**Chapter 1**

**The Demand for Audit and Other Assurance Services**

**Overview**

Usually students will not have read Chapter 1 before the material in this chapter is covered. Most students are also not familiar with the concept of “audit” and we also need to keep in mind that the vocabulary used in this course is also new for most students.

Accordingly we spend more time taking up this material, and explaining the fundamental concept of audit, which usually requires the majority of the scheduled time of the first day of class (assuming 1 ½ hour class). In addition to reviewing the detailed course outline for the course, we attempt to cover the opening vignette and learning objectives.

**Learning Objectives**

1. Describe auditing and its purpose.
2. Distinguish between auditing and accounting.
3. Explain how auditing reduces information risk.
4. Determine the causes of information risk.
5. Explain how information risk can be reduced.
6. Identify major types of audits and auditors.
7. Explain the general characteristics of an assurance engagement.
8. Describe assurance and nonassurance services provided by public accountants and distinguish the audit of financial statements from other assurance services.

Chapter opening vignette: “Brown Goes Green”

This vignette first discusses United Parcel Service’s (UPS) commitment to sustainability and how through optimization of delivery routes, in 2014, UPS reduced its annual carbon emission by 1.5 percent even though delivery volume increased by 3.9 percent. It then outlines how the UPS Corporate Sustainability Report is prepared and how the increase in sustainability reporting by companies such as UPS has resulted in increased interest in the accuracy of reported information. The vignette then goes on to describe the reports issued by a Big 4 public accounting firm that were included in the UPS Corporate Sustainability Report.

Information from the opening vignette can be used during the lecture as an example to explain to students that assurance services are not only limited to financial information, but extend to all kinds of different information, including greenhouse gas emissions.

**LO 1 Describe Auditing and Its Purpose**

Three concepts to highlight:

1. Assertions
2. Quantifiable information
3. Established criteria

We start by asking students to discuss in small groups what auditors do and why auditing is important. The feedback from the groups usually provides lots of material to generate class discussion. (A common response is that auditors are like policemen looking for fraud and for individuals that “cook the books”.)

An easy means by which to help students understand the basic premise of auditing is to describe it as “checking” – students are usually able to grasp this simple term much easier.

We can facilitate this discussion by asking students how they would audit or “check” if all students present in class are actually registered in the course. For instance, the following could be part of the discussion:

* How would you audit “check” if all students that are currently sitting in the classroom are actually registered in the course?
* What evidence would you need to check this?
  + Each student can be asked to verbally confirm their registration in the course.
  + Each student may be required to show identification.
* Why would you need this evidence? – This part of the discussion can be used to show students the difference in evidence strength. Verbal evidence (inquiry) – less reliable versus documentation (such as students’ identification cards and the class list) – more reliable evidence.
* How would you report the results of the checking that has been performed? This part of the discussion can be linked to the independent auditor’s report, which communicates the outcome of the auditor’s work.

Students tend to think of auditing as the auditing of financial statements by public accounting firms in accordance with GAAS. It is therefore helpful to use Figure 1-1 (“Audit of a Corporate Tax Return”) to discuss the definition and inform the students that an audit of financial statements is just one type of information that can be audited. Refer to the opening vignette to show another type of information that can also be audited that is not related to financial statements.

As a part of this discussion, students are briefly introduced to Canada Revenue Agency (CRA) auditors. Be sure to identify this as a tax compliance audit (tax returned is checked against the *Income Tax Act*) rather than a financial statement audit.

After you have gone over this information, refer students to the definition of auditing and ensure they comprehend that auditing is simply “checking” of information.

Briefly talk about the importance of:

* *Competence of auditor* For example, auditors who audit financial statements must have a strong knowledge of financial accounting (they must be competent), otherwise how would they know what and how to “check” if transactions were accounted for correctly in accordance with an applicable financial accounting framework?
* *Professional judgment* Competence is more than having a technical knowledge – the auditor must act with integrity and apply professional scepticism (a critical assessment of audit evidence and a willingness to challenge the auditee’s assertions)
* *Independence of the auditor* A key characteristic that the public values is the auditor’s independence and objectivity. This is closely related to professional scepticism (it would be hard to be sceptical if the auditor was biased).

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|  | **Teaching Tip:** A good question to ask in relation to the opening vignette is what is causing an increased interest in the accuracy of reported greenhouse gas emissions and how could this be related to the CO2 cap and trade programs launched in some Canadian provinces and states in the USA? To further enhance the discussion, the instructor may access more information about Ontario’s cap and trade at: https://www.ontario.ca/page/cap-and-trade |

*Need to report on findings* At this point we ask the student to identify those individuals or parties who rely on financial statements. It’s important for the student to understand who relies on the audited information and for what purposes (decision-making). It is also important that we tell students that information is not always “correct”, even on financial statements, and that’s why we need an auditor to check it.

The following question can help with this discussion (this can be tied into the concept of information risk):

* What would happen if investors made decisions based on financial statement information that is incorrect?
* Why would someone want to present financial statement information that is not correct?

**LO2 Distinguish Between Auditing and Accounting**

A short amount of time may be spent on the distinction between accounting and auditing, although it is at least desirable to point out the differences and relationship between the two. Ask the students to identify who is responsible for accounting as well as auditing (client versus the auditor.) It may be helpful to explain to the students that the process of accounting is to document events that have taken place (using a specific accounting framework), for instance, recording sale transactions. Whereas auditing happens after the transactions have been recorded and is the process of checking documentation that supports the event (in this example, a sale transaction).

The key concept that student should understand is that:

* Accounting is the process of recording events that generates documents. Auditing does NOT generate any new documents but is simply the process of “checking” documents that were created by the accounting process.

It is important to point out that auditing is more than checking documentation and requires considerable professional judgment.

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|  | **Teaching Tip:** Question 1-19 is a good question to use to highlight the three concepts in the definition of auditing as well as the attributes of the auditor. |

**LO3 Explain How Auditing Reduces Information Risk**

Review the various factors that affect the demand for audits and allow the students an opportunity to discuss the various factors and gain a better understanding of why audits are conducted. The following questions can help facilitate this discussion.

* Why are people willing to pay for audits? (this can be connected to causes of information risk)
* Where is the value of an audit derived from?
* Why would you pay someone to “check” information?

Students might find it difficult to relate to the impact that material misstatements in the financial statements could have on investors (users of financial statements). To help them better relate to this, we present to them the following situation. We tell the students that their mid-term exam grades will be posted online on the course website. Each student will be able to view their mid-term exam grade prior to when the actual exams are returned back to them during class. Now we tell the students to imagine that when they check their mid-term grade on the course website, they find the letter “A” beside their student number/name. Just like an investor reading the financial statements and finding favourable results (growth in revenue or net income), the student reads the favourable exam grade and becomes excited. However, few days later when the instructor returns back the mid-term exams, instead of seeing the letter “A” on the front page of his/her exam, the student finds the letter “F”. Unfortunately, the instructor was marking the exams really late at night and accidentally, when posting the grades online, keyed in the wrong letter grade beside the student’s name. We explain to the students that similar to what they would feel in this scenario, users of financial statements feel the same way if it turns out that the information they believed to be true was in fact false, especially if as a result they suffered a financial loss. Thus, that is why there is a need for auditing, to minimize the risk of an “F” accidentally becoming an “A” or vice versa.

It is good to spend a few minutes discussing the economic role of auditors in society and their impact on the economy by providing confidence in the financial information reported (and, reducing the cost of capital).

Ask the students to identify the goal of an audit. The discussion should encompass the reliability of information to the users of the information and providing more confidence in the reported information. This is something that the mid-term exam scenario should help them better understand.

Point out to the students that the auditor obtains “a high level of assurance” that there are “no material errors.” Most students will not be familiar and will not understand what is meant by the term “assurance” and “material error”. A few minutes should be spent on explaining these terms in simple language. Ask the students why the auditor can’t provide absolute or 100% assurance that there are no material errors. In other words, why can’t the auditor be absolutely sure that everything that was checked is 100% correct? (*Answer:* test checking performed, judgement involved, evidence is pervasive but not conclusive).

Ask the students why the auditor can’t provide assurance that the financial statements are correct to the nearest dollar. (*Answer:* cost effectiveness of an audit and timeliness of the results).

Highlight the key components of this objective: reasonable assurance, opinion, fairly presented, materiality, GAAP, IFRS or appropriate disclosed basis of accounting. A few minutes should be spent on explaining these terms as most students will not be familiar with them.

**LO 4 Determine the Causes of Information Risk**

Refer to Figure 1-2 to discuss the unique accountability relationship among the auditor, client, and external users to highlight the responsibilities with an assurance engagement, why the users want assurance, and how the audit report reduces information risk.

We briefly go over the causes of information risk, providing examples that relate to remoteness of information, biases and motives of the provider of information, voluminous data, and complexity of transactions.

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|  | Teaching Tip: Parts of question 1-20 are useful to demonstrate how users can reduce information risk and the important role that “assurers” can play in reducing information risk. (Students tend to relate to buying a car). |

LO 5 Explain How Information Risk Can Be Reduced

We refer here back to the mid-term exam example and expand the situation by asking the students how they would react to finding out online that their posted final exam grade is poor (final exams are usually not returned back to the students). Knowing about the entry error with the mid-term exam grades, we ask the students what, if any, action they would take to verify that their poor grade on the final exam is not a result of another entry error. (Students would want to make an appointment with their professor to review their actual final exam to check the grade that they received). Using this example, we highlight to students the concept of risk (because of the error with the mid-term exam grades (increased risk) the student wanted to check their final exam grade). The information risk was reduced directly by the student through an “audit” procedure: review and inspection of the grade indicated on the actual final exam. We can point out here to students that, in their daily lives, sometimes without realizing it, they perform many audit-type procedures to reduce information risk. (Reviewing their final exam, cell-phone bill, matching their purchase receipts to their credit card statement are few of the examples).

We point out here to the students that similar to how they rely on their grades (information) to make decisions (enroll into the next course or retake the course, switch into a different program or enroll into the CPA training program), external users (such as shareholders and lenders) rely on financial statements to make business decisions. Whereas it is feasible for a student to review their final exam to reduce the information risk, external financial statement users look to the independent auditor’s report as an indication that the information presented on the financial statements is overall reasonably complete, accurate, and unbiased.

LO 6 Identify Major Types of Audits and Auditors

Most students at colleges/universities know little of the types of auditors and the nature of public accounting. In a brief lecture, we tell the students:

* The nature of financial, compliance, and operational audits
* The primary difference between independent PAs, government auditors, Canada Revenue Agency auditors, internal auditors, forensic and fraud auditors

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|  | Teaching Tip: Table 1-1 and Auditing in Action 1-1 and 1-2 provide useful examples for this discussion. |

LO 7 and LO 8 Assurance and Non-assurance Services Offered by Public Accounting Firms

We highlight to students that an engagement that fulfills the following criteria is an assurance engagement:

• Existence of a three-party relationship

• Subject matter

• Criteria

• Gathering of sufficient appropriate evidence

• Expression of opinion or conclusion

Most students will not yet be familiar with these terms; therefore, we spend a few minutes explaining their meaning by relating to real-life examples.

Students usually struggle to understand the difference between moderate vs. high assurance. To help them understand this difference, we can use the following scenario. We ask the students to imagine a situation where they suspect that a poultry farm where they purchase “organic” meat is adding antibiotics and growth hormones to the animal feed. The students decide to hire a farm inspector to visit and inspect the farm for one week and report back to them. We then tell the students that, assuming the inspector does not find any problems, the inspector can provide the students with one of two conclusions, and ask which one they would prefer. If the inspector provides moderate assurance, the conclusion will state that that *during the week of the inspection, nothing has come to the farm inspector’s attention that would indicate antibiotics or growth hormones were added to the animal feed.*  Alternatively, a higher assurance conclusion would state that *during the week of the inspection, no antibiotics or growth hormones were added to the animal feed.* (Students should prefer the second conclusion as it offers more certainty). We then highlight to students that both conclusions provide assurance, with the first one providing moderate and the second one providing a higher level of assurance. We then explain that the level of assurance is tied to the amount and type of gathered evidence. Obtaining higher level assurance usually requires more work (evidence); as a result, it takes more time and is more costly.

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|  | Teaching Tips: Auditing in Action 1-3 provides a short summary of events surrounding the erroneous announcement of the 2017 Oscars for best picture and is a good way to start a class discussion related to this topic. |

We can then ask students to describe assurance services. The term will be unfamiliar to most students, but some may recognize the concept.

We briefly provide an overview of the following services:

* Assurance services – Financial information (Attestation)
* Assurance services – Non-financial information (Attestation and direct reporting engagements)
* Non-assurance services – compilations, management advisory services, tax services, and accounting and bookkeeping

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|  | Teaching Tips: You could show a webpage from any of the major accounting firms to demonstrate the variety of services provided.  Question 1-28 is useful for reinforcing some concepts regarding how assurance services aid in adding credibility to information and provides a different type of assurance engagement and discussion of the types of services provided by public accounting firms. |

Although the financial audit is the main focus of the book, this brief overview provides some background on the different types of services offered by public accounting firms. This is a good opportunity to explain the difference between an attestation engagement versus a direct reporting engagement (Students tend to have considerable difficulty in understanding the differences). The best example of the attestation engagement is the financial statement audit (the auditor attests (by providing an opinion) to the reliability of the financial statement prepared by management). In contrast, for direct reporting engagements, which are common for internal auditors and auditor generals, the criteria are embedded in the report itself.

In the discussion of non-financial assurance services, instructors may wish to highlight that assurance engagements that are not in connection with the financial statements do not require a public accountant, yet public accountants are often hired to perform these engagements. The same applies to the variety of non-assurance services. A good question is to ask why do many users prefer a public accountant over other service providers? (*Answer*: They are trained in assurance and are required to follow rules of professional conduct. For many of these engagements, the profession has developed standards.)

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|  | Instructors may wish to show this video  <https://www.youtube.com/watch?v=Nd-lQJt_T5E&feature=youtu.be>  It is part of the Center for Audit Quality video series “Focus on the Profession.” The CEO of Crowe Horwath LLP discusses the various services offered at the US public accounting firm and provides a discussion of the importance of independence, competence, integrity and professional skepticism for public accountants. |

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|  | Teaching Tips: Auditing in Action 1-4 is a good example to end the class discussion related to this topic. | |
|  | | Instructors may wish to show this video  <https://www.youtube.com/watch?v=O1HZYjBAooc>  A lot has changed since the economic crisis and, today, boards and audit committees are asking for—and expecting—more from their audit. KPMG’s new report, “Future thought: the audit is changing,” discusses how audit delivery is being transformed by new technologies and techniques in order to provide business executives with insights they want and need. This video highlights the role of Data & Analytics and Lean in Audit™ methodologies and demonstrates how they are helping to meet the needs of today’s modern business. **(5 min)** |

**Lecture Review**

This chapter defined auditing and distinguished auditing from accounting. Audits are valuable because they reduce information risk, which, in the case of a financial statement audit, lowers the cost of capital. The chapter outlined the common types of audits and different types of auditors. The final part of the chapter explained the general characteristics of an assurance engagement and described assurance and nonassurance services that public accountants can provide.

*What is the role of auditing?* Auditing adds value to various types of information – from financial statements to green house emissions. Ultimately, audits assess the reliability of the information that is of interest. Auditors add value by being competent in the relevant subject matter, being independent and acting with integrity, and using professional judgment and scepticism when evaluating the evidence which supports the assertions made by the auditee.

*Why do organizations obtain audit and assurance services?* Organizations request audit and assurance services to help reduce information risk.

*What are the different types of audits and auditors?* The chapter highlights a variety of auditors – financial statement, fraud and forensic, internal, and auditor generals. It also provides an overview of the type of assurance and non-assurance services provided by public accounting firms.

**Suggested Homework Problems**

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| Learning Objectives | Review Questions | Multiple Choice Questions | Discussion Questions and Problems | Professional Judgment Problems and Cases |
| LO 1 | 1-1, 1-3, 1-4, 1-5, 1-6, 1-7 | 1-17 | 1-19, 1-20, 1-21, 1-22 | 1-26, 1-27, 1-28, 1-29 |
| LO 2 | 1-2, 1-8 |  | 1-21, 1-22 | 1-29 |
| LO 3 | 1-3, 1-8, 1-9 |  | 1-20, 1-22 | 1-26, 1-28, 1-29 |
| LO 4 | 1-8, 1-9 |  | 1-20 |  |
| LO 5 | 1-8, 1-9 | 1-17, 1-18 | 1-23, 1-25 |  |
| LO 6 | 1-10, 1-11, 1-12,  1-13, 1-16 | 1-17, 1-18 | 1-21,1-22 | 1-26, 1-27 |
| LO 7 | 1-14, 1-15 |  | 1-24 | 1-28 |
| LO 8 | 1-15, 1-16 |  | 1-24 | 1-26, 1-28, 1-29 |