

Audit and Assurance Primer

Table of Contents

INTRODUCTION.....	1
PART 1: BASIC ASSURANCE CONCEPTS AND REGULATIONS.....	1
Basic concepts of assurance	1
Auditing standards and regulations.....	3
Rules of professional conduct, ethical standards and legal considerations	4
Practice questions	5
PART 2: AUDIT ACCEPTANCE, CONTINUANCE AND PLANNING.....	8
Acceptance and continuance.....	8
Planning.....	9
Practice questions	13
PART 3: INTERNAL CONTROL.....	16
Introduction to internal controls.....	16
Key internal controls	18
Practice questions	18
PART 4: EXECUTION OF THE AUDIT.....	21
Introduction to audit procedures	21
Audit evidence	21
What is the best approach?	24
Practice questions	24
PART 5: AUDIT COMPLETION.....	28
Documentation.....	28
Completion procedures.....	28
Evaluation of audit evidence	30
Management representations	31
Communication with management and those charged with governance	31
Internal completion documents.....	31
Quality control over the audit engagement	31
Reporting	32
Practice questions	32

PART 6: OTHER ENGAGEMENTS	35
Key process stages	35
Levels of assurance	35
Assurance engagements	36
Non-assurance engagements.....	37
Examples of other engagements	37
Practice questions	39

PRIMER

INTRODUCTION

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

PART 1: BASIC ASSURANCE CONCEPTS AND REGULATIONS

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

Basic concepts of assurance

Definition and objectives of an assurance engagement

The International Framework for Assurance Engagements defines an assurance engagement as “an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.”¹

The Framework states that an engagement is an assurance engagement when it has all of the following five elements:

- a three party relationship that involves a practitioner, responsible party and intended user
- appropriate subject matter
- criteria to evaluate or measure the subject matter
- sufficient appropriate evidence about whether the subject matter complies, in all material respects, with the criteria
- a conclusion that provides a level of assurance about whether the subject matter complies, in all material respects, with the criteria

¹ IFAC, *International Framework for Assurance Engagements*
(<http://www.ifac.org/system/files/downloads/b003-2010-iaasb-handbook-framework.pdf>, 2010)

The most commonly seen assurance engagement is a financial statement audit. External auditors are required to express an opinion on whether the company's financial statements are presented fairly or give a fair view of the entity; that is, financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework. Canadian Auditing Standards (CASs) dictate the work that the auditor should undertake to express this opinion.

The economic purpose of an audit

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

The audit opinion

One of the key responsibilities of the auditor is to express an opinion, with reasonable assurance, on the fairness of the financial statements.

CAS 200 describes reasonable assurance as a high, but not absolute, level of assurance; that is, the audit is not a guarantee that the financial statements are 100% correct. The auditor seeks to obtain sufficient appropriate evidence to be able to provide a high level of assurance that the financial statements are free from material misstatements, that is, misstatements that would affect the decisions of the shareholders.

The auditor's report

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

Types of assurance engagements

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

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

The expectations gap

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

Other common misconceptions are as follows:

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

Auditing standards and regulations

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

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

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

Rules of professional conduct, ethical standards and legal considerations

Rules of professional conduct

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

Credibility encompasses the following qualities: competence, independence, integrity and ethics.

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

Rules vary slightly from one body to the next and one region to the next; however, they are generally similar to the rules outlined by IFAC's *Handbook of the Code of Ethics for Professional Accountants*. IFAC's Code provides five principles for professional conduct for accountants:

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

Ethical standards

Public accountants in Canada must also follow the ethical pronouncements relating to the work of auditors issued by the auditors' own relevant professional body (usually the CPA provincial body). Ethical considerations that are most important to assurance engagements are as follows:

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

Legal considerations

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

The risk-based audit approach

A risk-based audit approach focuses the nature, timing and extent of audit procedures on areas with the highest potential for material misstatement. After the audit has been accepted, this approach splits the audit process into five phases:

1. Planning (including planning of controls)
2. Audit execution (controls and substantive testing)
3. Audit completion
4. Risk assessment
5. Engagement and client management

Different activities occur within each phase of the audit process.

Practice questions

1. Multiple-choice questions:
 - i. Which of the following statements is true?
 - a) Any professional accountant who holds a CPA designation can be an auditor.
 - b) Any professional accountant who holds a CPA designation and works in the private sector can be an auditor.
 - c) Any professional accountant who holds a CPA designation and has proper audit knowledge and training can be an auditor.
 - d) Any professional accountant who holds a CPA designation, has proper audit knowledge and training, meets provincial licensing requirements and works in the public sector can be an auditor.

Solution

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

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

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

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

- ii. Which of the following lists includes all the elements that are present in a financial statement audit?
- a) Credibility, appropriate subject matter, suitable criteria, conclusion
 - b) Three party relationship, appropriate subject matter, suitable criteria, sufficient appropriate evidence, conclusion
 - c) The expectations gap, three party relationship, appropriate subject matter, sufficient appropriate evidence, conclusion
 - d) Three party relationship, appropriate subject matter, suitable criteria, conclusion

Solution

Option b) is **correct**. An engagement is an assurance engagement when it has all of the following five elements: a three party relationship, appropriate subject matter, suitable criteria, sufficient appropriate evidence and a conclusion.

Option a) is incorrect. While an audit adds credibility to the financial statements, credibility is not an element that defines an assurance engagement.

Option c) is incorrect. The expectations gap is not one of the five elements of a financial statement audit. The expectations gap is the difference between the understanding that the public has about the auditor's responsibilities and the actual defined responsibilities of the auditor. It is important that the auditor take steps to reduce the expectations gap.

Option d) is incorrect. Sufficient appropriate evidence is also an element that is present in a financial statement audit.

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

Required:

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

Solution

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

PART 2: AUDIT ACCEPTANCE, CONTINUANCE AND PLANNING

Part 2 discusses the beginning of the process of conducting a financial statement audit, starting with a discussion of the client acceptance and continuance procedures for prospective and recurring audit clients.

Acceptance and continuance

Audit firms undertake acceptance/continuance procedures for prospective and recurring clients to ensure that the firm complies with specific requirements laid out in the auditing standards, regulations and statutes.

Obtaining an audit engagement

Before obtaining an audit client, an audit firm may invest substantial amounts of money and time in preparing proposals and tenders and in making presentations to potential clients with a view to winning or retaining an engagement with the client.

The extent of the procedures undertaken prior to obtaining an audit or assurance client depends on the size of the client and of the public accounting firm. These procedures can involve the following:

- understanding the client and the services required
- preparing budgets and considering resources
- drafting a proposal for the client's management and directors outlining the audit, assurance or other services that could be provided
- submitting the proposal and giving a presentation to the potential client

When undertaking the first two steps, the firm will gather information that makes its proposal specific and relevant to the client. At the same time, the firm must also decide whether it wants to take on this potential client. During this process, the firm may review financial reports, industry reports, analysts' information and press stories. It may also meet with different members of management.

The firm's proposal document outlines the services the firm will provide and the approach it will adopt. It can include the following:

- an estimate of the audit fee
- the audit team profile and details of experience relevant to the potential client
- an initial assessment of the key risk areas and areas for audit effort
- client deliverables, meeting requirements and an engagement timetable, to provide the client with an appreciation of what it can expect and to determine whether this meets the client's expectations

Acceptance risks

Prior to accepting a new engagement, the audit firm must assess the risks to the firm that would arise from being associated with the prospective client. After a client has been accepted, this assessment should be repeated annually to identify changes in circumstances that impact the client's risk profile. In doing this, the auditor considers the knowledge of the business that was developed during the prior year audit along with new developments that have become known.

Engagements can bring a variety of commercial and professional risks to the audit firm. Commercial risks include financial and reputational risks. Professional risks include non-compliance with standards and regulations. Auditors must consider both types of risk categories prior to agreeing to accept/continue with the engagement.

Acceptance and continuance procedures

Defined acceptance and continuance procedures are undertaken to identify the information that could result in commercial or professional risks to the firm. This ensures that all the facts that could result in a risk to the firm are identified and assessed. These procedures are usually documented in an acceptance and continuance checklist.

To enable the auditor to determine if there are any facts that identify specific risk factors relating to a particular engagement, the auditor should do the following (not necessarily in this order):

- Identify the users and the nature of the engagement.
- Assess the legal and financial stability of the prospective client.
- Assess the integrity of those charged with governance, management and the principal owners.
- Communicate with the predecessor auditor with regard to a new client acceptance decision.
- Evaluate the audit firm's ability to audit the entity — practically and ethically.
- Agree on the basis for performance of the audit.

Planning

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

An external audit involves managing a series of conflicting objectives. The shareholders want the audit to be effective (that is, to highlight any irregularities in the financial statements). At the same time, they want this service to be efficient (that is, provided without delaying the publication of the information that is being audited and without running up an enormous audit bill). Auditors have responded to these pressures by developing a risk-based approach to auditing. This is designed to provide the highest-

quality evidence in a given time or for a given fee while ensuring that sufficient appropriate evidence is collected on which the audit opinion can be based. In short, the risk-based approach to auditing means that the auditor does more audit testing on areas of the financial statements that have an increased risk of misstatement. That is why applying this approach requires an understanding of the underlying business.

The purpose of planning

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

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

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

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

Materiality

The overall objective of the auditor is to obtain reasonable assurance about whether the financial statements are free from material misstatement to enable the auditor to express an opinion on the financial statements.

Audit materiality

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

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

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

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

Audit risk

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

Audit risk model

Audit risk can be defined using the following formula:

Audit risk (AR) = inherent risk (IR) × control risk (CR) × detection risk (DR)

Inherent risk is the likelihood that the financial statements are misstated before considering internal control (that is, assuming that the client has no internal controls).

Control risk is the likelihood that misstatements due to inherent risk will not be prevented, or detected and corrected by the client's internal controls.

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

Detection risk is the likelihood that the auditor will not detect existing misstatements in the financial statements.

Potential areas of misstatement

CAS 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment requires that risks of material misstatements should be identified in terms of their impact "at the financial statement level; and at the assertion level for individual balances, transactions and disclosures."

At the overall financial statement level, misstatements are considered pervasive, and they could potentially affect many assertions. These misstatements could arise from a weak control environment, fraud or going-concern issues. At the assertion level, misstatements are linked to individual transactions, balances and disclosures assertions.

Obtaining an understanding of the entity and its environment

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

Risk assessment techniques

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

These techniques include the following:

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

Developing a response to assessed risks

Once the materiality has been defined, risk assessment procedures have been carried out, and risks of material misstatement identified, auditing standards require the auditor to then design and implement responses to those risks.

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

An overall response will address a risk of material misstatement that has arisen at the financial statement level:

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

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

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

Practice questions

1. Multiple-choice questions:

- i. Which of the following situations demonstrates the commercial risks of accepting a new audit client?
 - a) The auditor has a close personal relationship with the audit client.
 - b) The auditor lacks the necessary skills or knowledge of the client's industry.
 - c) The auditor may face financial losses due to the audit costing more than the fees paid by the client.
 - d) The auditor did not complete the audit in accordance with CASs.

Solution

Option c) is **correct**. Financial losses due to the audit costing more than the fees paid by the client would be a commercial (financial) risk.

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

Option b) is incorrect. The auditor's lack of the necessary skills or knowledge would be a professional risk, as they would not be in compliance with standards and regulations.

Option d) is incorrect. If the audit has not been completed in accordance with CASs, the auditor has taken a professional risk.

- ii. Which of the following is **NOT** included in the definition of materiality found in CAS 320 *Materiality in Planning and Performing an Audit*?
 - a) It influences the economic decisions of users.
 - b) It is based solely on quantitative factors affecting the audit risk.
 - c) It is affected by the size or nature of a misstatement, or a combination of both.
 - d) It is relevant to the common information needs of users as a group.

Solution

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

Options a), c) and d) are incorrect. These are included in the definition of materiality in CAS 320.

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

Required:

Based on the acceptance and continuance checklist, what factors should your accounting firm as the auditor examine when determining whether Company XYZ should be taken on as a new client? Use the CPA Way methodology.

Solution

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

- **Identify the users and the nature of the engagement.** The user is the bank, and the nature of the engagement is a financial statement audit.
- **Assess the legal and financial stability of the prospective client.** Company XYZ is financially stable, since it has been profitable since its inception and has had stable growth.
- **Assess the integrity of those charged with governance and management, as well as the principal owners.** The auditors will need to assess the Wong family and assess whether there are any concerns with management's integrity and how any concerns may impact the audit engagement.

- **Communicate with the predecessor auditor with regard to a new client acceptance decision.** Communication with the predecessor auditor is not required, as Company XYZ has never been audited.
- **Agree on the basis for performance of the audit.** Company XYZ and the auditor will need to agree on the details of the audit, such as the period to be audited and the reporting framework (IFRS or ASPE) against which Company XYZ is to be assessed. Moreover, the auditor must be satisfied that management understands and has agreed to its responsibilities.

PART 3: INTERNAL CONTROL

Introduction to internal controls

Recall from Part 2 that control risk is the likelihood that the misstatements due to inherent risk will be prevented or detected by the client’s internal controls. To assess the control risk of the audit, the auditor will examine the internal controls of the audit client. Internal control is the system of policies and procedures put into place to ensure that a company meets business objectives. There are five elements of internal control: control environment, risk assessment, control activities, information and communication, and monitoring. The auditor must consider each of these components when assessing the internal control system within an entity and consider how each component may affect the audit.

Impact on audit approach

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

<p>Weak control environment</p>	<p>When there is a weak control environment, control activities are less likely to be designed well or operating consistently, which increase the risk of material misstatement in the financial statements.</p> <p>Weaknesses in the control environment are likely to affect a number of systems and therefore will probably affect a number of areas of the financial statements.</p> <p>When there is a weak control environment, the auditor will be far less likely to use a combined audit approach (use tests of controls and substantive testing) and will be inclined to use a substantive audit approach (use substantive testing only). If the auditor decides to rely on controls (that is, to use a combined audit approach), the audit approach will have to be amended to address the weak control environment — for example, the extent of controls testing may increase, and/or the auditor may increase the level of substantive testing in a particular area.</p>
---------------------------------	---

Weak risk assessment procedures	When there are weak risk assessment procedures, it is more likely that there will be risks in a client's business that are not identified and being controlled. Moreover, control activities may not be designed according to the nature of risks in the client's business. This may indicate weaknesses in the client's control system and can result in a higher risk of material misstatement over particular areas of the financial statements. The auditor should identify these risks/weaknesses and evaluate their impact on the financial statements. This will change the nature and extent of testing over areas of the financial statements where there is a higher risk of material misstatement.
Weak information systems	When there are weak information systems, the potential for override of controls over journal entries or incorrect processing of transactions, such as clearing out a suspense account, may be higher. This can result in a higher risk of material misstatement over particular areas of the financial statements, which will change the nature and extent of testing over these areas.
Weak monitoring of controls	When there is weak monitoring of controls, controls are less likely to be operating during the period, so the auditor may increase the extent of testing on the controls and may test a range of controls to obtain sufficient audit evidence.

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

What are control activities?

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

Why should management implement control activities?

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

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

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

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

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

Key internal controls

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

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

Practice questions

1. Multiple-choice questions:

- i. Linda, an auditor, is reviewing the internal controls related to the sales cycle in place at Mighty Jack Inc. Which of the following controls helps to ensure that the sales have been recorded in the correct accounting period?
 - a) Shipping documentation is forwarded to the invoicing clerk on a daily basis.
 - b) Sales are recorded based on approved sales order forms and shipping documents.
 - c) Monthly customer statements are sent out with customer complaints followed up on.
 - d) The shipping document is matched to the sales invoice.

Solution

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

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

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

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

Solution

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

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

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

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

2. The following are three independent scenarios:

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

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

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

Required:

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

Solution

Each scenario can be analyzed using the CPA Way.

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

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

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

PART 4: EXECUTION OF THE AUDIT

This week covers the execution of the audit. The focus is on the *approach* to take in designing audit procedures, tests and programs. This allows the auditor to tailor the audit work to be performed to the particular circumstances of the client.

Introduction to audit procedures

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

Audit evidence

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

- obtaining an understanding of the entity and its environment, including its internal controls, and performing risk assessment procedures
- testing the operating effectiveness of the controls of the entity
- performing substantive procedures to detect material misstatements in the financial statements at the assertion level

The audit must always include some substantive testing. Irrespective of the risks of material misstatements, substantive procedures must be performed for all material classes of transactions, account balances and disclosures. This is because, even if the business has a very good internal control system, there are still inherent limitations to internal controls, such as management override, that cannot be mitigated. For this reason, control risk cannot be eliminated, although it may be assessed as very low.

Sufficiency

Sufficiency is a measure of the quantity of audit evidence. The quantity of audit evidence needed is affected by the risk of material misstatement and the quality of the evidence. The greater the risk of material misstatement, the more evidence required to reduce the risk that a misstatement is not detected. But if the quality of evidence obtained is high, less further evidence will be required. However, obtaining more audit evidence may not compensate for poor quality evidence.

Appropriateness of evidence

Appropriateness is a measure of the quality of audit evidence — that is, its reliability and relevance. The reliability of evidence is affected by its source and its nature.

Reliability — Source

There are three sources of audit evidence: auditor, client and third party. Auditor-generated evidence will generally be the most reliable. The reliability of client-generated evidence will depend on the effectiveness of internal controls. The reliability of third-party-generated evidence will depend on the third party's knowledge of the matter, its willingness to provide the evidence and its objectivity.

Reliability — Nature

Evidence may vary in nature but can be split roughly into three categories:

- **Natural evidence:** the auditor physically witnesses the event or asset.
- **Created evidence:** the auditor obtains documentary evidence, such as invoices, board minutes or a letter from the client's bank.
- **Rational argument:** the auditor obtains evidence through applying logic, for example, checking the reasonableness of a depreciation figure by multiplying the cost of an asset by the appropriate rate of depreciation.

Natural evidence is generally the most reliable (if auditors see an asset, they are more confident that it exists than if they were to see an invoice), followed by created evidence and lastly rational argument.

Relevance

For evidence to be relevant, it must satisfy the management assertions that the auditor is testing. Management assertions are claims or representations on the financial statements made by management. Assertions fall into the following three categories:

Balance sheet (account balances)	Income statement (classes of transactions)	Disclosure and presentation
Rights and obligations Existence Completeness Valuation and allocation	Completeness Occurrence Classification Accuracy Cut-off	Accuracy and valuation Occurrence Rights and obligations Completeness Classification and understandability

Thus, the audit test itself will determine whether the evidence collected through the test is relevant. For example, accounts receivable confirmations test the existence and rights and obligations of accounts receivable balances; therefore, replies from the client's customers provide evidence that is reliable (third-party written evidence) and relevant for those particular assertions. However, this audit test does not provide evidence regarding valuation of accounts receivable balances, as the customer is only being asked to confirm the balance; this does not confirm the customer's intention or ability to pay the balance.

Audit evidence from controls testing compared to substantive testing

Test of controls

CAS 330 *The Auditor's Responses to Assessed Risks* defines a test of controls as an audit procedure designed to evaluate the operating effectiveness of controls in preventing or detecting and correcting material misstatements at the assertion level.

The following are examples of tests of controls:

- observing audit committee meetings
- re-performing a sample of supplier statement reconciliations
- inspecting sign-off of weekly payroll register

In these cases, the auditor is obtaining evidence that something the client does reduces the risk of misstatement in the financial statements either by preventing misstatements from occurring or by identifying and correcting misstatements before the financial statements are finalized. In controls testing, the auditor looks at procedures performed by the client during the financial year rather than at year-end figures. A control deviation indicates that a control is not operating as intended; it does not indicate an actual dollar error in the financial statements.

Substantive testing

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

CAS 330 divides substantive tests into two categories:

- substantive analytical procedures
- tests of details

Substantive analytical procedures involve testing the whole population of an account at once, such as depreciation expense for motor vehicles. Substantive analytical procedures are generally more applicable to large volumes of transactions that tend to be predictable over time.

Tests of details involve selecting specific items within that population for testing, such as recalculation of the depreciation expense for a sample of assets using the depreciation policy of the client.

The following are examples of tests of details:

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

What is the best approach?

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

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

Practice questions

1. Multiple-choice questions:

- i. Evan has completed a substantive test of details and has verified that a sample of sales recorded in the general journal are supported by invoices. Which management assertion for sales transactions is Evan testing?
 - a) Completeness
 - b) Accuracy
 - c) Occurrence
 - d) Cut-off

Solution

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

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

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

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

- ii. Deepak is completing a substantive analytical procedure on Raven Inc.'s insurance expense account. The insurance expense increased by \$24,000 compared to the prior year. Which of the following explanations from management best supports the variance in the insurance expense account?
- a) An additional warehouse is being rented during the current year.
 - b) An insurance claim was filed at the end of the current year.
 - c) Raven prepaid insurance fees for the upcoming fiscal year.
 - d) Raven changed from a monthly to an annual payment plan at the start of the current year.

Solution

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

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

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

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

- iii. Brenda is completing an audit procedure for the cash cycle. Brenda requested that the client count the petty cash in front of her. Which management assertion is Brenda most likely testing with this audit procedure?
- a) Classification
 - b) Existence
 - c) Completeness
 - d) Presentation

Solution

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

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

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

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

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

Required:

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

Solution

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

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

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

As for the nature of evidence, the evidence in this case is created evidence because the auditors obtained documentary evidence. This is not as reliable as natural evidence. However, it is usually more reliable than rational argument.

PART 5: AUDIT COMPLETION

Part 5 focuses on the typical activities during the completion of an audit engagement, which include the following:

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

Documentation

It has always been accepted that it is not enough for auditors to carry out audit procedures, but that the audit procedures must also be properly documented. With documentation, auditors can demonstrate that they have obtained sufficient appropriate evidence to support their opinions. This also demonstrates that the auditors have complied with CASs and the applicable ethical, legal and regulatory requirements. Audit documentation includes everything in relation to the engagement, whether on paper, electronic or other media. Most audit firms still use paper to some degree, but it is becoming more common for firms to move toward a completely paperless audit with all audit documentation being maintained on computer only.

Completion procedures

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

Assessment of going concern

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

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

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

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

Subsequent events review

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

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

Evaluation of related party transactions

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

Communication with law firms

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

Evaluation of audit evidence

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

- audit differences identified through substantive testing that may result in a reassessment of the effectiveness of the client's control systems
- missing audit evidence
- overall review procedures at the completion of the audit that may indicate a previously unrecognized risk of material misstatement

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

Final analytical procedures

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

Evaluation of misstatements

Throughout the audit, members of the audit team may discover misstatements in the financial statements. Whenever misstatements are found, unless they are clearly trivial, the auditor records those misstatements on a summary of audit differences (SAD). This summary is also called the summary of unadjusted differences or the summary of accumulated misstatements. The SAD shows the cumulative effect of identified misstatements and records which misstatements have been adjusted for in the client financial statements and which misstatements remain unadjusted for at year end. According to CAS 450 *Evaluation of Misstatements Identified during the Audit*, the auditor needs to evaluate the following:

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

Management representations

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

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

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

Communication with management and those charged with governance

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

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

Internal completion documents

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

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

Quality control over the audit engagement

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

Reporting

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

Practice questions

1. Multiple-choice questions:

- i. Joginder, a student in the CPA program working as an audit senior, is reviewing subsequent events for ProNorth Ltd. Each of the subsequent events identified by Joginder is material in nature and occurred after the balance sheet date of December 31, 20X6, but prior to the audit report date. Which of the following events will Joginder adjust within the 20X6 financial statements?
 - a) A flood on January 5, 20X7, caused significant damage to ProNorth's warehouse.
 - b) ProNorth's key customer declared bankruptcy due to the outcome of a lawsuit on January 10, 20X7.
 - c) ProNorth took out a new loan on January 8, 20X7, to proceed with its planned expansion.
 - d) ProNorth signed a union agreement on January 12, 20X7.

Solution

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

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

- ii. Inaya, an audit manager, is reviewing the working paper file of KE Motors in order to evaluate the audit findings. Which of the following procedures would Inaya be **LEAST** likely to complete as she is evaluating the results of the audit?
 - a) Reviewing financial statement disclosures
 - b) Evaluating the sufficiency and appropriateness of evidence collected
 - c) Completing variance analysis on the financial statements
 - d) Obtaining the management representation letter

Solution

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

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

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

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

- iii. Karen, an audit partner, has provided updates throughout the audit of Great Electronics Ltd. to the audit committee. Which of the following is Karen **LEAST** likely to have communicated to the audit committee?
- a) Strategies to deal with significant risks
 - b) Sample selection strategies for the engagement
 - c) Controls that will be relied on during the engagement
 - d) Materiality as it applies to the engagement

Solution

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

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

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

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

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

Required:

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

Solution

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

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

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

PART 6: OTHER ENGAGEMENTS

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

Key process stages

Any engagement performed by a professional accountant will follow similar stages to those in a financial statement audit engagement.

The stages of a financial statement audit engagement that were introduced previously are as follows:

1. Acceptance and continuance
2. Planning:
 - understanding the entity and its environment
 - materiality
 - risk assessment
 - planned response to risk
3. Execution
4. Completion and reporting

Each of these stages should be considered when performing an engagement. Therefore, it is important to refer regularly to this engagement process checklist when going through the various steps of an engagement.

Levels of assurance

There are several types of engagements that the auditor or practitioner can be associated with. Some engagements, called assurance engagements, will provide a high (positive) or moderate (negative) level of assurance, whereas others, called non-assurance engagements, will offer no assurance at all:

- The opinion or conclusion for an engagement with a high level of assurance or positive assurance should clearly state that “in our opinion the financial statements present fairly, in all material respects....” This includes the understanding that there is a remote likelihood that material misstatements will not be prevented or detected on a timely basis.
- The opinion or conclusion for an engagement with a moderate level of assurance or negative assurance states, “nothing has come to our attention....” This form of expression conveys a level of limited assurance that is proportional to the level of

the auditor's evidence-gathering procedures given the characteristics of the subject matter and other engagement circumstances described in the assurance report.

- In a non-assurance engagement, no opinion or conclusion is provided.

Assurance engagements

An assurance engagement is any engagement where an auditor or practitioner (public accountant) provides communication with a high degree of confidence. The term *auditor* describes a person's association with audited information, whereas *practitioner* describes a person's association with all other types of engagements.

As outlined previously, an engagement is an assurance engagement when it has all of the following five elements:

1. A three party relationship, involving a practitioner, a responsible party and intended users.
2. An appropriate subject matter, which might be financial performance, non-financial data, physical characteristics (such as the capacity of a facility), systems and processes, or behaviour (such as corporate governance or human resource practices). This may be presented as at a point in time or covering a period of time.
3. Suitable criteria, that is, benchmarks or standards used to evaluate or measure the subject matter.
4. Sufficient, appropriate evidence. The practitioner plans and performs the assurance engagement with an attitude of professional skepticism to obtain sufficient, appropriate evidence to confirm whether the subject matter is free from material misstatements.
5. Conclusion. This should provide a level of assurance regarding whether the subject matter conforms in all material respects with the identified suitable criteria.

The essential element that defines an assurance engagement is the expression of a conclusion that provides a level of assurance, rather than the reporting of factual findings that leaves recipients to derive their own conclusions.

An assurance engagement can take the form of an assertion-based engagement or a direct reporting engagement. An assertion-based engagement is provided when assertions are made in writing by the accountable party (for example, financial statements). A direct reporting engagement does not have explicit assertions. In a direct reporting engagement, an auditor is required to derive suitable criteria before communicating the results. The auditor's conclusion will report on the subject matter that the accountable party is responsible for.

Non-assurance engagements

A non-assurance engagement may contain many of the same elements as an assurance engagement; however, in a non-assurance engagement, the professional accountant does not offer any assurance over the subject matter being examined. That is, the professional accountant may help in the preparation of information or may perform certain procedures, but does not provide an opinion as to whether or not the client's information is in compliance with pre-established criteria. In a non-assurance engagement, the accountant simply presents the results of the work performed and allows recipients to draw their own conclusions from those results.

Examples of other engagements

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

Engagement	Related standards	Type of engagement	Level of assurance
Audit of financial statements prepared in accordance with special purpose financial frameworks	CAS 800	Other assurance engagement	Positive
Audit of single financial statements and specific elements, accounts or items of a financial statement	CAS 805	Other assurance engagement	Positive
Engagement to report on summary financial statements	CAS 810	Other assurance engagement	Positive
Report on controls at a service organization	CSAE 3416	Other assurance engagement	Positive
Audit report on compliance with agreements, statutes and regulations	Section 5815	Other assurance engagement	Positive
Audit of internal control over financial reporting that is integrated with an audit of financial statements	Section 5925	Other assurance engagement	Positive
Auditing for compliance with legislative and related authorities in the public sector	Section PS 5300	Other assurance engagement	Positive

Engagement	Related standards	Type of engagement	Level of assurance
Assurance engagement other than audit of financial statements and other historical financial information	Section 5025	Other assurance engagement	Positive or negative
Review of financial statements	CSRE 2400 (effective for periods ending on or after December 14, 2017) / Sections 8100 and 8200; AuG-20 and AuG-17 (for periods ending before December 14, 2017)	Review engagement	Limited / Negative
Review of financial information other than financial statements	CSRE 2400 (effective for periods ending on or after December 14, 2017) / Section 8500 (for periods ending before December 14, 2017)	Review engagement	Limited / Negative
Review of compliance with agreements and regulations	Section 8600	Review engagement	Negative
Auditor review of interim financial statements	Section 7060	Review engagement	Negative
Compilation (Notice to Reader)	Section 9200 and AuG-5	Non-assurance engagement	No assurance provided
Compilation of a financial forecast or projection	AuG-16	Non-assurance engagement	No assurance provided
Report on results of applying specified auditing procedures to financial information other than financial statements	Section 9100	Non-assurance engagement	No assurance provided
Agreed-upon procedures regarding internal control over financial reporting	Section 9110	Non-assurance engagement	No assurance provided

Practice questions

1. Multiple-choice questions:

- i. Brianna, a student in the CPA program, has been asked to prepare a set of financial statements to enable the preparation of a tax return to be submitted to the Canada Revenue Agency. Which type of engagement is Brianna most likely completing?
- a) Review of financial statements
 - b) Compilation
 - c) Audit of financial statements
 - d) Review of compliance with agreements and regulations

Solution

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

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

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

Option d) is incorrect. A review of compliance with agreements and regulations engagement under Section 8600 provides a moderate level of assurance, whereas the preparation of financial statements for a tax return does not require assurance.

- ii. Abdullah, a student in the CPA program, is learning about the similarities between audit and review engagements. Which of the following statements is true?
- a) Independence is required in both an audit and a review engagement.
 - b) Fraud risk is assessed in both an audit and a review engagement.
 - c) Obtaining an understanding of internal controls is required in both an audit and a review engagement.
 - d) Corroboration of management's representations is required in both an audit and a review engagement.

Solution

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

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

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

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

2. Steven, a student in the CPA program, is reviewing the working paper files for a review engagement and a compilation engagement in order to understand the commonalities shared by the documents included in the working paper files for each type of engagement. In particular, Steven is examining the following documents:
- the independence letter
 - a summary of the company's operations
 - the materiality level set for the engagement
 - the signed representation letter

Required:

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

Solution

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