

Preface

Welcome to the Canadian Eleventh Edition of *Auditing: The Art and Science of Assurance Engagements*. It is with great pleasure that I bring forward this eleventh edition, after having discussed with numerous practitioners the impact of the international auditing standards that are being adopted here in Canada. Practitioners highlighted the fact that many of these standards represent work that is already being done but is being codified and organized in a different way. Accordingly, this text represents a major shift to further clarify the risk-based model, where the audit work conducted is a response to identified risks.

What's New to This Edition?

- More practice, more examples, and more stories help illustrate the assurance material.
- Up-to-date information about auditing standards in transition—New icons and text boxes highlight the changes that are occurring as Canada incorporates new international standards.
- Concept Check questions—Concise review questions appear at the end of each major chapter section and test the reader's understanding of the section material. Solutions to the Concept Check questions are provided on the textbook's Companion Website.
- ACL audit software—Students will be able to download a trial version of this widely used audit software from the Premium Companion Website. ACL software is used by professional auditors to extract and analyze data on clients' computerized systems. ACL Problems in the text show students how audit software is used to perform specific types of audit tests.
- CondoCleaners.com—A running case with discussion questions about a small company, CondoCleaners.com, has been added to focus attention on the auditing needs of small businesses.
- Chapters are organized in a new order to facilitate progressive learning; details are provided below.

Students want more practical information and practice to illustrate the assurance material that can, at times, be quite technical. *Auditing*, Canadian Eleventh Edition, therefore contains more stories and practice questions that relate to small and large businesses at home or from the international business perspective. We are currently living in a period of shifting standards, when some International Standards on Auditing (ISAs) have been adopted as Canadian Auditing Standards (CASs), while others are being reviewed, and the revision of the *CICA Handbook* from the Canadian Institute of Chartered Accountants continues.

To guide students and instructors throughout this change, *Auditing*, Canadian Eleventh Edition, focuses on the required standards and audit practices. A cross-referenced appendix of new as well as prior standards, available on the Companion Website, facilitates finding the exact standards that you need.

Objectives

This book is intended for use in a first auditing course, for one-semester or two-semester instruction at the undergraduate or graduate level. Using a risk-based approach, this text focuses on the auditor's decision-making process. It is important to keep the underlying

objective in mind—the need to collect evidence to enable the auditor’s statement of opinion with respect to financial statements (and other types of information, as discussed in the later chapters). Assessing and documenting the risks associated with the client’s business and the various components of the financial statements allows the auditor to target the fieldwork to specific objectives called audit assertions. If a student in auditing understands the objectives to be accomplished in a given audit area, the circumstances of the engagement, and the decisions to be made, he or she should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

The title of this book reflects the reality that auditing goes beyond financial statement auditing to other assurance services. Auditing is an art, as it requires considerable use of professional judgment, but it is also a science, resting upon a solid frame of technical skills and knowledge of multiple disciplines, including accounting, tax, and information systems. In incorporating substantial new material on risk assessment and corporate governance, my primary purpose is to integrate the most important concepts of financial statement auditing and the general assurance engagement framework. Electronic commerce, non-profit businesses, and many topics that engage professional judgment are highlighted by Problems and new, specialized boxes: Auditing in Action, Audit Challenge, and New Standards.

Organization

This text is divided into five parts.

Part 1, The Auditing Profession (Chapters 1–4)

We begin with explaining the importance of assurance services, including auditing, and differentiating accounting from auditing. Then we talk about the different types of accountants and what they do. In Chapter 2, we move to the role of public accounting firms and other organizations, such as the Office of the Auditor General of Canada, in doing audits. We show how the Sarbanes–Oxley Act, Canadian and international quality control standards, and the Canadian Public Accountability Board have resulted in methods that produce high-quality audits. Chapter 3, Professional Relationships, reflects the fact that professional rules of conduct govern the behaviour of the public accountant in the context of relationships with corporations, other business entities, and the users of reports. Independent standards using a threat-based model are applied to public and non-public engagements. Threats to independence and the way these are mitigated with good quality-control practices are thoroughly examined. Part 1 concludes with Chapter 4, which presents an investigation of the auditor’s legal liability and the profession’s response.

Part 2, The Audit Process (Chapters 5–13)

This section has been adapted to international terminology, whereby the audit process phases are grouped into three sections: Risk Analysis, Risk Response, and Reporting. Chapter 5 allocates eight phases to those three sections, integrating international standards with Canadian practice and standards. It explains the auditor’s and management’s responsibilities and the key role of the audit committee in corporate governance. Transaction cycles are explained with the help of the annual report and financial statements of Hillsburg Hardware Limited, a fictitious public company located in eastern Canada. Chapter 6 discusses evidence decisions and the general concepts of evidence accumulation. The risk-based audit approach with its large investment in up-front planning and the concepts of materiality and the audit risk model are covered in Chapter 7. Chapter 8 focuses on the development of a client risk profile in the context of the business environment. Chapter 9, Internal Controls and Control Risk, uses the components of internal control that are consistent with international standards.

Corporate Governance and Entity-Level Controls, the new Chapter 10, provides a basic discussion of enterprise-wide risk-management processes, crucial to auditors

who must conduct their audit using a risk-based approach. After explaining the role of the auditor in assessing corporate governance, more advanced topics, such as information technology governance and the effect of advanced information systems on the audit, are included. Chapter 11, Fraud Auditing, and examines the nature of fraud and the auditor's responsibilities with respect to fraud. Chapter 12 provides an overall risk-based audit plan, linking planning to assertion-based audit programs, and Chapter 13 discusses sampling concepts relevant to the audit process.

Part 3, Application of the Audit Process to the Sales and Collection Cycle (Chapters 14 and 15)

These chapters apply the concepts from Part 2 to the audit of sales, cash receipts, and the related income statement and balance sheet accounts, using further details from Hillsburg Hardware Limited as examples. In Chapter 14, the audit procedures for sales and cash receipts are related to internal control and audit objectives for tests of controls. Chapter 15 continues to use audit objectives and the results of internal controls tests to formulate tests of details of balances. Students will learn to apply audit sampling to the audit of sales, cash receipts, and accounts receivable by incorporating sampling into the appropriate test, showing the design, conduct, and evaluation of the sample.

Part 4, Application of the Audit Process to Other Cycles (Chapters 16–20)

Each of the chapters in Part 4 deals with a specific transaction cycle or part of a transaction cycle in much the same manner as Chapters 14 and 15 deal with the sales and collection cycle. Each chapter is meant to demonstrate the relationship of internal control and tests of controls for each broad category of transactions to the related balance sheet and income statement accounts. Cash in bank is the first chapter studied, since the audit of cash balances is related to most other audit areas.

Part 5, Completing the Audit and Offering Other Services (Chapters 21–24)

Completion of the audit depends on evaluating whether sufficient audit evidence has been gathered, in the context of the client risk profile and the audit risk model, to enable provision of an opinion on the financial statements. This final phase is explained in Chapter 21. Chapter 22 describes audit reports and variations to such reports. The chapter has significant changes due to the adoption of international standards resulting in a longer and more specific audit report. The impact of electronic filing is considered, as are events discovered after the report date. Chapter 23 focuses on review and compilation engagements, a common service for small- and medium-sized businesses, both profit-oriented and non-profit-oriented. It also describes other types of assurance engagements, such as a report of assurance with respect to internal control over financial reporting, required by public companies under Section 404 of the Sarbanes–Oxley Act of 2002 in the United States. The final chapter, Chapter 24, covers services performed most often by governmental and internal auditors, including risk assessment and systems control design, training and education on risk management and internal controls, specialized audits such as operational audits, and financial statement audits.

Chapter Outline

Each chapter contains the following:

- Learning objectives, listing the concepts that you should be able to address after reading the chapter.
- An opening vignette discussing a real-world topic to highlight a theme and the importance of the chapter. Each vignette describes the importance of the topic to auditors and provides questions to think about the topic further.

- A list of *CICA Handbook* sections referenced in the chapter, targeting additional readings.
- Figures and tables to illustrate, summarize, or clarify topics covered.
- **NEW!** Auditing in Action, Audit Challenge, and New Standards boxes identifying relevant challenges to auditors, successes and research, key current topics, further cases and questions, or recent events in the area.
- **NEW!** An icon (**CAS**) highlights discussions of new standards in the text.
- Essential terms defined in the margin and presented in boldface in the running text, for easy reference.
- **NEW!** Concept Check questions placed at the end of each major chapter section, testing and reinforcing the section material.
- A summary expanding upon the learning objectives.
- Review questions for students to assess comprehension of chapter material.
- Discussion questions and one or two professional judgment problems offering real-world topics to which chapter content can be applied.
- **NEW!** Discussion questions about a small company, CondoCleaners.com, to focus attention on the needs of small business.
- **NEW!** ACL Problems that show students how audit software is used to perform specific types of audit tests. A trial version of the software can be downloaded from the text's Companion Website.

Student Resources

COMPANION WEBSITE *Auditing: The Art and Science of Assurance Engagements*, Canadian Eleventh Edition, is supported by a Premium Companion Website at www.pearsoned.ca/arens that truly reinforces and enhances the text material.

Here you will find additional information about ISAs, self-test quizzes, and additional chapter review material, including:

- **NEW!** ACL audit software available for download.
- **NEW!** An integrated case, Pinnacle Manufacturing, containing questions and detailed financial statements for Chapters 6, 8, 10, 12, and 13.
- **NEW!** Internet problems that encourage using the Internet to research additional material for discussion and presentation in class.
- **NEW!** Answers to the Concept Check questions.

To enhance your use of these materials for self-study, we have also provided you with a function known as Grade Tracker. With Grade Tracker, the results from the self-test quizzes you take are preserved in a grade book. Each time you return to the Companion Website, you can refer back to these results, track your progress, and measure your improvement. You can log on to the Companion Website using the Student Access Code that comes packaged with every copy of *Auditing: The Art and Science of Assurance Engagements*, Canadian Eleventh Edition.

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Instructional Support Materials

INSTRUCTOR'S RESOURCE CD-ROM The Instructor's Resource CD-ROM contains a rich collection of materials to facilitate the teaching of the course. Some of the materials presented on the CD-ROM can also be downloaded from a secure password-protected

instructor's area of the Pearson Canada online catalogue. The CD-ROM includes the following items:

Instructor's Resource Manual and Transparency Masters The Instructor's Resource Manual assists the instructor in teaching the course more efficiently. The features include instructions for assignments, practical examples to help the students understand the material, and helpful suggestions on how to effectively teach each chapter. This manual includes numerous enlarged transparency masters, including key tables and figures from the book.

Instructor's Solutions Manual This comprehensive resource provides detailed solutions to all the end-of-chapter review questions, multiple choice questions, problems, and cases.

Pearson MyTest and TestGen A comprehensive testbank of questions has been prepared to accompany the new edition. The questions are rated by difficulty level, and the answers are referenced by section. The test bank is presented in a special computerized format known as Pearson TestGen. It enables instructors to view and edit the existing question, add questions, generate tests, and print the tests in a variety of formats. Powerful search and sort functions make it easy to locate questions and arrange them in any order desired. TestGen also enables instructors to administer tests on a local area network, grade the tests electronically, and prepare the results in electronic or printed reports. Issued on the Instructor's Resource CD-ROM, the Pearson TestGen is compatible with PC and Macintosh systems.

PowerPoint Slides Electronic colour slides are available in Microsoft PowerPoint. The slides illuminate and build on key concepts in the text.

Image Library The Image Library is an impressive resource that helps instructors create vibrant lecture presentations. Almost all figures and tables in the text are included and organized by chapter for convenience. These images can easily be imported into Microsoft PowerPoint to create new presentations or to add to existing ones.

COURSESMART CourseSmart goes beyond traditional expectations—providing instant, online access to the textbooks and course materials you need at a lower cost for students. And even as students save money, you can save time and avoid any hassle by using a digital eText that allows you to search for the most relevant content at the very moment you need it. Whether it is evaluating textbooks or creating lecture notes to help students with difficult concepts, CourseSmart can make life a little easier. See how when you visit www.coursesmart.com/instructors.

COMPANION WEBSITE The Companion Website prepared for this textbook includes an exciting new function: Class Manager. This feature gives you the ability to quickly and easily monitor student progress on quizzes and other website activities in an online gradebook. A variety of browse and search functions are available and allow you to quickly find any particular activity or student.

Ask your Pearson Canada sales representative about how to obtain an Instructor Access Code for the Companion Website. Once you have logged into the website, you can begin using Class Manager by clicking on the Class Manager tab on the home page and creating a new class. Follow the on-screen instructions to generate a Course ID to distribute to your students. When students register for the website using their access code, they will be given the option to join a class; at this point, they can input the specific Course ID that you have given them.

Students can also use the Companion Website's Grade Tracker function to record and review their own progress on the self-graded quizzes. This function is available even if you decide not to use Class Manager.

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Acknowledgments for the Canadian Eleventh Edition

Our world is changing. This text reflects some of those changes in the rapid pace of standards shifts in the external auditing profession. The feedback and assistance from individuals both inside and outside the profession, with different perspectives, have spurred on my creativity and reinforced the knowledge that we are all different and bring a broad spectrum of skills to the work we do.

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Ingrid B. Spletstoesser-Hogeterp