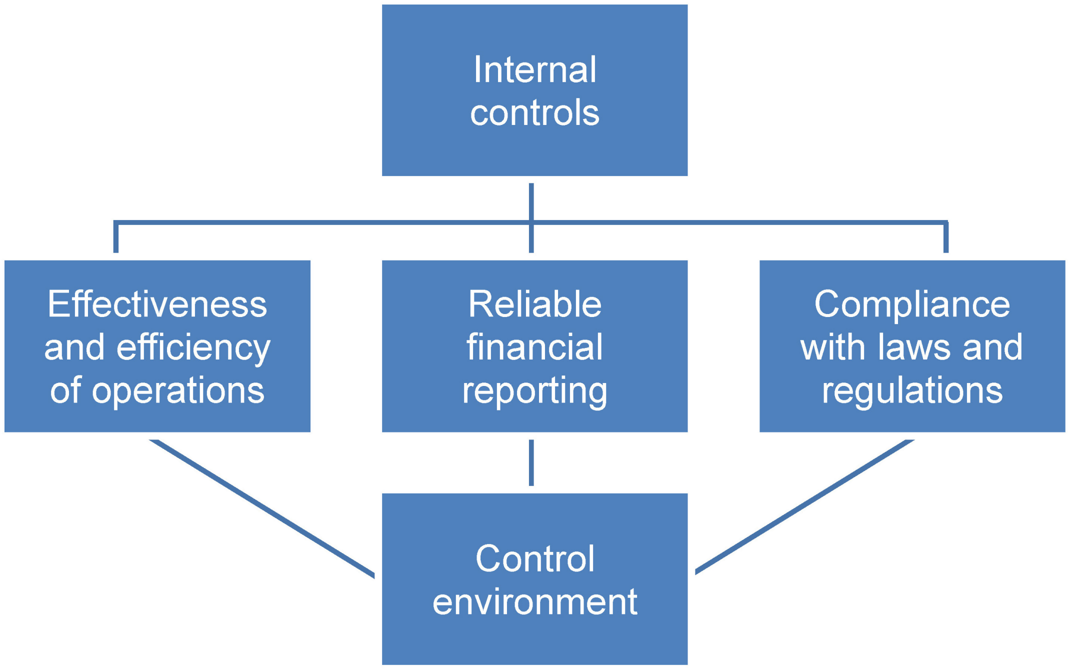
Control activities are one of the five elements of internal control. Control activities are the **policies and procedures** that help ensure that management's directives are carried out. They are mechanisms for managing the achievement of objectives.

Why should management implement control activities?

Every business process is susceptible to risks that could compromise the effectiveness and efficiency of the process and hence the company's ability to meet its objectives.

Control activities at the entity level should be designed to mitigate and reduce business risks. They should provide management with reasonable assurance regarding the following objectives:

- effectiveness and efficiency of operations
- reliability of management reporting, analysis, and decision-making
- reliability of financial reporting
- compliance with applicable laws and regulations



At the transaction level, control activities are implemented to ensure that all transactions processed meet the following criteria:

- They are complete (completeness).
- They have occurred (occurrence).
- They are recorded in the correct accounting period (cutoff).
- They are accurate (accuracy).
- They are correctly classified (classification).

Key internal controls

If the auditor decides to test controls to gather audit evidence in relation to particular assertions, the **key** control activities within a system that are relevant to the audit will need to be identified. Organizations have many different controls operating within their information systems relating to their objectives of financial reporting, efficient and effective operations, and compliance. Auditors are not interested in testing all controls, as some will not prevent or detect material misstatements in the financial statements. Auditors are therefore only interested in the controls that do the following:

- Mitigate risks that can result in a misstatement in the financial statements.
- Prevent material misstatements in the financial statements.
- Detect and correct material misstatements in the financial statements.
- Detect and prevent fraud from occurring.

Impact on audit approach

The impact of weaknesses in each of the aspects of internal control on the audit approach can be as follows:

Weakness	Impact
Weak control environment	When there is a weak control environment, control activities are less likely to be designed well or to be operating consistently. As a result, the RMM in the financial statements increases. Weaknesses in the control environment are likely to affect a number of systems and therefore will probably affect a number of areas of the financial statements. When there is a weak control environment, the auditor will be far less likely to use a combined audit approach (tests of controls and substantive testing) and will be inclined to use a substantive audit approach (substantive testing only). If the auditor decides to rely on controls (that is, to use a combined audit approach), the audit approach will have to be amended to address the weak control environment — for example, the extent of controls testing may increase, and/or the auditor may increase the level of substantive testing in a particular area.
Weak risk assessment procedures	When there are weak risk assessment procedures, there will be a greater likelihood of risks in a client's business that are not identified and not being controlled. Moreover, control activities may not be designed according to the nature of risks in the client's business. This may indicate weaknesses in the client's control system and can result in a higher RMM over particular areas of the financial statements. The auditor should identify these risks/weaknesses and evaluate their impact on the financial statements. This will change the nature and extent of testing over areas of the financial statements where there is a higher RMM.
Weak information systems	When there are weak information systems, the potential for override of controls over journal entries or incorrect processing of transactions, such as clearing out a suspense account, may be higher. This can result in a higher RMM over particular areas of the financial statements, which will change the nature and extent of testing over these areas.
Weak monitoring of controls	When there is weak monitoring of controls, controls are less likely to be operating during the period, so the auditor may increase the extent of testing on the controls and may test a range of controls to obtain sufficient audit evidence.

The auditor should report weaknesses in the client's internal control system to management.

Accounting systems and control procedures

Once the auditor has an understating of the control environment of the entity, they will spend time understanding the accounting system. An accounting system refers to accounting processes, such as purchases, sales, and other financial processes of an organization. The development of these systems depends on the size of the business, the volume of transactions, and the nature of the business itself. An accounting system should result in information that is relevant, reliable, understandable, timely, and comparable.

This topic will provide some practical examples of accounting processes, including the following:

- **credit sales systems** — reviewing credit applications, sales orders, order fulfilment, invoicing, and payment processing
- **purchasing systems** — vendor screening, PO authorization, receipt of goods, three-way matching, and payment processing
- **human resources and payroll systems —** hiring/terminating contracts, maintaining employee master files, recording work performed, calculating payroll expense, and payment processing
- **financial reporting systems**:
  - month-end reconciliations
  - month-end journal entries
  - production of interim and year-end financial statements

An overview of each of the processes will be discussed in addition to key controls that reside within each system.

Practice questions

1. Multiple-choice questions:

   i. Linda, an auditor, is reviewing the internal controls related to the sales cycle in place at Mighty Jack Inc. Which of the following controls helps to ensure that the sales have been recorded in the correct accounting period?

      a) Shipping documentation is forwarded to the invoicing clerk on a daily basis.
      b) Sales are recorded based on approved sales order forms and shipping documents.
      c) Monthly customer statements are sent out with customer complaints followed up on.
      d) The shipping document is matched to the sales invoice.

Solution

Option a) is **correct**. The control relates to cutoff by ensuring that transactions have been recorded in the correct accounting period. Forwarding the shipping documentation to the invoicing clerk daily will help to ensure that the sales are recorded in the correct accounting period.

Options b) and c) are incorrect. These procedures relate to the occurrence assertion by ensuring that the recorded sales transactions represent goods shipped.

Option d) is incorrect. Having the shipping document matched to sales invoices ensures that all goods and services sold (and shipped) are correctly invoiced. This control addresses the completeness and accuracy assertions.

ii. Jian, an accounting student who is working as a junior auditor, has identified that Bigger Furniture Outlet has a tendency to not record sales when customers pay for their purchase in cash. Which assertion related to the revenue account has a higher risk due to this practice?

a) Occurrence
b) Cutoff
c) Classification
d) Completeness

Solution

Option d) is **correct**. Completeness is a concern related to the understatement of the revenue account. The fact that cash sales have not been recorded means that there is a high risk related to completeness of this account.

Option a) is incorrect. Occurrence would be a risk if revenue was aggressively recorded, in which case the revenue may not have actually occurred, resulting in a possible overstatement within the revenue account. The concern in this situation is an understatement (revenues are not being recorded), as opposed to an overstatement.

Option b) is incorrect. The concern in this situation is that revenues are not being recorded, as opposed to sales transactions near year end not being recorded in the correct accounting period.

Option c) is incorrect. The concern in this situation is that revenues are not being recorded, as opposed to sales transactions not being recorded in the proper account.

2. The following are three independent scenarios:

   Scenario 1: The client has controls in place to prevent the excessive use of materials in the production of inventory and to ensure that procedures are efficient.

   Scenario 2: The client has controls over standard costing and monitoring of variances.

   Scenario 3: The client has controls to ensure that all customers are visited on a regular basis to maximize sales.

   Required:

   In each of the scenarios, identify if the external auditor would classify the control activity as a key control. Use the CPA Way methodology.

   Solution

   Each scenario can be analyzed using the CPA Way.

   Scenario 1: This is not considered a key control, because these controls are not relevant to the financial statement audit. They do not prevent or detect misstatements in the financial statements.

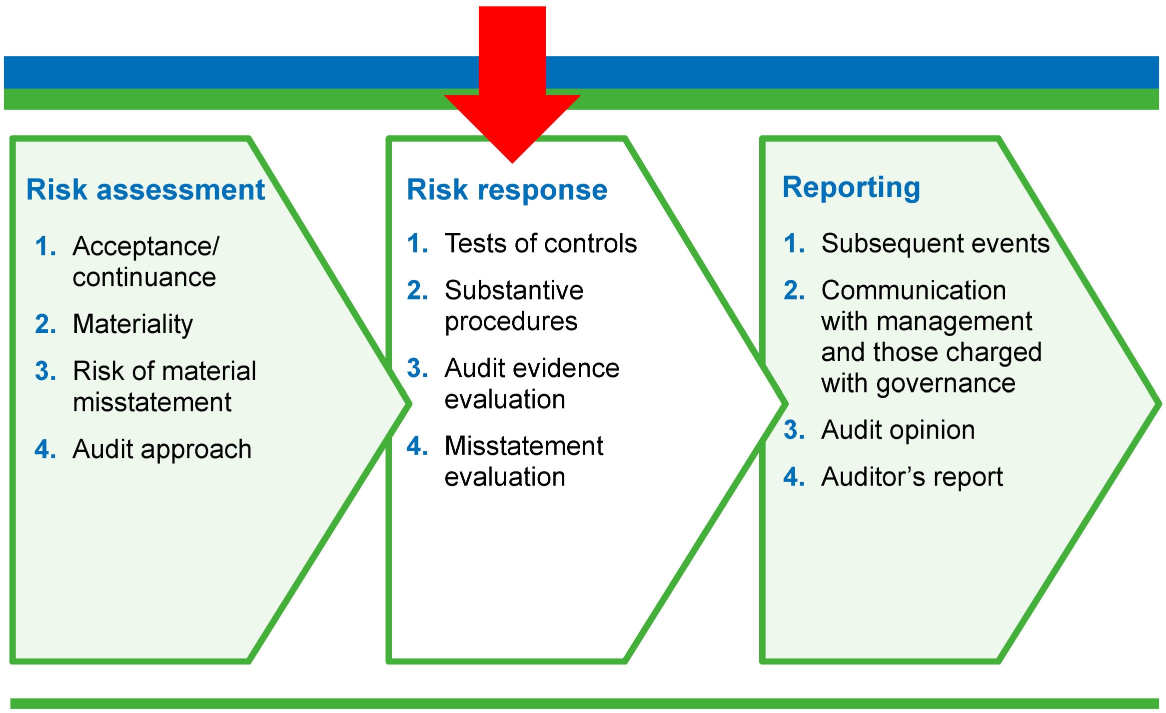
   Scenario 2: This is considered a key control. While it will have an operational objective in terms of pricing, it will also ensure that inventory is valued correctly in the financial statements. Therefore, these controls will be relevant to the external auditor. Key controls for sales are those that ensure that sales are complete, accurate, have occurred, are classified correctly and are recognized in the correct accounting period (cutoff).

   Scenario 3: This is not a key control, as it does not prevent or detect misstatements in the financial statements. Key controls for sales are those relating to sales and cash receipts, and also controls over the valuation of accounts receivable. Key controls for the valuation of accounts receivable would be setting appropriate credit limits, stopping sales over credit limits and following up on outstanding debts, because these prevent unrecoverable receivables from being recognized in the financial statements (valuation).

PART 4: RISK RESPONSE

In this part, we discuss the risk response phase of the audit process. In Part 3, we focused on discussing tests of controls and the impact the control environment can have on the auditor's audit approach. In Part 4, we shift our focus to discuss what substantive audit procedures are. A clear understanding of both tests of controls and substantive procedures allows the auditor to develop an audit program and tailor the program to the particular circumstances of a client.

Audit programs provide detailed instructions on the procedures to perform in each audit area during the risk assessment, risk response, and reporting stages of the audit process. Audit programs will detail not only the nature of the procedures, but also the timing and extent of work to be performed.



Audit evidence

Sufficient appropriate audit evidence is required to ensure that the audit opinion reached by the auditor and provided in the audit report is supported by the work performed. This evidence must be adequate and of a suitable quality to support that opinion. Throughout the audit process, auditors perform audit procedures to collect sufficient appropriate audit evidence.

According to CAS 500 *Audit Evidence,* audit evidence is all the information used by the auditor in arriving at the conclusions on which the audit opinion is based. Audit evidence is collected throughout the audit process by doing the following:

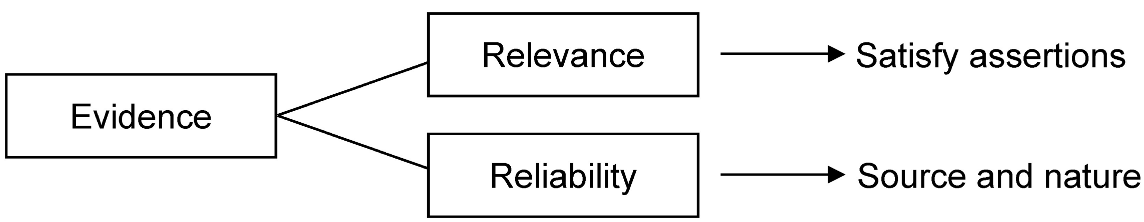
- Obtaining an understanding of the entity and its environment, including its internal controls, and performing risk assessment procedures.
- Testing the operating effectiveness of the controls of the entity.
- Performing substantive procedures to detect material misstatements in the financial statements at the assertion level.
- Performing overall review procedures at the completion stage of the audit process.

Sufficiency

The quantity of audit evidence needed is affected by the **risk of material misstatement (RMM)** and the **quality** of evidence. The higher the RMM, the more evidence required to reduce the risk that a material misstatement is not detected by the auditor. The higher the quality of evidence obtained, the lower the amount of further evidence required. Obtaining more audit evidence, however, may not compensate for its poor quality.

Appropriateness of evidence

Appropriateness is a measure of the quality of evidence — that is, its **relevance** and **reliability**.



Relevance

For evidence to be relevant, it must satisfy one or more of the audit assertions. Audit assertions are claims or representations on the financial statements made by management. Recall from Topic 2.3-3 that the assertions fall into the following two categories:

Balance sheet (account balances)	**Income statement (classes of transactions)**
Rights and obligations	Completeness
Existence	Occurrence
Completeness	Classification
Accuracy, valuation, and allocation	Accuracy
Classification	Cutoff
Presentation	Presentation

Thus, the nature of the audit procedure itself will determine whether the evidence obtained is relevant to the assertion it aims to test. For example, accounts receivable confirmations test the **existence** and **rights and obligations** of accounts receivable balances; therefore, the replies from the client's customers provide evidence that is **relevant** for that particular assertion. However, this audit procedure does not provide evidence regarding **valuation**, as the customer is only being asked to confirm the outstanding balance; this does not confirm the customer's intention or ability to pay the balance.

Reliability

The reliability of evidence is affected by its **source** and its **nature**.

Audit evidence from controls testing compared to substantive testing

Controls testing

Audit evidence from understanding the business and testing controls is obtained by examining what someone at the client's business does to reduce the risk of misstatement. Through a test of controls, the auditor is looking for a deviation condition. In other words, the control is operating as intended, or it is not.

In these cases, the auditor is obtaining evidence that something the client does reduces the risk of misstatement in the financial statements either by **preventing** it from occurring or by **identifying and correcting** the misstatement before the financial statements are finalized. In controls testing, the auditor looks at procedures performed by the client during the financial year rather than at year-end figures.

A control deviation indicates that a control is not functioning as intended. It does not indicate an actual dollar error in the financial statements.

Substantive testing

Substantive tests are the procedures the auditor undertakes to detect possible misstatements that may exist in the financial statements — that is, testing the figures that appear in the statements.

CAS 330 divides substantive tests into two categories:

- substantive analytical procedures
- tests of details

Substantive analytical procedures are audit procedures designed to evaluate financial information through the analysis of reasonable relationships among both financial and non-financial data. They involve testing the whole population of an account at once, such as depreciation expense for motor vehicles.

Tests of details involve selecting specific items within the population of an account for testing, such as recalculation of the depreciation expense for a sample of assets using the depreciation policy. Tests of details are any substantive procedures that are not substantive analytical procedures.

The following are examples of tests of details:

- agreeing property, plant, and equipment additions to invoices
- performing accounts receivable confirmations to ensure that year-end accounts receivable exist and are accurately recorded
- agreeing the year-end bank balance to a bank confirmation letter

What is the best approach?

Auditors must decide whether they will take a purely substantive approach or if they will take a combined approach by testing controls and conducting fewer substantive procedures. In both scenarios, some substantive procedures are required. If the auditor suspects that there is a lack of effective controls, or if testing controls would be inefficient — that is, tests of controls would be more expensive to perform than tests of details — a substantive approach would be appropriate. For example, in an environment where there is clearly a lack of segregation of duties, a substantive approach would likely be most efficient because the auditor would not be able to rely on controls.

If the auditor's assessment of the RMM includes an expectation that controls are operating effectively, or if the auditor believes that only tests of controls will achieve effective testing, then a combined approach would be appropriate. For example, if the auditor concludes that the control risk for the occurrence assertion for payroll expense is low, a test of controls could be performed on this assertion, and so a combined approach would be taken.

Different testing techniques can be used, each with a different level of reliability and relevance. When designing tests over a particular account, the auditor will use a mix of techniques, considering whether the reliability and relevance of all the tests in combination are sufficient and appropriate to conclude on the balance, transactions, presentation, and disclosure.

Testing techniques

The techniques outlined in CAS 500 *Audit Evidence* include:

- **C**onfirmation (external)
- **I**nspection of records or documents and tangible assets
- **I**nquiry
- **R**ecalculation
- **O**bservation
- **A**nalytical procedures

- **R**eperformance

Students may use the acronym ***CIIROAR*** to remember these seven techniques. The testing technique used will depend on what audit test/procedure the auditor wishes to perform. Not all techniques are appropriate for all audit tests. The table below summarizes when the testing techniques should be used:

Technique	**Test of controls**	**Substantive test of details**	**Substantive analytical procedures**
Confirmation		X	
Inspection	X	X	
Inquiry	X	X	X
Recalculation	X	X	
Observation	X		
Analytical procedures			X
Reperformance	X	X	

Practice questions

1. Multiple-choice questions:

   i. Evan has completed a substantive test of details and has verified that a sample of sales recorded in the general journal are supported by invoices. Which management assertion for sales transactions is Evan testing?

      a) Completeness
      b) Accuracy
      c) Occurrence
      d) Cutoff

      Solution

      Option c) is **correct**. Evan is testing occurrence. By verifying that a sales transaction recorded in the general journal is supported by an invoice — that is, a valid invoice exists for the transaction that has been recorded — Evan is verifying that the sale occurred through the invoice documentation.

      Option a) is incorrect. Testing completeness would involve evaluating if all sales that have occurred during the period are recorded in the general journal. Evan could select a sample of invoices and trace each invoice to the general journal — that is, verify that the sales transaction has been recorded.

      Option b) is incorrect. Testing accuracy would involve evaluating if sales transactions are accurately recorded. Evan could compare the quantities shipped with the customer order. Evan could also verify that the prices used in preparing invoices are correct.

Option d) is incorrect. Testing cutoff is verifying that sales transactions are recorded in the proper period. Evan would need to verify the date that the transaction has been recorded based on the sales invoice and the general ledger. Ideally the shipping documents would also be used to verify the shipping date.

ii. Deepak is completing a substantive analytical procedure on Raven Inc.'s insurance expense account. The insurance expense increased by $24,000 compared to the prior year. Which of the following explanations from management best supports the variance in the insurance expense account?

a) An additional warehouse is being rented during the current year.
b) An insurance claim was filed at the end of the current year.
c) Raven prepaid insurance fees for the upcoming fiscal year.
d) Raven changed from a monthly to an annual payment plan at the start of the current year.

Solution

Option a) is **correct**. A new asset being rented that needs to be insured is a valid reason for the insurance expense to increase.

Option b) is incorrect. A claim filed at the end of the current year would not specifically result in an increase to the insurance expense in the current year. Insurance expense for the next fiscal year may increase.

Option c) is incorrect. Prepaid insurance fees would not be recorded as an insurance expense in the current year; rather, they would be recorded as a prepaid expense. This is not a valid explanation for the increase in insurance expense.

Option d) is incorrect. Changing from a monthly payment plan to an annual payment plan will not specifically cause an increase in the total amount of premiums. Premiums may go down slightly with the change to an annual upfront payment. Even with a large prepayment, the increase would be to prepaid insurance, not to insurance expense.

iii. Brenda is completing an audit procedure for the cash cycle. Brenda requested that the client count the petty cash in front of her. Which management assertion is Brenda most likely testing with this audit procedure?

a) Classification
b) Existence
c) Completeness
d) Presentation

Solution

Option b) is **correct**. Brenda is verifying the existence of the cash by observing the count. If the cash is all in Canadian currency, then Brenda may also be verifying the accuracy of the petty cash balance.

Option a) is incorrect. Brenda is not verifying whether the cash is properly classified. To do this, Brenda could determine whether there are any restrictions on the cash.

Option c) is incorrect. Brenda is not verifying that the balance of the cash account reflects all cash balances. It is likely that petty cash is just one of many cash accounts, and therefore Brenda is not evaluating completeness by looking only at petty cash.

Option d) is incorrect. Brenda is not verifying that the cash has been properly presented within the financial statements.

2. Nelly & Timber LLP are the auditors for Furtado Inc. They are planning audit procedures over the accounts receivable. To test the valuation of accounts receivable, they will select a sample of customers' outstanding balances that are over 90 days old from the aged accounts receivable report produced by the accounting system. They will then review post-year-end cash receipts to see if the debt has been settled, discuss the recoverability of the balance with management and review customer correspondence.

   Required:

   In assessing the reliability of the test and the evidence obtained, what factors should Nelly & Timber consider?

   Solution

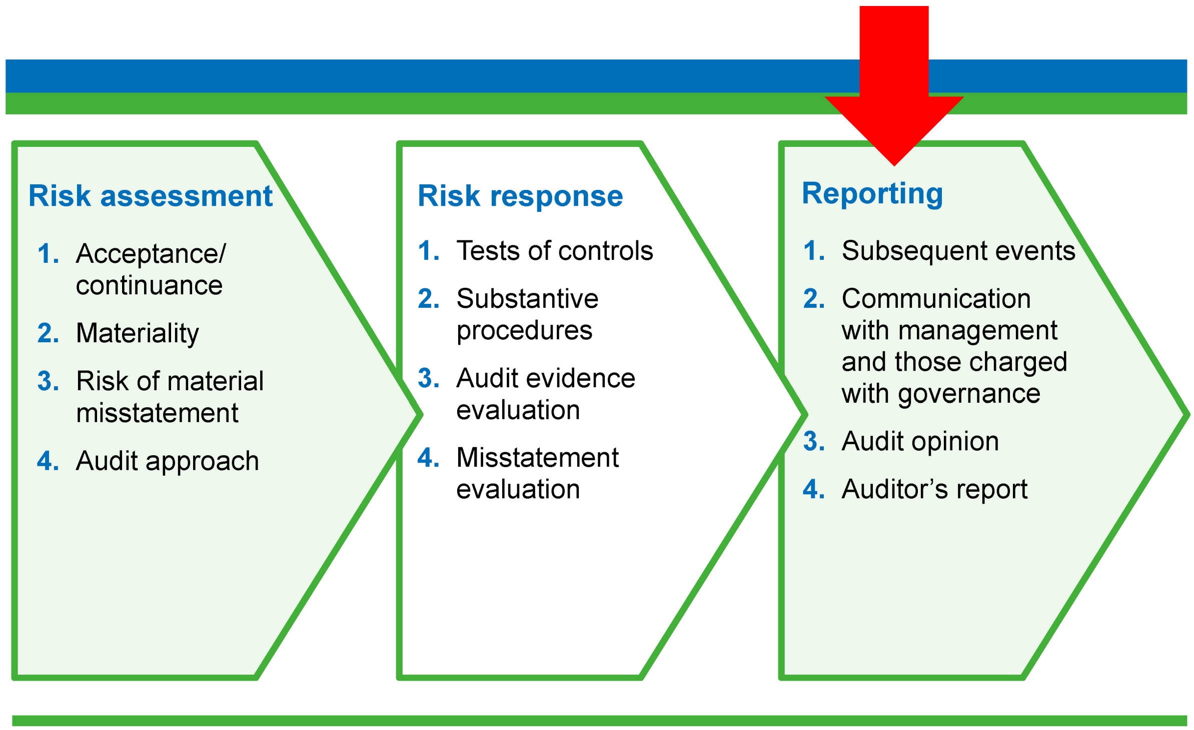
   Nelly & Timber will have a CPA mindset and exercise professional judgment. The reliability of audit evidence is affected by its source and its nature.

   In this case, the source of evidence is a third party: customers of Furtado Inc. The reliability of third-party-generated evidence will depend on the third party's knowledge of the matter, its willingness to provide the evidence and its objectivity. This is not as reliable as auditor-generated evidence.

   For the test and the evidence obtained to be reliable, the information from which the sample is selected (the aged accounts receivable report) must be accurate and complete. For example, if there are overdue customer accounts that have not been identified in the accounts receivable report, the information is not complete, and therefore the results of the test may not be reliable. Usually, evidence on the reliability of the aged accounts receivable report is obtained when controls are tested over the client's sales system. Testing will be done to ensure that invoices are allocated to the correct date in the sales ledger and that the aged accounts receivable report is allocating outstanding invoices to the correct aging category based on the invoice date.

PART 5: AUDIT COMPLETION

Part 5 focuses on the typical activities during the audit reporting phase of an audit engagement.



Completion activities that occur in the reporting phase include the following:

- documentation
- completion procedures — assessment of going concern, subsequent events review, evaluation of related party transactions and communication with law firms
- evaluation of audit evidence
- management representations
- communication with management and those charged with governance
- internal completion documents
- quality control over the audit engagement

Documentation

It has always been accepted that it is not enough for auditors to carry out audit procedures, but that the audit procedures must also be properly documented.

With documentation, auditors can demonstrate that they have obtained sufficient appropriate evidence to support their opinions. This also demonstrates that the auditors have complied with CASs and the applicable ethical, legal, and regulatory requirements.

Audit documentation includes everything in relation to the engagement, whether on paper, electronic, or other media. Most audit firms still use paper to some degree, but it is becoming more common for firms to move toward a completely paperless audit with all audit documentation being maintained on computer only.

Completion procedures

An auditor performs completion procedures at the final stages of an audit, when the main audit fieldwork has been completed but before the final audit opinion is reached.

Assessment of going concern

Going concern is a fundamental principle in the preparation of financial statements. It is the responsibility of management preparing the financial statements to make an assessment of whether the entity is a going concern and to prepare the financial statements accordingly. The auditor is then required to evaluate the appropriateness of the use of the going-concern assumption throughout the audit process.

The assessment of going-concern status will vary from company to company depending on the company's size and complexity, the nature and condition of the business, and the effect of external factors. If there is a history of profitable operations and ready access to financial resources, the assessment of going-concern status is likely to be relatively straightforward, with less detailed work required, than for a company that has struggled to stay solvent.

If the auditor becomes aware of an event or condition that does cast doubt on the ability of the company to continue as a going concern (which may not appear until after the completion of the majority of fieldwork), then CAS 570 requires additional procedures to be performed:

1. Request management to make an assessment of going-concern status where it has not done so.
2. Review management's plans for future actions based on its going-concern assessment; consider whether these plans are feasible and whether their outcome will improve the situation.
3. When cash flow forecast is a significant factor in considering management's plans:
    a) Evaluate the reliability of the underlying data used to prepare the forecast.
    b) Obtain support for assumptions used.

4. Consider whether any other facts are available since management completed its assessment.
5. Seek written representations from management regarding its plans for future action and the feasibility of these plans.

Subsequent events review

The purpose of a subsequent events review, also known as a post-balance-sheet events review, is to ensure that any events that occur after the balance sheet date, which may require adjustment or disclosure in the financial statements, have been identified and properly accounted for. Two different types of events occur after the balance sheet date:

1. Adjusting events provide evidence of conditions that existed at the period end. An example is the sale of inventory for a loss after the balance sheet date, showing that the estimate of net realizable value at the period end was incorrect.
2. Non-adjusting events are indicative of conditions that arose after the period end. An example is the loss of capital assets or inventories due to a catastrophe such as fire or flood that occurred after the period end. Non-adjusting events do not result in changes to amounts included in the financial statements. They will only be disclosed in the notes to the financial statements if they are judged to be sufficiently material (that is, the non-disclosure could influence the decisions taken by users on the basis of the financial statements).

Evaluation of related party transactions

If related party transactions were identified during the planning phase of the audit, the auditor is required to perform further audit procedures. CAS 550 *Related Parties* outlines the auditor's responsibilities pertaining to related party transactions.

Communication with law firms

CAS 501 *Audit Evidence — Specific Considerations for Selected Items* requires auditors to communicate with law firms when the RMM has been identified pertaining to litigation or claims. This is done through a letter of inquiry prepared by management. The letter of inquiry will ask the legal firm to prepare a response letter at or near completion of the fieldwork.

Evaluation of audit evidence

Throughout the audit, the auditor should evaluate the outcome of the audit procedures performed and determine whether the auditor's assessment of the RMM remains appropriate. Information may come to the auditor's attention from the following:

- audit differences identified through substantive testing that may result in a reassessment of the effectiveness of the client's control systems
- missing audit evidence

- overall review procedures at the completion of the audit that may indicate a previously unrecognized RMM

As a result, the auditor may obtain further audit evidence.

Final analytical procedures

CAS 520 *Analytical Procedures* requires analytical procedures to be used at the completion stage of the audit to assess whether the financial statements as a whole are consistent with the auditor's understanding of the entity. The results of the analytical review are intended to corroborate conclusions formed during the audit fieldwork.

Evaluation of misstatements

Throughout the audit, members of the audit team may discover misstatements in the financial statements. Whenever misstatements are found, unless they are clearly trivial, the auditor records those misstatements on a summary of audit differences (SAD). This summary is also called the summary of unadjusted differences or the summary of accumulated misstatements. The SAD shows the cumulative effect of identified misstatements and records which misstatements have been adjusted for in the client financial statements and which misstatements remain unadjusted for at year end.

According to CAS 450 *Evaluation of Misstatements Identified during the Audit*, the auditor needs to evaluate the following:

- the effect of identified misstatements on the audit
- the effect of uncorrected misstatements, if any, on the financial statements

Management representations

CAS 580 *Written Representations* requires the auditor to obtain written representation:

- that those charged with governance believe they have fulfilled their responsibilities
- to support other audit evidence or specific assertions in the financial statements

This usually occurs toward the end of an audit by obtaining a representation letter from management. The auditor cannot obtain sufficient appropriate audit evidence if management does not provide the representation letter. However, management representations do not provide sufficient audit evidence on their own, and they cannot be used to reduce the nature or extent of other audit procedures the auditor must perform.

Communication with management and those charged with governance

Throughout the audit, certain things need to be communicated on a timely basis to management and those charged with governance. Specifically, the auditor must communicate the following:

- information on auditor independence for listed entities
- significant findings from the audit
- significant deficiencies in internal control
- other matters, such as concerns regarding fraud or illegal activities

Internal completion documents

In addition to external completion documents such as the letter of management representation, a number of internal completion documents need to be completed by the auditor. These documents are necessary to conclude that there is sufficient appropriate evidence of the audit completion. Practice and terminology will vary from firm to firm, but versions of the following documents are usually used on each audit:

- issues to carry forward
- audit summary review memorandum
- financial statement disclosure checklist

Quality control over the audit engagement

Recall that the audit process must be controlled to ensure both that quality service is provided to the client and that the professional obligations of the auditor are complied with. The methods used to plan and control audit work will vary according to the nature and size of the audit engagement. Quality control procedures are performed at the overall engagement level. They provide the engagement partner with assurance that the professional and ethical standards have been complied with and that the audit opinion is appropriate based on the evidence collected.

Reporting

The objectives of the auditor are (i) to form an opinion on whether the financial statements are free from material misstatements and are fairly stated and (ii) to express that opinion clearly. The audit report is used by the independent external auditor to communicate to the shareholders his or her opinion on the financial statements.

A brief summary of various audit opinions that an auditor may issue is shown in the tables below:

Modifications to standard unmodified report

Standard report — no modifications

Description	Modification	Opinion wording
Financial statements are fairly stated.	Unmodified	"In our opinion the financial statements present fairly, in all material respects, the financial position of…"

Amended report — modifications to standard report

Description	Modification	Opinion wording
Financial statements are fairly stated, but there are certain matters disclosed in the financial statements that the auditor wants to draw the user's attention to.	Unmodified with emphasis of matter	"We draw attention to Note X to the financial statements, which describes the <explain matter>. Our opinion is not modified in respect of this matter." The emphasis of matter paragraph is AFTER the opinion paragraph.
Financial statements are fairly stated, but there is relevant information not in the financial statements that the auditor considers important to highlight to the user.	Unmodified with other matter	"The comparative information presented in these financial statements was audited by a predecessor auditor. The predecessor's audit report was dated XXX and was unmodified." The other matter paragraph is AFTER the opinion paragraph.

Modification to opinion paragraph(s)

Material but not pervasive

Description	Modification	Opinion wording
Financial statements are materially misstated (GAAP departure)	Qualified	"…*except for* the effects of the matter described in the Basis for Qualified Opinion paragraph: (a) The financial statements present fairly, in all material aspects…"
Inability to obtain sufficient appropriate audit evidence (scope limitation)	Qualified	"…*except for* the possible effects of the matter described in the Basis for Qualified Opinion paragraph…"
Matter of fundamental importance	No amendment	

Material and pervasive

Description	Modification	Opinion wording
Financial statements are materially misstated (GAAP departure)	Adverse	"…because of the significance of the matter described in the Basis for Adverse Opinion paragraph: (a) The financial statements *do not present fairly*…"
Inability to obtain sufficient appropriate audit evidence (scope limitation)	Disclaimer	"…because of the significance of the matter(s) described in the Basis for Disclaimer of Opinion paragraph, the auditor has not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion, and accordingly the auditor *does not express* an opinion on the financial statements…"

Practice questions

1. Multiple-choice questions:

   i. Joginder, a student in the CPA program working as an audit senior, is reviewing subsequent events for ProNorth Ltd. Each of the subsequent events identified by Joginder is material in nature and occurred after the balance sheet date of December 31, 20X6, but prior to the audit report date. Which of the following events will Joginder adjust within the 20X6 financial statements?

      a) A flood on January 5, 20X7, caused significant damage to ProNorth's warehouse.
      b) ProNorth's key customer declared bankruptcy due to the outcome of a lawsuit on January 10, 20X7.
      c) ProNorth took out a new loan on January 8, 20X7, to proceed with its planned expansion.
      d) ProNorth signed a union agreement on January 12, 20X7.

      Solution

      Option b) is **correct**. The outcome of the lawsuit on January 10 provides evidence of conditions that existed at the period end — that is, the supplier is no longer a going concern. This subsequent event confirms that an account receivable from the key customer would not be collected and therefore the financial statements would need to be adjusted.

Options a), c) and d) are incorrect. These events would not require an adjustment in the financial statements. They happened after year end and do not relate to the current year being audited. They are indicative of conditions that arose after the period end.

ii. Inaya, an audit manager, is reviewing the working paper file of KE Motors in order to evaluate the audit findings. Which of the following procedures would Inaya be **LEAST** likely to complete as she is evaluating the results of the audit?

a) Reviewing financial statement disclosures
b) Evaluating the sufficiency and appropriateness of evidence collected
c) Completing variance analysis on the financial statements
d) Obtaining the management representation letter

Solution

Option d) is **correct**. Obtaining the management representation letter is not one of the steps in reviewing the audit results. The review of the audit results includes the following tasks: evaluating the sufficiency and appropriateness of evidence collected, reviewing the disclosures in the financial statements, performing an overall financial statement analysis, assessing whether the evidence collected supports the conclusions of the auditor's report, reviewing the content of the working paper file, and issuing the auditor's report.

Option a) is incorrect. Inaya would review the financial statement disclosures as part of her review.

Option b) is incorrect. Inaya would evaluate the sufficiency and appropriateness of evidence collected as part of her review.

Option c) is incorrect. Inaya would complete a variance analysis on the financial statements as part of her review.

iii. Karen, an audit partner, has provided updates throughout the audit of Great Electronics Ltd. to the audit committee. Which of the following is Karen **LEAST** likely to have communicated to the audit committee?

a) Strategies to deal with significant risks
b) Sample selection strategies for the engagement
c) Controls that will be relied on during the engagement
d) Materiality as it applies to the engagement

Solution

Option b) is **correct.** The auditor would not provide the audit committee with the sample selection strategies for the engagement.

Option a) is incorrect. The auditor should discuss strategies to deal with significant risks with the audit committee.

Option c) is incorrect. The auditor should discuss whether internal controls can be relied upon with the audit committee.

Option d) is incorrect. The auditor would communicate materiality as it applies to the audit engagement to the audit committee.

2. Carrier Inc. has a bank loan due for repayment three months after year end which would have a severe impact to cash flow. This is casting doubt over the company's ability to function on a going-concern basis. Management's plan to address this issue is to renew the bank loan for another two years. This will improve the situation only if the entity has sufficient cash to continue operating in the interim and has the prospect of generating sufficient cash to repay the loan in the future. The plan to generate cash is to introduce a new product and improve sales.

   Required:

   You are the auditor of Carrier Inc. Assess management's plan to improve cash flow and assess whether the plan is feasible, as part of your review of Carrier Inc. as a going concern.

   Solution

   If the auditor becomes aware of an event or condition that casts doubt on the ability of the company to continue as a going concern, the auditor is required to review management's plans for future actions and consider whether these plans are feasible and whether their outcome will improve the situation.

   When the cash flow forecast is a significant factor in considering management's plans, the auditor should evaluate the reliability of the underlying data used to prepare the forecast and obtain support for assumptions used.

   The entity may have had successive years of significant losses and has now run out of cash. The plan to generate cash is to introduce a new product and improve sales. Therefore, future cash flows are a significant factor in determining whether the entity is a going concern. The auditor would need to examine the data used in management's cash flow forecast for reliability and ensure that the assumptions used are reasonable.

PART 6: OTHER ENGAGEMENTS

An external financial statement audit is only one type of assurance engagement. Part 6 focuses on other types of assurance engagements and non-assurance engagements commonly undertaken by professional accountants and considers the different stages involved.

Key process stages

You can use the principles, processes, and skills that you have previously developed for a financial statement audit engagement and apply these to various other types of engagements. These skills are easily transferable and therefore can be applied to other engagements that are not specifically covered here.

The specific engagements considered are the following:

1. Other assurance engagements
2. Review engagements
3. Non-assurance engagements
4. Auditor's involvement with offering documents
5. Comprehensive audit engagements
6. Other engagements

Any of the above engagements performed by a professional accountant will follow similar stages to those in an audit engagement: risk assessment, risk response, and reporting.

Risk assessment

Intended user

Similar to a financial statement audit in other assurance engagements, the accountant needs to determine for whom, and for what purpose, the report is being prepared. This will enable the accountant to determine the risk of performing the engagement and whether the accountant is willing to accept a duty of care should a third party place reliance on the report.

Levels of assurance

There are several different types of engagements the auditor or practitioner can be associated with, providing a high to moderate level of assurance or no assurance at all.

The level of assurance provided is key to determining the form of the report and therefore the scope of the engagement. Some engagements will provide positive or limited assurance, whereas others will offer no assurance at all.

Engagement letter

Regardless of the type of service to be provided (assurance or non-assurance engagement), there should still be an engagement letter. The engagement letter is a contract of work to be performed and should detail this work, the timeline involved, the resulting fees, and the deliverables. This letter will have to be signed by the client and potentially any third party that will be using the results of the reporting accountant's work.

The engagement letter clarifies responsibilities, the scope of the engagement, and the form of assurance that will be provided or the work that will be performed. Without this, the reporting accountant has no starting point from which to commence the procedures and to evaluate the results.

Planning

The reporting accountant should plan the engagement to establish a general strategy and detailed approach. In addition, the reporting accountant will need to consider the following additional issues in order to design appropriate procedures:

- the level of assurance to be provided
- characteristics of the subject matter
- the criteria or benchmarks to be used
- potential sources of evidence
- materiality

Materiality

As with a financial statement audit, the definition of materiality for any engagement, when applicable, requires the reporting accountant to consider what factors could reasonably influence the decisions of the intended users. Therefore, the purpose of the report will influence materiality.

Risk response (Level C)

As with a financial statement audit, the reporting accountant on other engagements should consider the following issues regarding engagement execution and evidence collection:

- determining types and mix of procedures to be performed (for example, testing controls or detailed substantive evidence collection)
- documenting evidence
- using the work of an expert
- reviewing the work performed
- evaluating the evidence collected

Reporting (Level C)

The final stage of the engagement is the report. This will be on the basis agreed upon in the engagement letter and should contain a clear expression of the reporting accountant's conclusion. The form of the report will vary depending on the nature of the engagement. Sample reports are shown throughout this week's notes.

Types of engagements (Level C)

There are various types of other engagements that a reporting accountant may be asked to undertake. The following table summarizes some of the different types of engagements and their related level of assurance.

Students can also refer to the *CPA Canada Learning eBook: Audit and Assurance*, Chapters 20 and 21, located on Brightspace (D2L), for a summary of the discussion on the different levels of assurance and determining the appropriate level of reporting based on client and user needs, as well as for a comparison of the various assurance and non-assurance engagements provided by public accounting firms.

Service	Related reference	Type of engagement	Level of assurance
Audit of financial statements prepared in accordance with special purpose frameworks	CAS 800	Other assurance engagement	Reasonable
Audit of single financial statements and specific elements, accounts, or items of a financial statement	CAS 805	Other assurance engagement	Reasonable
Engagement to report on summary financial statements	CAS 810	Other assurance engagement	Reasonable
Report on controls at a service organization	CSAE 3416	Other assurance engagement	Reasonable
Attestation engagements to report on compliance	CSAE 3530	Other assurance engagement	Reasonable or limited
Direct engagements to report on compliance	CSAE 3531	Other assurance engagement	Reasonable or limited
Audit report on compliance with agreements, statutes, and regulations	CSAE 3530/3531	Other assurance engagement	Reasonable
Audit of internal control over financial reporting that is integrated with an audit of financial statements	Section 5925	Other assurance engagement	Reasonable
Auditing for compliance with legislative and related authorities in the public sector	CSAE 3530/3531	Other assurance engagement	Reasonable

Service	Related reference	Type of engagement	Level of assurance
Assurance attestation engagement other than audits or reviews of financial statements and other historical financial information	CSAE 3000	Other assurance engagement	Reasonable or limited
Review of financial statements	CSRE 2400	Review engagement	Limited
Review of financial information other than financial statements	CSRE 2400	Review engagement	Limited
Auditor review of interim financial statements	Section 7060	Review engagement	Limited
Compilation (Notice to Reader)	Section 9200	Non-assurance engagement	No assurance provided
Compilation of a financial forecast or projection	AuG-16	Non-assurance engagement	No assurance provided
Report on results of applying specified auditing procedures to financial information other than financial statements	Section 9100	Non-assurance engagement	No assurance provided
Agreed-upon procedures regarding internal control over financial reporting	Section 9110	Non-assurance engagement	No assurance provided

Practice questions

1. Multiple-choice questions:

   i. Brianna, a student in the CPA program, has been asked to prepare a set of financial statements to enable the preparation of a tax return to be submitted to the Canada Revenue Agency. Which type of engagement is Brianna most likely completing?

      a) Review of financial statements
      b) Compilation
      c) Audit of financial statements
      d) Attestation / direct engagements to report on compliance

      Solution

      Option b) is **correct**. A compilation engagement under Section 9200 is often applicable when the financial statements are prepared for income tax purposes.

      Option a) is incorrect. A review of financial statements engagement under CSRE 2400 provides a moderate level of assurance, whereas the preparation of financial statements for a tax return does not require assurance.

Option c) is incorrect. An audit engagement provides a high (positive) level of assurance, whereas the preparation of financial statements for a tax return does not require assurance.

Option d) is incorrect. Attestation / direct engagements to report on compliance under CSAE 3530/3531 provide a reasonable or limited level of assurance, whereas the preparation of financial statements for a tax return does not require assurance.

ii. Abdullah, a student in the CPA program, is learning about the similarities between audit and review engagements. Which of the following statements is true?

a) Independence is required in both an audit and a review engagement.
b) Fraud risk is assessed in both an audit and a review engagement.
c) Obtaining an understanding of internal controls is required in both an audit and a review engagement.
d) Corroboration of management's representations is required in both an audit and a review engagement.

Solution

Option a) is **correct**. The practitioner must be independent to perform an audit and a review engagement because both engagements provide a level of assurance.

Option b) is incorrect. Fraud risks are evaluated in an audit engagement but not in a review engagement.

Option c) is incorrect. In an audit engagement, the auditor will obtain an understanding of internal controls, whereas in a review engagement, an understanding of internal controls is not required. In a review engagement, the practitioner will need to obtain an understanding of the industry in which the client operates.

Option d) is incorrect. In an audit engagement, the auditor will corroborate management's representations. In a review engagement, there is no requirement for the practitioner to corroborate management's representations.

2. Steven, a student in the CPA program, is reviewing the working paper files for a review engagement and a compilation engagement in order to understand the commonalities shared by the documents included in the working paper files for each type of engagement. In particular, Steven is examining the following documents:

   - the independence letter
   - a summary of the company's operations
   - the materiality level set for the engagement
   - the signed representation letter

   Required:

   Discuss whether each of the above documents is found in both the review and compilation working paper files or in the working paper files for only one of these engagements.

   Solution

   - In a review engagement, independence is a requirement because this engagement provides a level of assurance. Therefore, independence will need to be verified with an independence letter sent to the client and included in the working paper files. In a compilation engagement, independence is not a requirement. Therefore, an independence letter is neither sent to the client nor included in the working paper files.
   - In a review engagement, understanding of the company and its environment is a requirement. Therefore, a summary of the company's operations will be included in the working paper files. In a compilation engagement, understanding of the company and its environment is not a requirement. Therefore, a summary of the company's operations is not included in the working paper files.
   - Materiality level set for the engagement is found in the working paper files for a review engagement but not a compilation engagement.
   - A signed representation letter is found in the working paper files for a review engagement. It is not required for a compilation engagement; however, it is often completed and would be found in the working paper file.