

ACC531: Auditing and Assurance Services  
Ch1. Auditing and Assurance Services

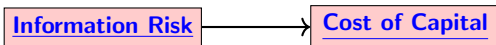
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- 1 User Demand for Reliable Information
- 2 Auditing, Attestation and Assurance Services
- 3 Management's FS assertions
- 4 Professional Skepticism

## LO 1-1

Define **information risk** and explain how the FS auditing process helps to reduce this risk, thereby reducing the **cost of capital** for a company.

- Information Risk:  $Prob(\text{info is false})$ .<sup>1</sup>
- Cost of Capital: The cost of raising capital from investors and creditors.<sup>2</sup>



→ Demand for FS audit to reduce information risk.

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<sup>1</sup>directly related to the accuracy of the info and audit risk.

<sup>2</sup>How much interest rate to pay for debt?

**EX.** Suppose a company wants to borrow \$1,000,000 for 10 years.

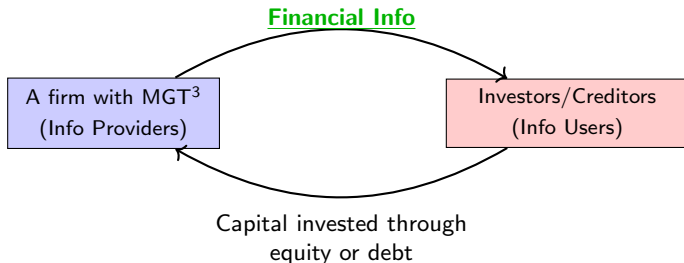
- Without an audit: The annual interest rate is 10%.
- With an audit: The annual interest rate can be reduced to 8%. Auditing fees are \$40,000 (one-time fee).
- Should the company pay for the audit?

Without audit:

- Every year, the company pays \$100,000 in interest.
- Total interest over 10 years: \$1,000,000

With audit:

- Every year, the company pays \$80,000 in interest.
- Total interest over 10 years: \$800,000
- Audit fees (one-time): \$40,000



Issues are:

- MGT has incentives to provide misleading, biased information.
- Information risk exists!

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<sup>3</sup>Management

### Theranos<sup>4</sup>

- was founded by Elizabeth Holmes in 2003 - a privately held health technology company.<sup>5</sup>
- claimed to have devised revolutionary blood tests using very small amounts of blood.
- was valued at \$9 billion in 2015.
- was dissolved in 2018.
- was charged with an "elaborate, years-long fraud" by the SEC.
- was never audited.

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<sup>4</sup>The Inventor: Out for Blood in Silicon Valley (2019) (YouTube Link)

<sup>5</sup>Audits were not required.

Bernard Madoff was<sup>6</sup>

- the operator of the largest Ponzi scheme in history.
- arrested in 2008.
- sentenced to 150 years in prison.

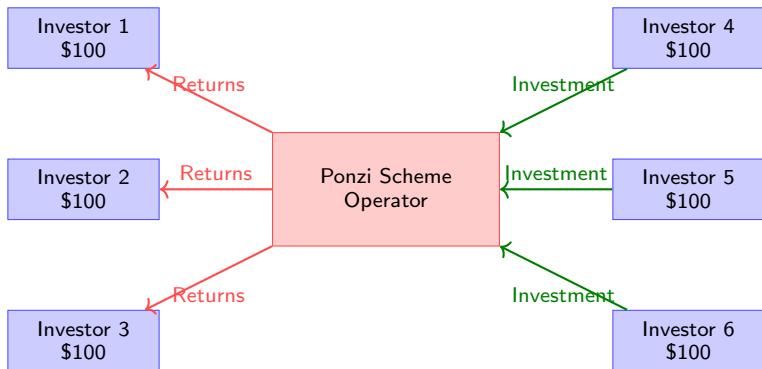
What happened?

- Madoff's firm reported consistently high returns (13~16% per year).
- The returns were too good to be true.
- The returns were not verified by an independent third party.
- The returns were not audited.

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<sup>6</sup>Bernard Madoff: The Wolf of Wall Street (2022) (YouTube Link)

# How a Ponzi Scheme Works



- New investors' money is used to pay returns to earlier investors.
- No real investment or profit generation occurs.
- The scheme collapses when new investors stop coming in.



# Why FS audits?

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When seeking capital from investors and creditors,

- MGT has incentives to make their firm's FS look better than they really are.
- MGT could misrepresent their financial position and results of operations.
- A potential conflict of interests<sup>7</sup> b/w MGT and investors/creditors exists.
- The users need assurance that they can rely on the information from MGT.

→ Demand for FS audit to reduce information risk.



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<sup>7</sup>MGT sometimes provides biased info while users need accurate info.

**Q.** Which of the following factors does **not** create a demand for external audit services?

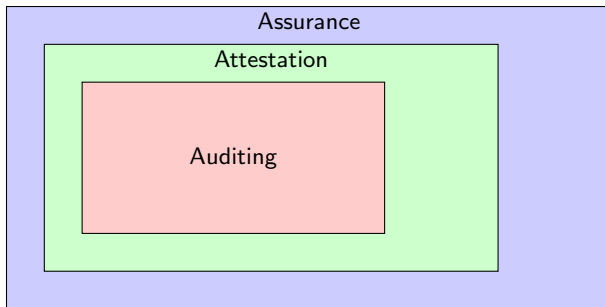
- a. Potential bias by management in providing information
- b. Requirements of the state boards of accountancy
- c. Complexity of the accounting processing systems
- d. Remoteness between a user and the organization

Answer: **B**

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## LO 1-2

Define and contrast assurance, attestation, and FS auditing services.



Assurance services are

- independent professional services that improve the quality of information.
- Examples: Assurance for...

Cybersecurity risk

XBRL reporting

Investment policies

Management policies

**Attestation** services are

- services where practitioners are requested to examine whether management's **assertions** about some type of subject matter can be relied upon.
- Examples: Attestation for...

MD&A<sup>8</sup>

Internal control systems

Compliance with regulations

ESG reporting

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<sup>8</sup>Management Discussion and Analysis (MD&A), included in quarterly and annual reports that provide information about the company's operations and financial performance.

A crude comparison:

	<b>Assurance Services</b>	<b>Attestation Services</b>
<b>Focus</b>	Improving info <u>quality</u> .	Evaluation of <u>assertions</u> .
<b>Opinion</b>	Not necessarily required.	Typically required.

Definition<sup>9</sup>: **Auditing** is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between the assertions and established criteria and communicating the results to interested users.

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<sup>9</sup>broadly defined by American Accounting Association (AAA) Committee on Basic Auditing Concepts



## Auditing is

- a systematic process of<sup>10</sup>
- objectively obtaining and evaluating evidence<sup>11</sup>
- regarding assertions about economic actions and events to<sup>12</sup>
- ascertain the degree of correspondence between the assertions and established criteria and<sup>13</sup>
- communicating the results to interested users<sup>14</sup>.

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<sup>10</sup> Auditing is a process!

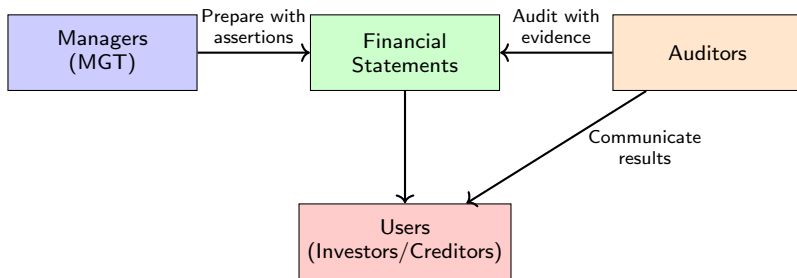
<sup>11</sup> Obtaining and evaluating high-quality evidence is a key to audit success.

<sup>12</sup> Think about assertions made for journal entries and transactions.

<sup>13</sup> Assertions should be made in accordance with the established criteria (e.g., US. GAAP).

<sup>14</sup> Communication through audit reports including audit opinions.

- FS is prepared by management.
- It includes management's assertions.
- Auditors obtain evidence and evaluate management's assertions to determine whether the FS are presented fairly based on the evidence obtained.
- Auditors communicate the results to interested users through audit reports including audit opinions.



Examples: if managers of a company asserted that...

- ...its **inventory** was \$1 million, the auditor would obtain evidence to determine whether the inventory was actually \$1 million.
- ...its **cash balance** was \$10 million, the auditor would have to verify with the bank that the company did in fact have \$10 million of cash in the bank.
- ...its **allowance for doubtful accounts** was \$5 million, the auditor would obtain evidence to confirm this assertion.

The more specific viewpoint of external auditors<sup>15</sup>: The purpose of an audit is to provide FS users with an opinion by the auditor on whether the FS are presented fairly, in all material respects, in accordance with the applicable financial reporting framework, which enhances the degree of confidence of intended users in the FS.

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<sup>15</sup>by AICPA. The previous definition by AAA is broad and general enough to encompass external, internal, and even governmental auditing.

**Q (T/F).** The sole responsibility of management with regard to financial reporting involves preparing and presenting financial statements in accordance with the applicable financial reporting framework.

Answer: **True**

**Q.** Which of the following are the responsibilities of the external auditor in auditing financial statements?

- a. Maintaining internal controls and preparing financial reports
- b. Providing internal assurance on internal control and financial reports
- c. Providing internal oversight of the reporting process
- d. Providing independent assurance on the financial statements

Answer: **D**

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<sup>16</sup> Exercise questions may either 1) test your understanding or 2) introduce additional knowledge beyond what has previously been covered.

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## LO 1-3

Describe and define the **assertions** that management makes about the **recognition**, **measurement**, presentation, and disclosure of the FS and explain why auditors use them as the focal point of the audit.

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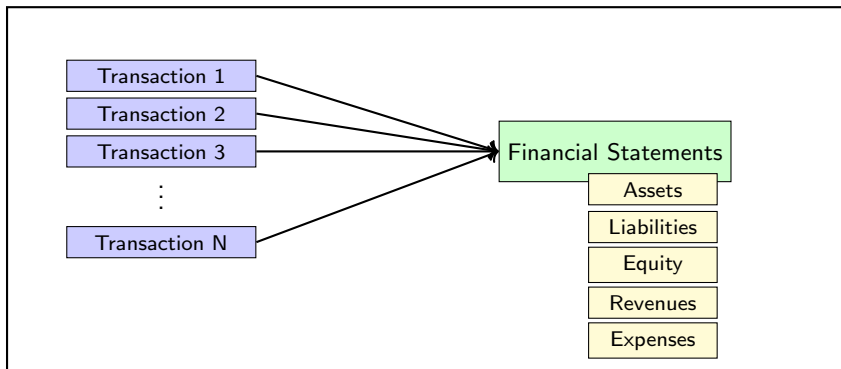
<sup>17</sup> Additional references for this section:

- ① Messier et al. Auditing & Assurance Services, 2025 release (pp.127-131).
- ② Whittington and Pany. Principles of Auditing & Other Assurance Services, 2024 release (pp.160-162).
- ③ Zehm et al. Auditing: A Risk-based Approach, 12th edition (pp.230-233).

# Accounting

Accounting is...

- the process of recording, classifying, and summarizing a company's transactions into FS that include five key accounts: assets, liabilities, equity, revenues, and expenses.
- the means of satisfying users' demands for financial information.





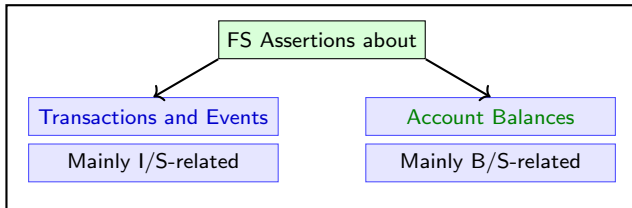
FS is prepared by management, not by auditors.

- ➊ MGT's responsibility: to prepare the FS.
- ➋ Auditors' responsibility: to audit the FS.

Wirecard: Missing Cash (YouTube Link)

According to ASB<sup>18</sup>, FS includes management's assertions about.

- ① transactions and events<sup>19</sup> that occurred during the period being audited.
- ② account balances<sup>20</sup> at the end of the period.



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<sup>18</sup> ASB: Auditing Standards Board.

<sup>19</sup> including related disclosures

<sup>20</sup> including related disclosures

# MGT's assertions (by ASB)

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## Assertions about Transactions and Events

Occurrence

Completeness

Cutoff

Accuracy

Classification

Presentation

## Assertions about Account Balances

Existence

Completeness

Accuracy, Valuation & Allocation

Rights & Obligations

Classification

Presentation

### Occurrence

Transactions and events that have been recorded or disclosed have occurred.

- Did they really occur?
- MGT might have incentives to overstate revenues.

**EX.** MGT asserts that all revenue transactions recorded during the period actually occurred. Otherwise, REVENUES would be overstated. Auditors need to verify the sales invoices with customers.

### Completeness

Transactions and events that should have been recorded have been recorded, and all related disclosures that should have been made have been made.

- Are all of them recorded? Anything missing?
- MGT might have incentives to understate expenses and liabilities.

**EX.** MGT asserts that all expense-related transactions that should have been recorded have been recorded. Otherwise, EXPENSES would be understated.

**Note:** auditors' concern with the completeness is opposite the concern for the occurrence.

### Cutoff

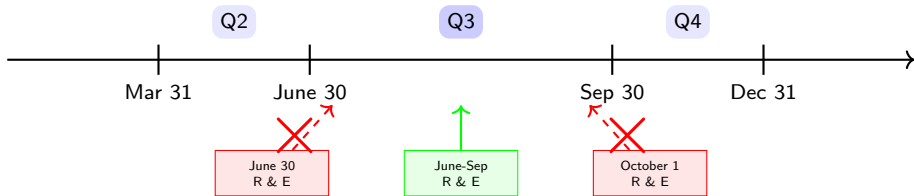
Transactions and events are recorded in the proper period (neither postponed nor accelerated).

- Are the transactions and events recorded in the proper period?
- MGT might have incentives to accelerate revenues while delaying expenses.

**EX.** An auditor want to test proper cutoff of revenue transactions at Dec 31, 2024. The auditor can examine a sample of shipping documents and sales invoices for a few days **before and after year-end** to test whether the sales transactions are recorded in the proper period. The objective is to determine that all 2024 sales (and no 2025 sales) have been recorded in 2024.

Examples:

- R & E on June 30 shouldn't be recorded in Q3 (July-September).
- R & E on October 1 shouldn't be recorded in Q3 (July-September).





### Accuracy

Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been made appropriately.

- Are the amounts recorded appropriately?
- MGT might have incentives to inflate the amounts of revenues.

**EX.** MGT asserts that the amount recorded for the cost of a new machine includes its purchase price plus all reasonable costs to install it. Otherwise, the cost of the new machine might have been understated. If the cost is not capitalized, expenses might have been overstated. Net income might have been understated.<sup>21</sup>

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<sup>21</sup>Capitalization: The expenditure is capitalized as an asset and later depreciated over its useful life. It is NOT expensed in the period of purchase.

### Classification

Transactions and events have been recorded in the proper accounts.

- Are the transactions and events recorded in the proper accounts?
- MGT might have incentives to misclassify transactions.

**EX.** MGT asserts that maintenance costs to repair a machine that do not add to its usefulness are properly charged to the repairs and maintenance expense account and not to the machine asset account. Otherwise, the machine asset would be overstated. Expenses would be understated. Net income would be overstated.

### Presentation

Transactions and events are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

- Are the transactions and events appropriately presented and disclosed?
- MGT might have incentives to obscure information in disclosures.

**EX.** MGT asserts that the company's revenue is appropriately aggregated or disaggregated and clearly described. Otherwise, the revenue would be misrepresented.

# MGT's assertions (by ASB)

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## Assertions about Transactions and Events

Occurrence

Completeness

Cutoff

Accuracy

Classification

Presentation

## Assertions about Account Balances

Existence

Completeness

Accuracy, Valuation & Allocation

Rights & Obligations

Classification

Presentation

### Existence

The ending balances of A, L, and SHE accounts included in the FS actually exist at the date of the FS.

- Auditors must test whether the B/S reported as assets, liabilities, and equities actually exist.

**EX.** MGT asserts the existence of cash, inventory, and accounts receivables. Auditors need to check them.

- Verify cash balance with banks
- Count the physical inventory
- Verify accounts receivables with customers

### Completeness

All of the assets, liabilities, and equities that should have been recorded have been recorded.  
All related disclosures that should have been made have been made.

- Auditors must test whether all of the assets, liabilities, and equities that should have been recorded during the period were recorded.

**EX.** MGT asserts that all inventory, A/P, and N/P are recorded in the B/S. Auditors need to check them.

- Are all inventory items recorded?
- Are all accounts payable recorded?
- Are all notes payable recorded?

### Accuracy Valuation and Allocation

A, L, and SHE included in the F/S are at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded. Recorded Related disclosures have been appropriately measured and described.

- Auditors must test whether all of the assets, liabilities, and equities that should have been recorded during the period were recorded.

**EX 1.** MGT asserts that inventory is carried at the lower of cost or market value on the B/S. Auditors need to ensure this. Errors could inflate or deflate net income.

**EX 2.** MGT asserts that the cost of PPE is systematically allocated to appropriate accounting periods. Auditors need to ensure this. Errors could inflate or deflate net income.

**EX 3.** MGT asserts that it is evaluating collectibility of accounts receivables to record accurate net A/R. Auditors need to ensure this. Errors could inflate or deflate net income.

### Rights and Obligations

A firm has ownership rights for assets reported in the F/S and obligations for liabilities reported in the F/S.

To test this assertion:

- Auditors must obtain evidence that the assets are really owned and that the liabilities are really owed by the company.

**EX 1.** MGT asserts that it owns its inventory. Auditors need to ensure this. For example, if consigned inventory is recorded as inventory, inventory account would be overstated.

**EX 2.** For leased assets, MGT asserts that it has the right to use the asset. The company should include lease liabilities on the B/S as well. Auditors need to ensure this.<sup>22</sup>

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<sup>22</sup>While the ownership isn't transferred, the company has the right to use the asset and is obligated to pay the lease payments. So they have both rights and obligations.



### Classification

A, L, and SHE have been recorded in the proper accounts.

**EX.** MGT asserts that the proportion of long-term debt shown as a current liability will mature in the current year. A proper classification should be made. Otherwise it affects important financial ratios such as current ratio.

### Presentation

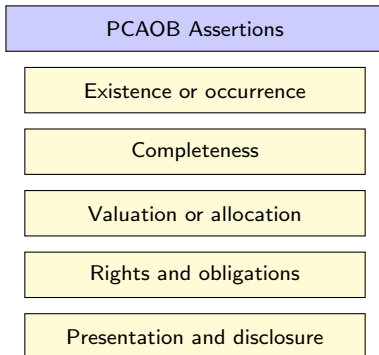
A, L, and SHE have been appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

**EX.** If a company has the right to use the licenses (i.e., intangible assets) for 10 years, these assets would be amortized over 10 years and would be aggregated and reported at their net value as long-term assets on the B/S. The nature of the licenses, the life-span, and amortization schedule should also be properly disclosed.

# Management assertions by PCAOB

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- ASB provides two sets of assertions, 1) transactions and events; 2) account balances.<sup>23</sup>
- PCAOB provides a combined set of assertions while aligning with ASB's assertions.<sup>24</sup>



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<sup>23</sup>Standards issued by ASB (Auditing Standards Board) are applicable to private companies in the United States.

<sup>24</sup>PCAOB (Public Company Accounting Oversight Board) is an independent, non-profit organization that oversees the audit of public companies in the United States.

**EX.** MGT asserts that it has PPE, net of depreciation of \$42 million. The following assertions are made by MGT:

- Existence: The PPE is physically present.
- Completeness: All purchases of PPE are fully recorded.<sup>25</sup>
- Rights and obligations: It owns the PPE and has title to the equipment.
- Valuation: The PPE is properly valued at cost with applicable allowances for depreciation.
- Presentation and disclosure: The PPE is appropriately classified and described.

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<sup>25</sup>No PPE is omitted.

# Management assertions by PCAOB and ASB

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Complete the matching between PCAOB and ASB assertions.

## Assertions about Transactions and Events

Occurrence

Completeness

Cutoff

Accuracy

Classification

Presentation

## Assertions about Account Balances

Existence

Completeness

Accuracy, Valuation & Allocation

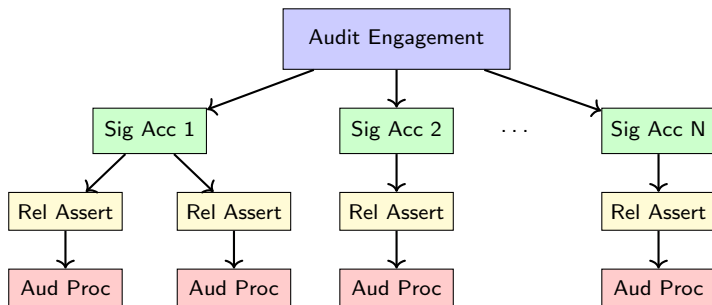
Rights & Obligations

Classification

Presentation

# Importance of Assertions: The focal point of the audit

- Auditors must identify each significant account or disclosure in the FS.<sup>26</sup>
- Auditors must consider the relevance of each FS assertion, one at a time.<sup>27</sup>
- Audit procedures are specified to obtain evidence about each of the relevant assertions.



<sup>26</sup> deemed significant if there's a reasonable possibility that the account or disclosure could contain a material misstatement.

<sup>27</sup> deemed relevant if there's a reasonable possibility that a material misstatement exists related to that assertion for the significant account.

**NOTE 1.** Which assertions are relevant to an identified sig account? It depends on.

- Valuation may not be a relevant assertion for CASH for a small domestic company.
- Valuation may be a relevant assertion for CASH if foreign currency translation is involved.
- Thus, a comprehensive understanding of the business and the industry is required to determine which assertions are relevant to an identified significant account.

In general,

- Assets and revenues are more likely to be overstated. So existence and occurrence assertions are more likely to be relevant for those accounts.
- Liabilities and expenses are more likely to be understated. So completeness assertions are more likely to be relevant for those accounts.
- Accounts that require subjective judgments by MGT will usually have valuation as a more relevant assertion as the valuation assessment is subject to MGT bias.<sup>28</sup>

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<sup>28</sup>e.g., Allowance for loan loss reserve; allowance for doubtful accounts; allowance for inventory obsolescence.

**EX 1.** MGT asserts that the sales revenue recorded in the I/S represents all valid sales transactions that occurred during the period. The auditor is concerned that MGT may have an incentive to overstate sales revenue<sup>29</sup>. A common method for overstating sales revenue would be for MGT to record the first week's sales in 20X1 in the current period 20X0 (i.e., accelerating the revenue recognition). The revenue from the first week's sales in 20X1 did not occur during the current period, thus MGT violated the occurrence assertion.

**EX 2.** MGT asserts that all accounts payable are completely and accurately recorded in the FS. Suppose the company is close to violating a debt covenant that limits the ratio of total liabilities to equity. In this situation, MGT may have an incentive to **understate** accounts payable (e.g., by delaying the recording of vendor invoices) to present a lower liabilities. If such payables are omitted or recorded late, the completeness assertion for accounts payable is violated.

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<sup>29</sup>e.g., bonus contingent on sales performance



## Examples of assertions

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**EX 3.** MGT asserts that all inventory recorded on the FS is owned by the company. Suppose inventory physically located in the company's warehouse<sup>30</sup> is included in the inventory account even though legal title has not passed to the company. In this case, inventory is *overvalued* because it includes items not actually owned. This violates the rights and obligations assertion for inventory.<sup>31</sup>

**EX 4.** MGT might improperly undervalue bad debt expense and the allowance for doubtful accounts in order to show higher net income. This violates the valuation assertion for bad debt expense and the allowance for doubtful accounts.

**EX 5.** MGT might assert that long-term liabilities in the B/S will not mature within the next year while they actually will mature within the next year. This violates the classification assertion.<sup>32</sup>

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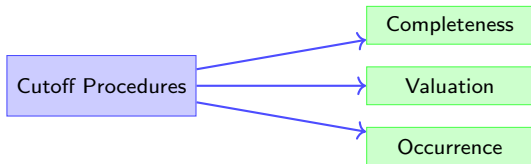
<sup>30</sup>e.g., consigned goods; goods that they need to return to the vendor

<sup>31</sup>Overvalued inventory leads to lower Cost of Goods Sold and higher net income.

<sup>32</sup>This assertion is considered "Presentation and disclosure" in PCAOB assertions as it encompasses the proper classification of the financial information in the FS.

**NOTE 2.** An audit procedure may provide evidence about more than one assertion.

- For example, although cutoff procedures provide evidence about completeness, they also provide evidence about valuation and occurrence.
  - ▶ Prematurely recording sales transactions inflates revenue and/or asset values because the transaction did not occur by the income statement date.
  - ▶ If a cutoff test shows a delay in recording a liability, the liability is not only incomplete but undervalued as well.
- Thus, errors in FS may affect multiple management assertions.



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## LO 1-4

Define **professional skepticism** and explain its key characteristics.

**Professional skepticism** is defined as having an attitude that includes

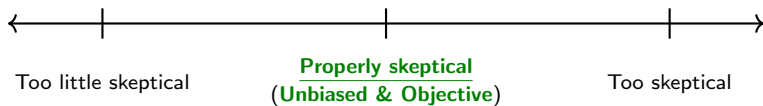
- a questioning mind and
- a critical assessment of evidence.

Auditors should

- **Not** accept MGT's assertions without corroboration.
- Ask MGT to "prove" each of relevant assertions with documentary evidence.
- Be aware of potential conflicts of interest between auditors and MGT because
  - ▶ MGT may have incentives to provide biased information.
  - ▶ Auditors must ensure that the information about the company's FS is "presented fairly."
- Be professionally skeptical throughout the entire audit process.

However, being professionally skeptical does not mean adversarial or confrontational.

- Indeed, the vast majority of audits do not contain fraud.
- Auditors should be unbiased and objective.



Indeed, auditors

- Rely on information obtained from MGT.
- Test it by obtaining sufficient, appropriate [audit evidence](#).
- Arrive at the most appropriate conclusion.

Properly skeptical auditors ask questions such as:

- ❶ What do I need to know?
- ❷ How well do I know it?
- ❸ Does it make sense?
- ❹ What could go wrong?