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The auditing profession

Who are auditors and why are they important? These first four chapters provide background for performing strategic financial statement audits, which is our primary focus. This background will help you understand why auditors perform audits the way they do.

Our book begins with a who's who of assurance services, including auditing, and the role of accountants, public accounting firms, and other organizations in doing audits. The chapters in Part 1 emphasize the regulation and control of public accounting through auditing and ethical standards and discuss the legal responsibilities of auditors. We also talk about audit reports, which are the final products of audits.

1 The demand for an auditing and assurance profession

Don't all accountants do the same thing? No, not really. There are well-trained accountants who do only accounting, accountants who do auditing (public accountants or internal auditors), and accountants who have many other specializations, such as financial planning or forensics. This chapter will talk about many different types of accountants. You can use this information to help you consider the focus that your accounting career will take.

LEARNING OBJECTIVES

1 Identify the components of an audit and explain why there is a demand for audits. Explain the strategic differences between accounting and auditing, contrasting professional risks and rewards.

2 Link the nature of assurance services to examples of actual services provided. Distinguish audit engagements from other assurance and non-assurance services. Consider why financial statement auditors rely upon internal auditors.

3 Explore the different types of accountants and what they do.

Why Do Auditing?

It has been a busy day for Rong, Celia, Matt, and Ruyan. Their auditing professor gave them the assignment of finding the firm that they wanted to work for as their dream job, and they have spent a few hours each poring through a variety of websites. They each discovered unusual things that auditors do, and are excited about the potential opportunity. Let us hear what each of them has decided.

Rong wants to move to Ottawa and join the federal Office of the Auditor General's (OAG) team. "They do so many different types of audits! They audit the biggest financial statement in Canada, the government of Canada itself, with a team headed by several Directors. The *June 2011 Status Report of the Auditor General of Canada* describes several special examinations that were conducted, with diverse organizations and purposes. One of these was an insurance company, the Canada Deposit Insurance Corporation (CDIC), which helps protect savings of individuals in the event that a bank fails. The OAG found that the CDIC was doing its job well, they assessed whether 'assets are safeguarded and controlled.' Two other organizations did not do as well in that report. There were 'deficiencies' at the Freshwater Fish Marketing Corporation and the National Arts Centre Corporation. I think it would be really interesting auditing these large organizations that have an impact upon our lives."

Celia is interested in working with information systems and new technology companies. She wants to specialize in computer consulting or computer auditing. She chose one of Canada's largest CA (Chartered Accountant) public accounting firms, KPMG. This is how she explains her choice. "Information technology is an international language. If you specialize in tax, it changes from country to country, but computing technologies are international. So, by specializing in technology, I can work with any of the industries that KPMG specializes in. They do say on their website that they have an industry focus on several industries including information, communications, and entertainment. I like to travel, so if I worked for an international company, I could transfer to Hong Kong, Japan, Bermuda, or other parts of the world once I qualify as a CA and public accountant."

Matt is an entrepreneur at heart, and thinks that by working with the small business sector, he will be working with the fastest-growing sector of the economy. "Porter Hetu International is a CGA (Certified General Accountants) public accounting firm. They work with small and medium-sized organizations and individuals. It's great that the firm was started by two individuals, one a

Sources: 1. KPMG home page, **www.kpmg.com/ca/en**. 2. KPMG "Information, Communications and Entertainment (ICE)," **www.kpmg.com/Ca/en/WhatWeDo/Industries/ICE/Pages/default.aspx**. 3. Ministry of Finance April 1, 2010 Organizational Structure, **www.fin.gov.on.ca/en/about/rbplanning/rbp2010-11_orgchart.pdf**. 4. 2011 Status Report of the Auditor General of Canada, Chapter 7 – Special Examinations of Crown Corporations – 2010, **www.oag-bvg.gc.ca/internet/English/parl_oag_201106_07_e_35375.html**. 5. Office of the Auditor General of Canada, web page titled About Us, **www.oag-bvg.gc.ca/internet/English/au_fs_e_43.html**. 6. Porter Hetu International home page, **www.porterhetu.com/**. All accessed: June 27, 2011.

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French-Canadian and the other English-speaking. The firm is relatively young (founded in 1988), so I expect them to be rapidly responsive to businesses. I would like to specialize in tax once I obtain my CGA and public accounting designation. I know that many public accounting firms offer tax services, but working with an organization that focuses on small business is the way to go for me."

Ruyan wants to get to know a single organization very well so that she can help improve the way the organization functions and provide regular advice to management. "I think I want to be part of an internal audit team. Internal audit teams can be small, from one or two people, to large groups that are as big as an accounting firm, consisting of hundreds of people! I found the organization chart for the Ontario Ministry of Finance, which includes the Ontario Internal Audit Division for the province of Ontario. The Internal Audit Division has 11 different teams, including health, education, justice, and finance and revenue. I think if I worked on one of those teams that I could help the province run better."

WHAT DO YOU THINK?

1. What kind of audit specialization are you interested in?
2. Once you have your university degree, what kind of accounting designations would you pursue?
3. Who can you talk to so that you can learn more about your choices and decide on your future career path in public accounting or auditing?

PROFESSIONAL accountants assess risks of errors or fraud, provide examinations of controls, audit financial statements, and help businesses be more successful. As businesses become more complex and need more reliable information, auditors play a vital role, both in providing assurance on information other than financial statements and in providing business advisory and tax services. For example, businesses and consumers who use information technology and electronic communication networks such as the internet to conduct business and make decisions are concerned about the risks of unauthorized access to systems. Auditors are valued because of their technical knowledge and independence in providing assurances about such access, as well as their competence and experience in assisting companies to improve operations. Auditors often make and help implement recommendations that improve profitability by enhancing revenue or reducing costs, by reducing risks of errors and fraud, and by improving operational controls.

1 Nature and Relevance of Auditing

To audit effectively, you need to learn the rules and procedures—the science—of auditing, after you have studied accounting, tax, finance, and management information systems. In addition, you need to practise this knowledge in a variety of situations and gain experience in the real world. The defined practice of **auditing**, below, includes several key words and phrases.

Auditing—the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria.

AUDITING **is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person.**

We will now look at each of these key phrases in turn.

INFORMATION AND ESTABLISHED CRITERIA To do an audit, there must be information in a verifiable form and some standards (criteria) by which the auditor can evaluate the information. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' federal income tax returns. Auditors also perform audits of more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria against which information is evaluated vary depending on the information being audited. For example, in the audit of historical financial statements by public accounting firms, the criteria are an accounting framework such as International Financial Reporting Standards (IFRS) or Accounting Standards for Private Enterprises (ASPE). To illustrate, this means that in the audit of RONA Inc.'s (**www.rona.ca**) financial statements, Raymond Chabot Grant Thornton LLP, the public accounting firm (**www.rcgt.com**), determines whether RONA Inc.'s financial statements have been prepared in accordance with the IFRS accounting standards. **Canada Revenue Agency auditors** use the provisions of the Income Tax Act to audit tax returns. In the audit of RONA's corporate tax return by the Canada Revenue Agency, the Income Tax Act, rather than an applicable reporting framework, would provide the criteria for assessment.

Canada Revenue Agency auditor—an auditor who works for the Canada Revenue Agency and conducts examinations of taxpayers' returns.

For more subjective information, such as auditing the effectiveness of computer operations, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For a computer application, the criteria might, for example, include the absence of input or output errors.

ACCUMULATING AND EVALUATING EVIDENCE **Evidence** is defined as any information used by the auditor to assess whether the information being audited is stated in accordance with the established criteria. The quality and amount of evidence collected depends upon the risks of misstatement. The auditor devises an **audit strategy** to effectively plan the evidence-gathering process. Evidence takes many different forms, including oral representation of the auditee (client), written communication with outsiders, and observations by the auditor. Certain evidence (from a third party) is considered more reliable than other evidence (from the client). It is important to obtain a sufficient quality and volume of evidence to mitigate the risks of the audit. The process of determining the amount of evidence necessary and evaluating whether the information corresponds to the established criteria in the context of identified

Evidence—any information used by the auditor to assess whether the information being audited is stated in accordance with established criteria.

Audit strategy—a planned approach to the conduct of audit testing, taking into account assessed risks.

risks is a critical part of every audit. This means that the strategic audit approach is the primary subject of this text.

COMPETENT, INDEPENDENT PERSON The auditor must be qualified to understand the engagement risks and the criteria used. This includes competence in selecting the types and amount of evidence to accumulate and effectively evaluating evidence to reach the proper conclusion. The auditor also must be independent in mind and appearance. Independence is discussed further in Chapter 3. The competence of the individual performing the audit is of little value if he or she is biased in the accumulation and evaluation of evidence. Requirements in Canada vary, since public accounting is a provincial jurisdiction. In those provinces (such as Ontario, Quebec, Newfoundland, and Nova Scotia at time of writing) where a licence is required, the public accountant would be termed an LPA (licensed public accountant).

Independent auditor—a public accountant or accounting firm that performs audits of commercial and non-commercial entities.

Internal auditor—an auditor employed by a company to audit for the company's board of directors and management.

Independent auditor's report—the communication of audit findings to users.

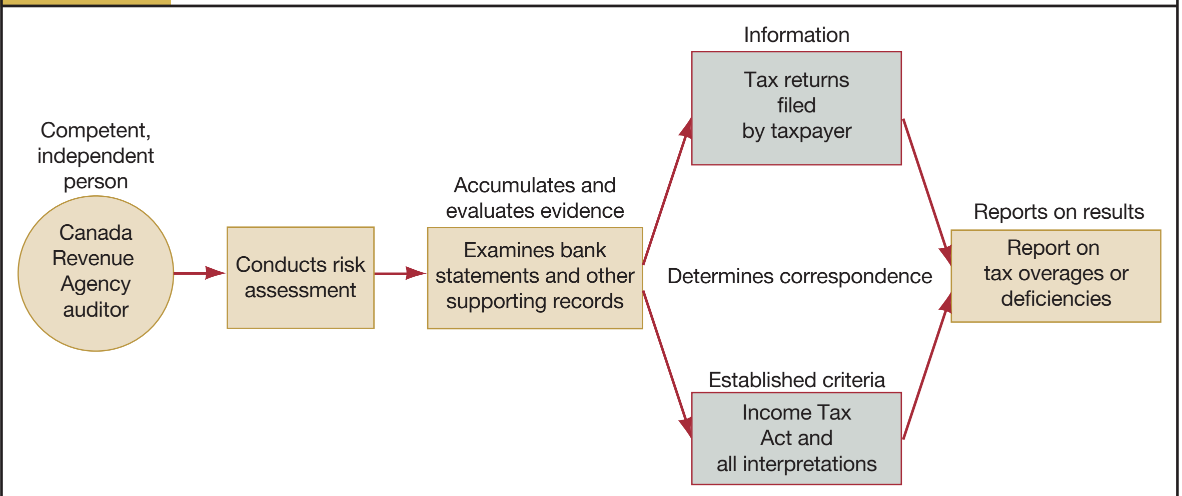
Auditors reporting on company financial statements are often called **independent auditors**. Even though an auditor of published financial statements is paid a fee by a company, he or she is normally sufficiently independent to conduct audits that can be relied on by users. Absolute independence is impossible, but auditors strive to maintain a high level of independence to keep the confidence of users relying on their reports. Although **internal auditors** work for the company, they usually report directly to the audit committee to help maintain independence from the operating units being audited.

REPORTING The final stage in the audit process is the **independent auditor's report**—the communication of the audit findings to users. Reports differ in nature, but in all cases they must inform readers of the degree of correspondence between information and established criteria. Reports also differ in form and can vary from the auditor's standard opinion usually associated with financial statements to a customized report in the case of an audit of effectiveness.

Figure 1-1 summarizes the important ideas in the definition of auditing by illustrating an audit of an individual's tax return by a Canada Revenue Agency auditor.

The objective is to determine whether the tax return was prepared in a manner consistent with the requirements of the Income Tax Act. The auditor first considers the potential risk of incorrect or fraudulent tax reporting by comparing the statistics of the tax return with other tax returns and by considering factors such as the taxpayer's industry and past income. The auditor next examines supporting records provided by the taxpayer and from other sources, such as the taxpayer's employer or bank. After completing the audit, the Canada Revenue Agency (**www.cra-arc.gc.ca**) auditor will issue a report to the taxpayer assessing additional taxes, advising that a refund is due or stating that there is no change in the status of his or her return.

Figure 1-1 Audit of a Tax Return



auditing in action 1 - 1

Fraud Fighters: Demand for Forensic Accountants Remains Strong through Economic Downturn

When Ron Forster conducts interviews, he watches his subjects as much as he listens to them. Even a seemingly innocuous gesture—an interviewee moving his hand away from his face before answering a sensitive question—could be a sign the subject is lying. Mr. Forster is a forensic accountant, a growing subset of the accounting field focused on uncovering financial fraud.

And while forensic accountants do their share of number crunching and computer analysis, they also do work that resembles television crime show investigations. "Forensic accountants are really financial detectives," says Alex Brown of the United Kingdom Institute of Chartered Accountants' forensic group. Brown has worked on cases involving Caribbean money laundering, Eastern European smuggling, and major commercial disputes. Forensic accountants use rigorous accounting skills and a flair for investigation to sniff out fraud, uncover money laundering, and trace missing assets.

The day-to-day work of a forensic accountant involves interviewing key people, studying accounts and, increasingly, examining electronic documents. The ever-growing volume of such documentation means that there is now a new branch of forensic accounting. Specialist computing forensic experts often have a background in information technology and receive accounting training on the job.

Forensic accounting is booming and continues to expand through the recent global recession. Over a five-year period, the number of fraud examiners certified by the Association of Certified Fraud Examiners increased from just over 15,000 to nearly 25,000 with over 55,000 members as of June 2011. "During a declining economy, fraud activity often comes to light," says Marc Brdar, a forensic accountant in Pittsburgh. "Prosperity can hide a multitude of sins."

"I was attracted to forensic accountancy because, like science, you need to have investigative skills," says forensic trainee Amy Hawkins. "I really like the sleuthing side of the job, where you're finding out whodunit and where the money went." Forensic accountant Simon Bevan adds, "When you find that killer document, it 's a real reward for all your hard work."

Sources: Adapted from Association of Certified Fraud Examiners home page, **www.acfe.com**, accessed June 28, 2011. 2. Anya Sostek, "Fraud Fighters: Forensic Accountants on Front Line in Fight Against Fraud," *Pittsburgh Post Gazette,* March 29, 2009. 3. Amy McClellan, "Forensic Accountancy: Hot on the Trail of the Fraudsters," *The Independent,* April 26, 2006.

Distinction between Auditing and Accounting

Many financial statement users and members of the general public confuse auditing and accounting. The confusion occurs because most auditing is concerned with accounting information, and many auditors have considerable expertise in accounting matters. The confusion is increased by giving the title "public accountant" to individuals of any accounting designation who are qualified to perform the external audit function.

Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. The function of accounting is to provide certain types of quantitative information that management and others can use to make decisions. Accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. Accountants also help to develop the systems used to record an entity's economic events in a timely way and at a reasonable cost.

Accounting—the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making.

When auditing accounting data, the concern is with evaluating whether recorded information reasonably reflects the economic events that occurred during the accounting period within specified dollar ranges (called materiality). The auditor must look at the organization's planning methods and risks, including its strategies and economic niches, as discussed further in Chapter 6. Since accounting standards are the criteria for evaluating whether the accounting information is properly recorded, any auditor involved with these data must also thoroughly understand the rules, such as accounting principles used in particular accounting frameworks for the audit of financial statements. These principles are constantly evolving as business practices and standards change—there are different accounting standards for public companies, private enterprises, not-for-profit organizations, and public sector entities. Throughout this text, the assumption is made that the reader has already studied accounting principles and standards for the appropriate type of entity under discussion.

Economic Demand for Auditing

Businesses, governments, and not-for-profit organizations use auditing services extensively. Publicly accountable organizations, such as businesses listed on securities exchanges or large not-for-profit organizations, are legally required to have an annual financial statement audit.

A look at the economic reasons for auditing highlights why auditing is valuable. Consider a bank manager's decision to make a loan to a business. The decision will be based on such factors as previous financial relations with the business and the financial condition of the business as reflected by its financial statements. Assuming the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

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

Information risk—the risk that information upon which a business decision is made is inaccurate.

Auditing has no effect on either the risk-free interest rate or business risk. It can have a significant effect on information risk. If the bank manager is satisfied that there is low information risk, the risk is lowered and the overall interest rate to the borrower can be reduced. For example, assume a large company has total interest-bearing debt of approximately $1 billion. If the interest rate on that debt is reduced by only 1 percent, the annual savings in interest is $10 million. Many lenders such as banks require annual audits for companies with large bank loans outstanding.

As society becomes more complex, there is an increased likelihood that unreliable information will be provided to decision makers. There are several reasons for this: remoteness of information, bias and motives of provider, voluminous data, and the existence of complex exchange transactions.

Managers of businesses and the users of their financial statements may conclude that the best way to deal with information risk is simply to have the risk remain reasonably high. A small company may find it less expensive to pay higher interest costs than to increase the costs of reducing information risk (e.g., by having an audit).

For larger businesses, it is usually practical to incur such costs to reduce information risk. There are three main ways to do so:

1. The user may go to the business premises to examine records and obtain information about the reliability of the statements.
2. Management is responsible for providing reliable information to users. Users may evaluate the likelihood of sharing their information risk loss with management.
3. An independent audit is performed. This is the most common way for users to obtain more reliable information.

In addition to understanding accounting, the auditor must also possess expertise in risk assessment processes and the accumulation and interpretation of audit evidence. It is this expertise that distinguishes auditors from accountants. Determining the proper audit procedures that mitigate risks, deciding the number and types of items to test, and evaluating the results are tasks that are unique to the auditor.

concept check

C1-1 List and explain the five key elements of the definition of auditing.

C1-2 Explain the difference between accounting and auditing.

C1-3 Describe the economic reasons for conducting an audit.

2 Assurance and Non-Assurance Services

Figure 1-2 shows the relationship between assurance and non-assurance services. Audits, reviews, reports on the effectiveness of internal control over financial reporting, and attestation services on information technology are all examples of attestation services, which are a subset of assurance services. Management consulting services, depending upon their purpose, could be assurance or non-assurance, while tax and bookkeeping services are non-assurance services.

Assurance Services

Assurance engagements, or "assurance services," are independent professional services that improve the quality of information for decision makers. The assurance engagement is an assurance service where the auditor issues a report about the reliability of an assertion (such as financial statements) prepared by another party (such as management). Assurance services are valued because the assurance engagement provider is independent and is perceived as unbiased with respect to the information examined.

Assurance engagement—a service where a written communication is provided expressing an opinion about the reliability of an assertion made by another party; also called "assurance service."

Assurance services can be performed by auditors or by a variety of other professionals. For example, companies that perform television ratings are performing an assurance engagement. BBM Canada (**www.bbm.ca**), a not-for-profit television rating organization, and Nielsen Media Research Canada (**www.ca.nielsen.com**) conduct television rating studies. These organizations provide assurance that a specified number of viewers are watching the identified television shows. As shown in Table 1-1, for a television viewing attestation engagement, the information provided (the assertion) would be the number of viewers, while the reliability of the assertion is assessed using surveys or other technical tools.

Another example of a company that provides assurance services is the Canadian Council of Better Business Bureaus (CCBBB, **www.bbb.org/canada**). The CCBBB collects information about Canadian businesses. Some of the information is not

Figure 1-2 Relationships Among Assurance Services, Attestation Services, and Non-Assurance Services

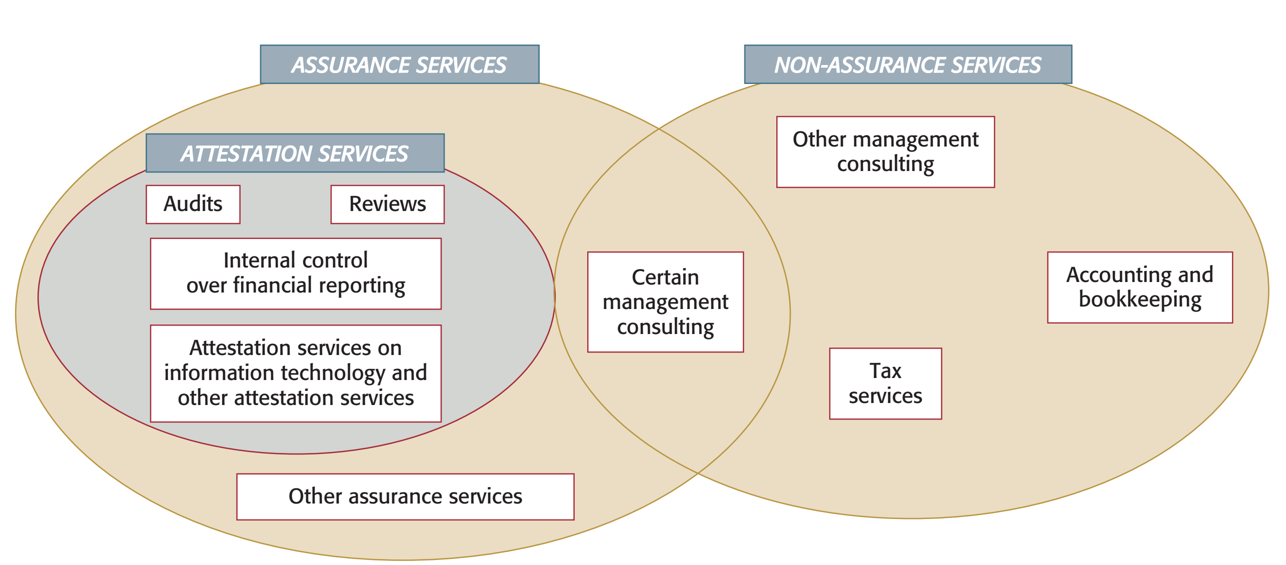


Table 1-1 Examples of Assurance Engagements That Are Also Attestation Engagements

Component of Engagement	Television Viewing Attestation Engagement	Financial Statement Attestation Engagement
Name of engagement	Attestation engagement, television rating study	Attestation engagement, financial statement audit
Name of third party (the client)	Television network, such as CTV Television Network	Management of the client, e.g., management of RONA, on behalf of the shareholders
Information provided by the client (what is being tested)	Circulation figures used to promote advertising	Annual and quarterly financial statements
Party providing assurance	BBM Canada	Financial statement auditor
Type of report issued	Reach report or demographic reach report	Independent Auditor's Report

verified (and so would be considered equivalent to a compilation engagement, discussed below), while other information, such as details about current business scams, are verified, providing assurance regarding the specifics of those illegal activities.

The need for assurance is ongoing. Auditors have provided assurance services for years, particularly for historical financial statement information. Accounting firms have also performed assurance services related to lotteries and contests to provide assurance that winners were determined in an unbiased fashion in accordance with contest rules. More recently, auditors have been expanding the types of assurance services they perform, such as assurance engagements about company financial forecasts, website controls, and the security of information. The demand for assurance services is expected to grow as the demand for forward-looking information increases and as more real-time information becomes available through the internet.

Attestation service—a special form of assurance engagement, such as a financial statement audit, in which the auditor evaluates the information provided by one party, using suitable criteria, and issues a report about the reliability of this information to another party.

A large category of assurance services provided by accounting firms is attestation services. The **attestation service** or engagement is a particular form of assurance service in which the auditor evaluates the information provided by one party, using suitable criteria, and issues a report about the reliability of this information to another party. Here, we use five categories to discuss attestation services:

1. Audit of historical financial statements.
2. Review of historical financial statements.
3. Attestation on internal control over financial reporting.
4. Attestation services on information technology.
5. Other attestation services that may be applied to a broad range of subject matter.

AUDIT OF HISTORICAL FINANCIAL STATEMENTS Audits of historical financial statements are a major service provided by public accounting firms. In an audit of historical financial statements, management states that the statements are fairly stated in conformity with an applicable financial reporting framework. Table 1-1 shows (using the definition of auditing) that the responsible third party for the audit of financial statements is management. The auditor's report expresses an opinion on whether those financial statements conform, in all material respects, with the specified financial reporting framework. External users of financial statements rely on the auditor's report for their decision-making purposes.

Publicly traded companies in Canada are required to have audits of their financial statements. Auditor reports can be found in the public company's annual report, and many companies' audited financial statements can be accessed via the internet from System for Electronic Document Analysis and Retrieval (SEDAR) at **www.sedar.com**. This website, developed by the Canadian Securities Administrators (CSA) and CDS Inc., a subsidiary of the Canadian Depository for Securities Limited, has been available

auditing in action 1 - 2

Green Initiatives Bring Assurance Opportunities, Competition

Global interest in sustainability and corporate responsibility has triggered a surge in corporate reports that address these topics. In a 2008 KPMG survey, 80 percent of the Global Fortune 250 released environmental, social, and governance data in standalone reports or integrated into annual financial reports, up from 50 percent in the last survey three years earlier. Over half of these reports included some form of commentary or formal assurance on the reports. Reports with formal assurance increased from 30 percent to 40 percent over the three year period. Major accounting firms were the most common choice of assurance provider. Other assurance providers included certification bodies and technical expert firms.

A proposed new Canadian Standard on Assurance Engagements, CSAE 3410, Assurance Engagement on Greenhouse Gas Statements, will likely be issued, based upon the parallel international standard on assurance engagements. The purpose of the standard is to identify the field work required for auditors to provide assurance about greenhouse gas statements issued by management or others.

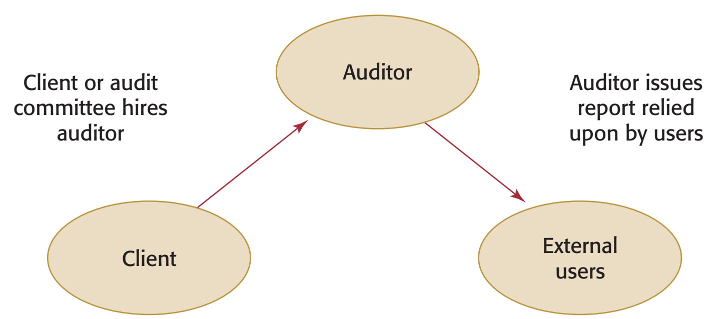
Source: Adapted from KPMG International Survey of Corporate Responsibility Reporting 2008, KPMG Sustainability Services, KPMG LLP; Exposure Draft, Assurance Engagements on Greenhouse Gas Statements, March 2011, Canadian Auditing and Assurance Standards Board.

since 1997. It contains public filings, such as annual reports, management discussion and analysis, and press releases from public companies. Most public companies also have a website where copies of financial statements are posted. The auditor's report on financial statements is carefully worded to provide information to users (as discussed further in Chapter 20). The report lists the financial statements being audited and the responsibility of the auditors and management, and briefly describes how an audit is conducted before providing the auditor's opinion.

Many privately held companies also have annual financial statement audits to obtain financing from banks and other institutions. Government and not-for-profit organizations often have audits to meet the requirements of lenders or funding sources.

External users, such as shareholders and lenders, who rely on those financial statements to make business decisions, look to the independent auditor's report as an indication of the statements' reliability. They value the auditor's assurance because of the auditor's independence from the client, expertise, and knowledge of financial statement reporting matters. Figure 1-3 illustrates the relationships among the auditor, client, and financial statement users.

Figure 1-3 Relationships Among Financial Statement Auditor, Client, and External Users



REVIEW OF HISTORICAL FINANCIAL STATEMENTS Many smaller, non-public companies want to issue financial statements to various users at a lower cost than an audit. They use a review, which provides a much lower degree of assurance than an audit. For a review, management also states that the financial statements are fairly stated in conformity with an applicable financial reporting framework, the same as for audits. A review provides moderate assurance, with the result that the public accountant (PA) provides a conclusion on the financial statements produced, rather than an opinion. Accordingly, the PA is required to do considerably less work than in an audit so the resulting cost is less. Reviews are discussed in more detail in Chapter 21.

ATTESTATION ON INTERNAL CONTROL OVER FINANCIAL REPORTING For an attestation on internal control over financial reporting, management states that internal controls have been developed and implemented following well-established criteria. Section 404 of the Sarbanes-Oxley Act in the United States requires publicly listed companies to report management's assessment of the effectiveness of internal control. The Act also requires auditors to evaluate management's assessment, which is an attestation of the effectiveness of internal control over financial reporting. This evaluation, which is integrated with the audit of the financial statements, increases user confidence about future financial reporting because effective internal controls reduce the likelihood of future misstatements in the financial statements. Canadian subsidiaries of U.S. companies and Canadian companies selling publicly listed shares in the United States would be subject to these requirements. This type of report is discussed further in Chapter 21.

ATTESTATION SERVICES ON INFORMATION TECHNOLOGY One of the major factors affecting the demand for other assurance services is the growth of the internet and electronic commerce. Concern over privacy and security of information on the internet continues as the volume of electronic commerce increases. The volume of real-time information available on the internet is shifting the need for assurance from historical information at a point in time, such as financial statements, to assurances about the privacy and reliability of processes generating information in a real-time format. For example, many business functions, such as ordering and making payments, are conducted over the internet and directly between computers using electronic data interchange (EDI). As transactions and information are shared online and in real time, there is an even greater demand for assurances about computer system controls surrounding information transacted electronically and the security of the information related to the transactions. Auditors can help provide assurance about these functions.

To respond to the growing need for assurance related to business transacted over the internet, the American Institute of Certified Public Accountants (AICPA) and the Canadian Institute of Chartered Accountants (CICA) developed two products (see also **www.webtrust.org**).

1. The *WebTrust* service is an electronic seal affixed to a website to assure the user that established criteria related to business practices, transaction integrity, and information processes have been met. The seal is a symbolic representation of the Public Accountant's report on management assertions about its disclosure of electronic commerce practices.
2. *SysTrust* provides assurance on information system reliability in areas such as security and data integrity. The accountant evaluates a company's computer systems using Trust Services principles and criteria, and determines whether controls over the system exist. The accountant then performs tests to evaluate the controls and prepares a report covering the specific period of the tests.

For an example of a WebTrust seal and report go to **www.confirmation.com**, an organization that provides audit confirmations electronically. You will see that confirmation.com has other types of assurance seals in addition to WebTrust.

OTHER ATTESTATION SERVICES Accountants may also prepare special reports for clients where the auditor provides an opinion on financial information other than financial

audit challenge 1 - 1

Assessing Privacy Practices

"IT will never happen here—our data will not be disclosed!" Unfortunately, it can happen, and it has. Every month there are new stories about data that has been compromised or stolen. For example, in May 2011 the big news item was Sony—the company shut down internet services in many countries, including Canada, after more than a hundred million customers had their data compromised. Gaming systems and online shopping sites (such as the company's eShop cellular telephone store) were compromised.

New systems providing automated services, such as ATM-like drug kiosks, hold customer data that needs to be protected. Accountants could help these organizations design and test privacy policies and practices. A privacy assurance engagement includes examining how information is used, accessed, stored, and retrieved. For example, how are passwords managed, or is information encrypted when stored on removable devices or transmitted to remote locations? Effective password management and encryption address both risks of privacy violation and other risks of data exposure.

CRITICAL THINKING QUESTIONS

1. What are some of the ways that information could be accessed from a gaming system or an automated drug-dispensing machine?
2. Identify the skills that would be required of a professional team called upon to do a privacy assurance engagement at Sony.
3. Link the skills needed to the professional designations that would be held by the team members. What types of auditors could complete a privacy assurance engagement?

Sources: 1. Bloomberg, "Sony shuts Canadian sites after attack," *The Globe and Mail*, May 26, 2011, p. B3; Dempsey, Amy, "ATM-like drug kiosks coming," *Toronto Star*, March 29, 2011, p. A16; Lewis, Michael, "Sony suffers two more hacker attacks," *Toronto Star*, May 25, 2011, p. B2.

statements or on compliance with an agreement or regulations. For example, an auditor might provide an opinion on the sales at a Shoppers Drug Mart in a Saskatoon shopping mall because the store's rent is based on sales and the owner of the mall requires an audit opinion.

OTHER ASSURANCE SERVICES There are almost no limits to the types of services that auditors can provide. A survey of large Certified Public Accountant (CPA) firms, performed by the AICPA Special Committee on Assurance Services, identified more than 200 assurance services currently provided. See also Chapter 21.

NON-ASSURANCE SERVICES Accounting firms perform numerous other services that generally fall outside the scope of assurance services. Some of these are related to financial statements, while others would be considered financial planning or management advisory services.

COMPILATIONS A compilation involves the accountant preparing financial statements from a client's records or from other information provided. Compilations are also called "Notices to Readers" or NTRs, after the name of the report issued with such engagements. A compilation is much less extensive than a review, and the cost is much less. No assurance is provided by a compilation, and readers are cautioned that the financial statements may not be appropriate for their purposes.

TAX SERVICES Accounting firms prepare corporate and individual tax returns for both audit and non-audit clients. In addition, sales tax remittance, tax planning, and other aspects of tax services are provided by most firms.

MANAGEMENT ADVISORY SERVICES Management advising includes services such as retirement planning and personal financial planning. Most accounting firms also provide services that enable businesses to operate more effectively, including simple suggestions for improving accounting systems, help with marketing strategies, computer installations, and pension benefit consulting. The firm offering these types of services needs to be aware of independence rules that prohibit the provision of some of these services to assurance clients, as discussed in Chapter 3.

ACCOUNTING AND BOOKKEEPING SERVICES Some small clients lack the personnel or expertise to prepare their own subsidiary records. Many small accounting firms work with accounting software packages to help clients record their transactions. Often such clients proceed with a compilation engagement.

When a PA conducts a review or an audit after doing bookkeeping work, he or she must take care to ensure that independence rules are properly followed. In particular, the PA must ensure that all transactions and journal entries are approved by management during the bookkeeping engagement. Additional prohibitions apply if the client is a public company.

Financial statement audit—an audit conducted to determine whether the financial statements of an entity are presented fairly, in all material respects, in conformity with an applicable financial reporting framework.

Compliance audit—(1) a review of an organization's financial records performed to determine whether the organization is following specific procedures, rules, or regulations set down by some higher authority; (2) an audit performed to determine whether an entity that receives financial assistance from a federal or provincial government has complied with specific laws and regulations.

Operational audit—a review of any part of an organization's operating procedures and methods for the purpose of evaluating economy, efficiency, and effectiveness.

Types of Audits and External Audit Reliance upon Internal Audit

Auditors perform three primary types of audits, as described and illustrated in Table 1-2.

1. **Financial statement audits**
2. **Compliance audits**
3. **Operational audits**

Financial statement audits are conducted by qualified public accountants. While compliance audits and operational audits are conducted by primarily government and internal auditors (discussed in the next section), public accountants may also do these types of engagements.

As part of the financial statement audit, external auditors evaluate whether their client's internal controls are designed and operate effectively and whether the financial statements are fairly presented. Because internal auditors spend all of their time with one company, their knowledge about the organization's operations and internal controls is much greater than the external auditors' knowledge.

Guidelines for conducting compliance or operational audits (the latter often termed "internal audits") for companies are not as well defined as for external audits. This occurs because of the wide variety of internal audits. Based on user requirements, the audit purpose, audit methods, and audit reports must be customized. Management of different companies may have widely varying expectations of the type and

Table 1-2 Examples of Three Types of Audits

Type of Audit and Description	Example	Available Evidence	Information	Established Criteria
Financial Statement Audit: an audit conducted to determine whether the overall financial statements of an entity are stated in conformity with an applicable reporting framework	Perform annual audit of Trans-Canada Corporation's financial statements	Documents, records, and outside sources of evidence	TransCanada Corporation's financial statements	Reporting framework such as IFRS or ASPE
Compliance Audit: (1) a review of an organization's financial records performed to determine whether the organization is following specific procedures, rules, or regulations set down by some higher authority; (2) an audit performed to determine whether an entity that receives financial assistance from a federal or provincial government has complied with specific laws and regulations.	Determine if bank covenants for loan continuation have been met	Financial statements and calculations by the auditor	Company records	Loan agreement provisions
Operational Audit: a review of any part of an organization's operating procedures and methods for the purpose of evaluating economy, efficiency, and effectiveness.	Evaluate whether the computerized payroll processing for subsidiary H is operating economically, efficiently, and effectively	Error reports, payroll records, and payroll processing costs	Number of payroll records processed in a month, costs of the department, and error rate	Company standards for economy, efficiency, and effectiveness in payroll department

extent of auditing to be done by internal auditors. For example, management of one company may decide that internal auditors should be extensively involved in systems development, whereas others may decide that their work should focus primarily on financial controls and fraud audits.

RELATIONSHIP OF INTERNAL AND EXTERNAL AUDITORS There are both differences and similarities between the responsibilities and conduct of audits by internal and external auditors. The primary difference is to whom each party is responsible. The external auditor is responsible to financial statement users who rely on the auditor to add credibility to the statements. The internal auditors are responsible to management, although, to improve independence, they should report to the audit committee. Even with this important difference, there are many similarities between the two groups. Both must be competent as auditors and remain objective in performing their work and reporting their results. They both follow a similar methodology in performing their audits, including risk assessment, planning, and performing tests of controls and substantive tests. For financial statement audit work, they both use the audit risk model and materiality in deciding the extent of their tests of financial systems and evaluating results. Their decisions about materiality and risks may differ, however, because external users may have different needs than management.

External auditors justify reliance on internal auditors through the use of an audit risk model, explained in Chapter 7, and by following specified standards (discussed further in Chapter 19). The fee reduction of the external auditor is typically substantial when there is a highly regarded internal audit function and the external auditor can rely upon their work.

concept check

C1-4 Explain the difference between assurance and non-assurance engagements, providing an example of each.

C1-5 List and describe three types of audits, giving an example for each. Why is each type of audit important?

C1-6 Why is it important for external auditors to be able to rely upon internal auditors?

3

Professional Accountants and Their Work

Professional Accounting/Auditing Organizations

Auditors are trained professionals, frequently coming from the accounting profession. Various organizations perform auditing functions—external and internal—in Canada. Selected organizations and the designations awarded by the organizations are described below. These organizations require that individuals have a university degree and obtain relevant work experience. Each organization conducts research and develops, monitors, and comments upon standards relevant to its members. Because of the dynamic nature of business environments, each organization requires regular continuing professional development and offers continuing education programs. Professional organizations may offer specific programs of study leading to further specialist designations. Accounting organizations in Canada and around the world cooperate in conducting this research.

The *Canadian Institute of Chartered Accountants* (CICA, see **www.cica.ca**), publishes audit and assurance standards developed by the AASB (Auditing and Assurance Standards Board). The AASB, in consultation with an advisory board and others, sets the private- and public-sector auditing and assurance standards followed by public accountants in Canada. Current Canadian auditing standards are based upon international auditing standards. The CICA is one of the three major accounting organizations in Canada providing a professional designation relating to accounting and auditing, and it is the umbrella organization of the provincial institutes and *ordre* that regulate the CA profession in Canada. Members of the CICA are *chartered accountants* (CAs). The educational requirements for becoming a CA vary among provinces, with a common experience requirement of 30 months. All provinces require that an individual, to qualify as a CA, pass a national uniform examination administered by the CICA.

The *Certified General Accountants Association of Canada* (CGAAC, see **www.cga-online.org**) also provides a professional designation relating to accounting and assurance. CGAAC is the umbrella organization of the provincial associations and *ordre* that regulate the CGA profession in Canada. The use of the title "certified general accountant" (CGA) is awarded by CGAAC. Experience requirements are set at a minimum of two years in a combination of intermediate and senior positions in accounting or finance. Individuals, depending upon educational background, must pass a variety of subject-based national examinations, with an integrated capstone national examination.

The *Society of Management Accountants of Canada* (SMAC, see **www.cma-canada.org**), provides a professional designation relating to accounting and assurance and regulates the CMA profession in Canada. The SMAC administers the *Certified Management Accountant* (CMA) program, leading to the CMA designation. Students must pass examinations in required subject areas, pass a uniform national examination, and meet experience requirements.

At time of writing, the national CA, CGA and CMA (and many provincial/regional associations) were engaged in unification talks to create a single accounting organization that would offer a CPA (Chartered Professional Accountant) designation.

For an accountant to work as a public accountant, that is, do the work to assess financial statements and provide an opinion upon them, the person must complete the requirements of both an accounting designation (CGA, CMA, or CA) and in certain regions must hold a licence for public accountant (LPA). Requirements for registration as a public accountant vary by province.

Internal auditors and operational or compliance auditors may be accountants or come from any area of specialization, such as information systems, actuarial science, or psychology, before moving into the audit field.

Internal auditors look to *The Institute of Internal Auditors* (IIA, **www.theiia.org**) for professional guidance. The IIA is an organization that functions for internal auditors much as the CICA does for CAs, the CGAAC for CGAs, and the SMAC for CMAs; it establishes ethical standards and standards for the practice of internal auditing, provides education, and encourages professionalism of its approximately 103,000 members. The IIA has played a major role in the increasing influence of internal auditing. For example, the IIA has a highly regarded certification program resulting in the designation of Certified Internal Auditor (CIA) for those who meet the testing and experience requirements.

The Information Systems Audit and Control Association (ISACA, see **www.isaca.org**) awards the Certified Information Systems Auditor (CISA) designation to individuals passing an international examination and meeting experience requirements.

Both the IIA and ISACA have several classes of members, including associate and educational members, who can join the association to have access to publications and educational material but who would not be permitted to use the CIA or CISA designation until they have completed the necessary examination and experience requirements.

Types of Auditors

What type of auditing would you like to specialize in? Financial statement audits are conducted by public accountants skilled in accounting and auditing. Compliance audits also require skill in legislation, regulations, or policies that are being audited, as well as knowledge of controls-related processes. Operational audits may require a multidisciplined specialist team that understands clearly the organizational and operational facets under audit. Operational and compliance audits are often conducted by governmental and internal auditors. Depending upon their work experience and training, professional accountants have the skills to conduct all of these audits.

Here, we briefly discuss four types of auditors. They are public accountants, government auditors, Canada Revenue Agency auditors, and internal auditors. Throughout the text, we will frequently talk about the roles of specialist auditors, such as that of the tax expert when reviewing a financial statement audit, the information systems specialist when assessing information systems functions, and the forensic auditor when assessing fraud risks and conducting fraud audits.

PUBLIC ACCOUNTANTS Public accounting firms conduct financial statement audits or reviews. If the audit is due to a size requirement, or required by law, the audit is a statutory audit. Because of the widespread use of audited financial statements in the Canadian economy, as well as businesses' and other users' familiarity with these statements, it is common to use the terms "external auditor," "independent auditor," "public accountant," and "licensed public accountant" synonymously. PAs also complete many of the other types of engagements discussed in this chapter.

GOVERNMENT AUDITORS The Government of Canada and the various provincial governments each have an Auditor General who is responsible for auditing the ministries, departments, and agencies which report to that government. These government auditors may be appointed by a bipartisan legislative committee or by the government in that jurisdiction. They report to their respective legislatures and are responsible to the body appointing them. The primary responsibility of the government audit staff is to perform the audit function for government. The extent and scope of the audits performed are determined by legislation in the various jurisdictions. For example, in 1977, the federal parliament revised existing legislation by passing the Auditor General Act to require the Auditor General to report to the House of Commons on the efficiency and economy of expenditures or whether value for money had been received.

In 1984, the House of Commons passed Bill C-24, which amended the Financial Administration Act with respect to Crown corporations.[1] The implications are significant for auditors in public practice and in the government. Included among its requirements are the following:

1. Internal audits that look at financial matters or compliance with regulations and audits that look at whether or not the operations are conducted in an efficient, effective, and economic manner.
2. External audits of the financial statements.
3. Special examinations of efficiency, effectiveness, and economy (every five years).

The audit responsibilities of these government auditors are much like those of a public accounting firm. Most of the financial information prepared by various government agencies and, in some cases, by Crown corporations is audited by these government auditors before the information is submitted to the various legislatures. Since the authority for expenditures and receipts of government agencies is defined by law, there is considerable emphasis on compliance in these audits. In many provinces, experience as a government auditor fulfills the experience requirement for a professional designation. Auditor General reports are available online. (Refer to Table 1-3.)

An example of audit work in the public sector is the evaluation of the computer system controls of a particular purpose within a governmental unit. For a financial application, this could include access controls (quality of management supervision, segregation of duties) and controls executed both by human beings and by computer systems.

CANADA REVENUE AGENCY AUDITORS The Canada Revenue Agency has as its responsibility the enforcement of the federal tax laws as they have been defined by Parliament and interpreted by the courts. A major responsibility of this agency is to audit the returns of taxpayers to determine whether they have complied with the tax laws. The auditors who perform these examinations are referred to as Canada Revenue Agency auditors. These audits are solely compliance audits.

[1] The interested reader is referred to A Director's Introduction to the Audit and Special Examination Provisions of the Financial Administration Act (as amended by Bill C-24), published by the Canadian Comprehensive Auditing Foundation, from which this material is taken.

Table 1-3 Website Locations for Federal and Provincial Auditor General Offices

Canada:	**www.oag-bvg.gc.ca** (also the Auditor General for Northwest, Nunavut, and Yukon Territories)
Alberta:	**www.oag.ab.ca**
British Columbia:	**www.bcauditor.com**
Manitoba:	**www.oag.mb.ca**
New Brunswick:	**www.gnb.ca/oag-bvg/index-e.asp**
Newfoundland and Labrador:	**www.ag.gov.nl.ca/ag/**
Nova Scotia:	**www.gov.ns.ca/audg/**
Ontario:	**www.auditor.on.ca**
Prince Edward Island:	**www.assembly.pe.ca/auditorgeneral/index.php**
Quebec:	**www.vgq.gouv.qc.ca/default-EN.aspx**
Saskatchewan:	**www.auditor.sk.ca**

It might seem that the audit of returns for compliance with the federal tax laws would be a simple and straightforward problem. However, tax laws are highly complicated, and there are hundreds of volumes of court interpretations. Taxation problems could involve individual taxpayers, sales tax, goods and services tax, corporate taxes, or trusts. An auditor involved in any of these areas must have expertise in the applicable taxes to conduct the audit. The tax returns being audited vary from the simple returns of individuals who work for only one employer and take the standard tax deductions to the highly complex returns of multinational corporations.

INTERNAL AUDITORS Internal auditors, many of whom are members of the IIA, are employed by individual companies to audit for management. The internal audit group typically reports directly to the audit committee of the board of directors or a senior executive. Internal auditors' responsibilities vary considerably, depending upon the employer. Internal audit staff size can range from one or two to hundreds of employees, each of whom has diverse responsibilities, including many outside the accounting area. In recent years, many internal auditors have become involved in operational auditing or have developed expertise in evaluating computer systems. They also provide assistance in evaluating new systems prior to implementation and in assessing risks within the organization.

Modern internal auditing takes a proactive business advisory approach in contrast to traditional operational- and compliance-based audits. The need to emphasize consulting is evident from the definition of internal audit provided by the Institute of Internal Auditors: "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes."

To operate effectively, an internal auditor must be independent of the line functions in an organization but will not be independent of the entity as long as an employer–employee relationship exists. Internal auditors provide management with valuable information for making decisions concerning the efficient and effective operation of its business. Users from outside the entity, however, are unlikely to want to rely on information verified by internal auditors because of their lack of independence (explained further in Chapter 3). This lack of independence is the major difference between internal auditors and public accounting firms.

concept check

C1-7 List and describe three professional accounting organizations in Canada.

C1-8 Which professionals could conduct the audit of a company that manufactures automobiles? Provide examples of the types of assurance or non-assurance engagements they could conduct for this company.

Summary

1. *What are the components of an audit?* An audit is an engagement where risk assessment, evidence collection, and evaluation are used to assess client information, such as a financial statements, using specific criteria, such as conformity with an applicable financial reporting framework. The results are reported by independent professionals.

   Why is there continued demand for audits? Audits provide added value to information since they provide independent assurance where the user of the report is remote from the provider, where the provider may be biased, or where data audited are voluminous or complex.

   What are the strategic differences between accounting and auditing? Accounting involves the actual preparation of underlying records, whereas auditing helps determine whether that recorded information reflects actual economic events. The auditor must plan the audit strategically, i.e., select evidence in response to identified risks of error or fraud.

2. *What are examples of the different types of engagements completed by auditors?* A financial statement audit is an attest engagement, a subset of assurance engagements. For an attest engagement, the client prepares the materials (such as the financial statements), and the auditor provides a written opinion on them, whereas for a specified auditing procedure engagement, the auditor may actually prepare the report (such as comments on lottery processes).

   Why do the financial statement auditors rely upon internal auditors? Having the PA rely upon internal audit saves the client money. Also, since the internal auditors work for the client full time, they are more familiar with the procedures at the client and are an important resource for the external auditors.

3. *What type of work do accountants complete?* Audits and assurance engagements are conducted by qualified accountants and other professionals. Public accountants (PAs), who audit financial statements as well as conducting these other engagements, can be CGAs, CMAs, or CAs in Canada. Although some CMAs provide assurance services, most CMAs are financial and management accounting professionals. CIAs and internal auditors often do operational audits and help management assess risks. There are also many specialist designations, such as the CISA.

Review Questions

1-1 1 Your local veterinarian is complaining about all of the "accountants" he has had to work with—the government has been in to look at his income taxes, the bookkeeper has been sick so he has had to hire someone else, and now you are coming in to do an audit. Using the definition of an audit, explain to the veterinarian what you will be doing with the financial statements.

1-2 1 Explain what is meant by determining the degree of correspondence between information and established criteria. What are the information and established criteria for the audit of Glickle Ltd.'s tax return by a Canada Revenue Agency auditor? What are they for the audit of Glickle Ltd.'s financial statements by a public accounting firm?

1-3 1 Explain why the auditor needs to know how to conduct a risk assessment.

1-4 1 What is the relationship between the risk assessment process and the collection of audit evidence?

1-5 2 Describe the different types of assurance engagements that could be provided for a hospital.

1-6 2 What are the differences and similarities among audits of financial statements, compliance audits, and operational audits?

1-7 2 List five examples of specific operational audits that could be conducted by an internal auditor in a manufacturing company.

1-8 2 Using a law firm as an example, describe the different audit, attestation, and assurance services that could be provided to the firm, with examples.

1-9 2 Explain why auditors need to be knowledgeable about e-commerce technologies.

1-10 3 Briefly describe the accounting organizations that exist in Canada and identify the professional designations they award. What roles do these organizations play for their members?

1-11 3 What are the major differences in the scope of the audit responsibilities for public accountants, auditors from the Auditor General's Offices, Canada Revenue Agency auditors, and internal auditors?

1-12 2 3 Distinguish the following three risks: risk-free interest rate, business risk, and information risk. Which one or ones does the auditor reduce by performing an audit?

Discussion Problems

1-13 1 Daniel Charon is the loan officer of the Georgian Bay Bank. Georgian Bay Bank has a loan of $540,000 outstanding from Regional Delivery Service Ltd., a company specializing in the delivery of products of all types on behalf of smaller companies. Georgian Bay's collateral on the loan consists of 20 small delivery trucks with an average original cost of $45,000.

Charon is concerned about the collectibility of the outstanding loan and whether the trucks still exist. He therefore engages Susan Virms, public accountant, to count the trucks, using registration information held by Charon. She is engaged because she spends most of her time auditing used automobile and truck dealerships and has extensive specialized knowledge about used trucks. Charon requests that Virms issue a report stating:

1. Which of the 20 trucks is parked in Regional's parking lot on the night of June 30?
2. The condition of each truck, using the categories poor, good, and excellent.
3. The fair market value of each truck using the current "blue book" for trucks, which states the approximate wholesale prices of all used truck models based on the poor, good, and excellent categories.

REQUIRED

a. Identify which aspects of this narrative fit each of the following parts of the definition of auditing:
   (1) Information.
   (2) Established criteria.
   (3) Accumulates and evaluates evidence.
   (4) Competent, independent person.
   (5) Report of results.

b. Identify the greatest difficulties Virms is likely to face doing this assurance engagement.

1-14 1 2 Vial-tek has an existing loan in the amount of $1.5 million with an annual interest rate of 9.5 percent. The company provides an internal company-prepared financial statement to the bank under the loan agreement. Two competing banks have offered to replace Vial-tek's existing loan agreement with a new one. First National Bank has offered to loan Vial-tek $1.5 million at a rate of 8.5 percent but requires Vial-tek to provide financial statements that have been reviewed by a public accounting firm. Second National Bank has offered to loan Vial-tek $1.5 million at a rate of 7.5 percent but requires Vial-tek to provide financial statements that have been audited. The controller of Vial-tek approached a public accounting firm and was given an estimated cost of $12,000 to perform a review and $20,000 to perform an audit.

REQUIRED

a. Explain why the interest rate for the loan that requires a review report is lower than that for the loan that does not require a review. Explain why the interest rate for the loan that requires an audit report is lower than the interest rate for the other two loans.

b. Calculate Vial-tek's annual costs under each loan agreement, including interest and costs for the public accounting firm's services. Indicate whether Vial-tek should keep its existing loan, accept the offer from First National Bank, or accept the offer from Second National Bank.

c. Assume that First National Bank has offered the loan at a rate of 8 percent with a review, and the cost of the audit has increased to $25,000 due to new auditing standards requirements. Indicate whether Vial-tek should keep its existing loan, accept the offer from First National Bank, or accept the offer from Second National Bank.

d. Explain why Vial-tek may desire to have an audit, ignoring the potential reduction in interest costs.

e. Explain how knowledge of e-commerce technologies and a strategic understanding of the client's business may increase the value of the audit service.

1-15 1 3 Projections indicated that there would be record numbers of homeless over the next few years, so the city decided that it was important to make shelters available. Accordingly, contracts were signed with two hotels in the downtown area over a three-year period. The hotels committed to have rooms available in the two coldest months of the year, and the city agreed to pay for the rooms at the rate of $40 per night. The hotel rooms were intended for homeless families.

At the same time, local churches got together and arranged to have volunteers staff the churches and provide hot meals so that the churches could be used as shelters by single individuals. The result was that the hotel rooms were not used, and over a period of three years, the city paid almost $850,000 for empty rooms. This was publicized when the Auditor General for the city published his annual report.

REQUIRED

a. What objectives and criteria would the city Auditor General have used when conducting his audit of expenditures for the homeless?

b. Draft a section of the value-for-money report that would explain how the audit was conducted as well as the findings.

c. What recommendations for improvement might be included in the audit report?

1-16 1 2 3 Dave Czarnecki is the managing partner of Czarnecki and Hogan, a medium-sized local PA firm located outside of Kamloops. Over lunch, he is surprised when his friend James Foley asks him, "Doesn't it bother you that your clients don't look forward to seeing their auditors each year?" Dave responded, "Actually, many of my clients look forward to discussing their business with me. Auditing is only one of several services we provide. Most of our work for clients does not involve financial statement audits, and our audit clients seem to like interacting with us."

REQUIRED

a. Identify ways in which a financial statement audit adds value for clients.
b. List services other than audits that Czarnecki and Hogan likely provide.
c. Assume Czarnecki and Hogan has hired you as a consultant to identify ways in which they can expand their practice. Identify at least one additional service that you believe the firm should provide and explain why you believe this represents a growth opportunity for PA firms.

1-17 1 2 3 Joy Wu, a PA, is planning her first audit of a closely held small business. In prior years, Wu compiled the financial statements of the company. She also helped to set up its accounting system and supervised the work of the company's bookkeeper, who has limited knowledge of accounting. This year, management wants Wu to perform an audit because a local bank has requested audited financial statements as a condition for granting the company a large loan needed to expand operations. During her discussions with management, Wu agreed to conduct the audit and to continue to supervise the company's day-to-day accounting. This will facilitate the audit work by giving her a good knowledge of the company's business transactions. The company would like Wu to continue to closely advise and support management with the bank loan negotiations to secure the best possible loan terms.

REQUIRED

a. Describe the different types of work that Wu is considering, and the stakeholders involved in or affected by this work.
b. Assess the appearance of independence here. Is it possible for Wu to do all of this work and still be independent? Why or why not?

Professional Judgment Problems

1-18 1 2 A small, but expanding, specialty home-products retailer recently implemented an internet portal that allows customers to order merchandise online. In the first few months of operation, their internet site attracted a large number of visitors; however, very few placed orders online. The retailer conducted several focus-group sessions with potential shoppers to identify reasons why shoppers were visiting the website without placing orders. Shoppers in the focus group made these comments:

1. "I am nervous about doing business with this retailer because it is relatively unknown in the marketplace. How do I know the product descriptions on the website are accurate and that the stated return policies are followed?"
2. "I am reluctant to provide my credit card information online. How do I know the transmission of my personal credit card information to the retailer's website is protected?"
3. "Retailers are notorious for selling information about customers to others. The last thing I want to do is enter personal information online, such as my name, address, telephone number, and e-mail address. I am afraid this retailer will sell that information to third parties and then I'll be bombarded with a bunch of junk e-mail messages!"
4. "Websites go down all the time due to system failures. How do I know the retailer's website will be operating when I need it?"

REQUIRED

Discuss whether this situation provides an opportunity for PAs to address these customer concerns. How could a PA provide assistance?

1-19 1 2 3 A large conglomerate is considering acquiring a medium-sized manufacturing company in a closely related industry. A major consideration by the management of the conglomerate in deciding whether to pursue the merger is the operational efficiency of the company. Management has decided to obtain a detailed report based on the intensive investigation of the operational efficiency of the sales department, production department, and research and development department.

REQUIRED

a. What professionals could the conglomerate hire to conduct the operational audit? What skills should be present in the audit team?
b. What major problems are the auditors likely to encounter in conducting the investigation and writing the report?

Case

1-20 1 2 3 Mont Louis Hospital, which is affiliated with a leading university, has an extremely reputable research department that employs several renowned scientists. The research department operates on a project basis. The department consists of a pool of scientists and technicians who can be called upon to participate in a given project. Assignments are made for the duration of the project, and a project manager is given responsibility for the work.

All major projects undertaken by the research department must be approved by the hospital's administrative board. Approval is obtained by submitting a proposal to the board outlining the project, the expected amount of time required to complete the work, and the anticipated benefits. The board also must be informed of major projects that are terminated because of potential failure or technological changes that have occurred since the time of project approval. An overall review of the status of open projects is submitted to the board annually.

In many respects, profit-making techniques utilized by business firms are applied to the management of the research department. For example, the department conducts preliminary research work on potential major projects that it has selected prior to requesting the board to approve the project and commit large amounts of time and money. The department also assesses the potential for grants for and for future revenues of the project. Financial reports for the department and each project are prepared periodically and reviewed with the administrative board.

Over 75 percent of the cost of operating the department is for labour. The remaining costs are for materials utilized during research. Materials used for experimentation are purchased by the hospital's central purchasing department. Once these materials are delivered, the research department is held accountable for their storage, their utilization, and the assignment of their costs to the projects.

In order to protect the hospital's right to discoveries made by the research department, staff members are required to sign waiver agreements at the time of hire and at certain intervals thereafter. The agreements relinquish the employees' rights to patent and royalty fees relating to hospital work.

The excellent reputation of Mont Louis is due, in part, to the success of the research department. The research department has produced quality research in the health-care field and has always been able to generate revenues in excess of its costs. The administrative board believes that the hospital's continued reputation for quality depends on a strong research department, and therefore the board has requested that the university's internal auditors perform an operational audit of the department. As part of its request for the operational audit, the board has presented a set of objectives that the internal audit is to achieve.

The operational audit to be conducted by the university's internal audit department should provide assurances as follows:

- The research department has assessed the revenues and cost aspects of each project to confirm that the revenue potential is equal to or greater than estimated costs.
- Appropriate controls exist to provide a means to measure how projects are progressing and to determine if corrective actions are required.
- Financial reports prepared by the research department for presentation to the administrative board properly reflect all revenues (both endowment and royalty sources and appropriated funding) and all costs.

REQUIRED

a. Evaluate the objectives presented by the administrative board to the university's internal audit department in terms of their appropriateness as objectives for an operational audit. Fully discuss the following:
   (1) The strengths of the objectives.
   (2) The modifications and/or additions needed to improve the set of objectives.

b. Outline, in general terms, the basic procedures that would be suitable for performing the audit of the research department.

c. Identify three documents that members of the university's internal auditing staff would be expected to review during the audit, and describe the purpose that the review of each document serves in carrying out the audit.

d. Discuss whether and how the work of the internal auditors could be used by the external auditors to reduce the cost of the financial statement audit.

(Adapted from CMA)

Ongoing Small Business Case: Thinking about CondoCleaners.com

1-21 1 3 Jim and Cecilia were having lunch at the public accounting firm cafeteria downtown and discussing the future. They had both been recently promoted to managers, with incomes approaching six figures. Cecilia and her husband had recently purchased a house, while Jim had accumulated a sizable nest egg, living with his parents. They were talking about the "departed ones"—their peers who had left the firm and were working as internal auditors or executives or had started their own business. Others had stayed with the firm but were now working as specialists in areas other than financial statement auditing. Jim had an idea that had been in the back of his head for two or three years—what about an online cleaning business? There were so many large condominium towers near the office—people could book their cleaning appointment online and then have the cleaning done within two or three days. Cecilia smiled, "I don't think I would take that kind of risk, having just committed to a mortgage, but I regret not using my skills in starting a new business."

REQUIRED

Using the definition of auditing, identify the types of skills that Jim and Cecilia have acquired at the public accounting firm. How would these skills translate into being able to run your own business? What types of skills might Jim need to run this new business?