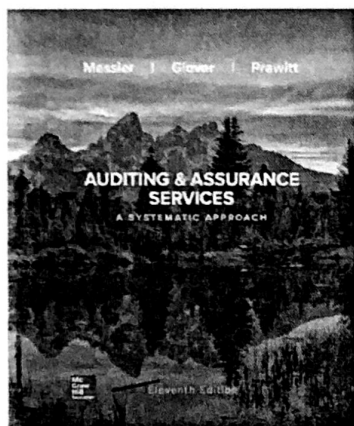


Auditing and Assurance Services

A Systematic Approach

Eleventh Edition



Chapter 1

An Introduction to Assurance and Financial Statement Auditing



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The auditor's report is for the benefit of shareholders to give them confidence whether the company is doing well or not.

Learning Objective 01-1

The Study of Auditing

The study of auditing is different from other accounting courses that you have taken in college because ...

OTHER COURSES

- Rules, techniques and computations to prepare and analyze financial information

AUDITING

- Analytical and logical skills
- Much more conceptual in nature

Logical, conceptual tools are useful for all business professionals, not just auditors!

The Demand for Auditing and Assurance

The development of the corporate form of business and the expanding world economy over the last 200 years have given rise to an explosion in the demand for assurance provided by auditors.

Principals and Agents

A public company is a company that sells its stocks or bonds to the public, giving the public a valid interest in the proper use of the company's resources.

Managers

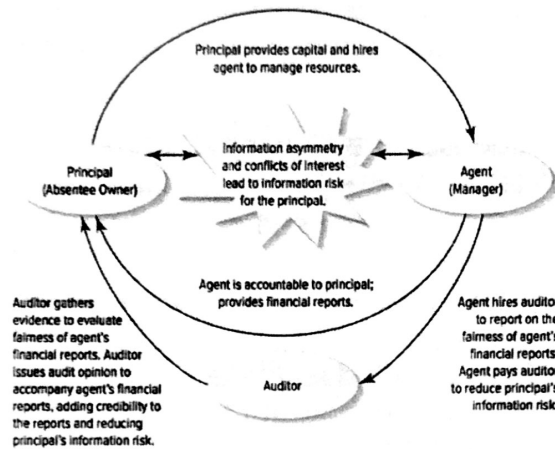
- Agents

Stockholders

- Principals

Learning Objective 01-2

Figure 1-1 Overview of the Principal-Agent Relationship Leading to the Demand for Auditing



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Learning Objective 01-2

Table 1-2 Summary of Management Assertions by Category (1 of 4)

Assertions about classes of transactions and events, and related disclosures, for the period under audit:

Occurrence - Transactions and events that have been recorded or disclosed have occurred, and such transactions and events pertain to the entity.

Completeness - All transactions and events that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

Authorization - All transactions and events have been properly authorized.

Accuracy - Amounts and other data relating to recorded transactions and events have been recorded appropriately, and related disclosures have been appropriately measured and described.

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Table 1-2 Summary of Management Assertions by Category (2 of 4)

Assertions about classes of transactions and events, and related disclosures, for the period under audit:

Cutoff: Transactions and events have been recorded in the correct accounting period.

Classification: Transactions and events have been recorded in the proper accounts.

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

Table 1-2 Summary of Management Assertions by Category (3 of 4)

Assertions about account balances, and related disclosures, at the period end:

Existence - assets, liabilities, and equity interests exist.

Rights and obligations - the entity holds or controls the rights to assets, and liabilities are the obligations of the entity.

Completeness - All assets, liabilities, and equity interests that should have been recorded have been recorded, and all related disclosures that should have been included in the financial statements have been included.

Valuation and allocation - assets, liabilities, and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

Table 1-2 Summary of Management Assertions by Category (4 of 4)

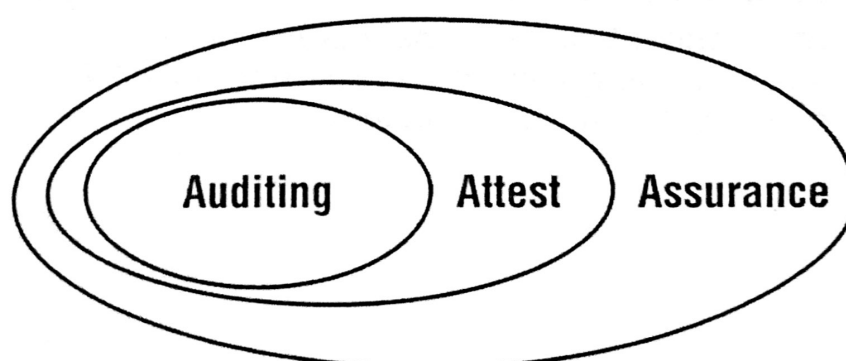
Assertions about account balances, and related disclosures, at the period end:

Accuracy, valuation and allocation: Assets, liabilities, and equity interests have been included in the financial statements at appropriate amounts, and any resulting valuation or allocation adjustments have been appropriately recorded, and related disclosures have been appropriately measured and described.

Classification: Assets, liabilities, and equity interests have been recorded in the proper accounts.

Presentation: Assets, liabilities, and equity interests are appropriately aggregated or disaggregated and clearly described, and related disclosures are relevant and understandable in the context of the requirements of the applicable financial reporting framework.

Relationships among Auditing, Attest, and Assurance Services



Auditing, Attest, and Assurance Services Defined (1 of 2)

Audit Services

- A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

Attest Services

- Attest services occur when a practitioner is engaged to issue ... a report on subject matter, or an assertion about subject matter, that is the responsibility of another party.

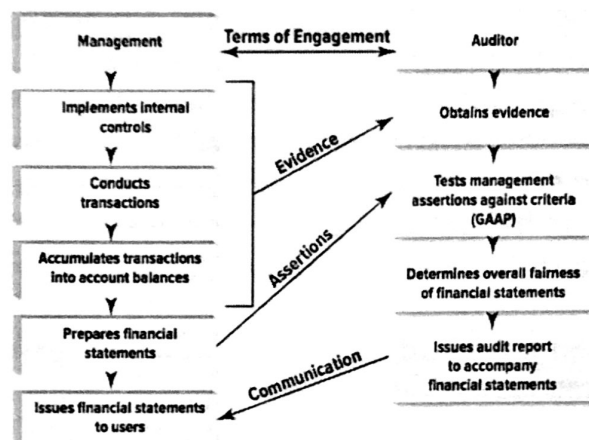
Auditing, Attest, and Assurance Services Defined (2 of 2)

Assurance Services

- Independent professional services that improve the quality of information, or its context, for decision makers.

Learning Objective 01-5

Overview of the Financial Statement Audit Process



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Learning Objective 01-5

Fundamental Concepts in Conducting a Financial Statement Audit

Materiality

Audit Risk

Evidence

* Auditors report to audit committee, not the management.

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Materiality

The magnitude of an omission or misstatement of accounting information that, in light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement.

materiality influences decisions on a big scale

Audit Risk

Audit risk is the risk that the auditor mistakenly expresses a clean audit opinion when the financial statements are materially misstated.

Auditing standards make it clear that the audit provides only **reasonable assurance** that the financial statements do not contain material misstatements.

Reasonable assurance implies some risk that a material misstatement could be present in the financial statements and the competent auditor will fail to detect it.

Audit Evidence Regarding Management Assertions

Evidence that assists the auditor in evaluating management's financial statement assertions consists of the underlying accounting data and any additional information available to the auditor, whether originating from the client or externally.

Relevance – Is the evidence related to the specific assertion being tested?

Reliability – Can the evidence be relied upon to signal the true state of the specific assertion being tested?

Sampling: Inferences Based on Limited Observations

Auditors use a sampling approach to examine a subset of the transactions based on previous audits, an understanding of the company's internal control system, or knowledge of the company's industry.

It would be too costly for the auditor to examine every transaction.

Data analytics will sometimes allow for testing entire populations.

Cannot look at each & every item, because it costs
→ to reduce cost, auditors use different sampling methods.

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(2)

The auditor must know everything about the company in order to accept auditing them

looking & checking everything about the company including their internal control

• the working papers are all reviewed and signed by the supervisor
• the report is discussed with management, but the management cannot influence the decision

Learning Objective 01-7

Major Phases of the Audit

Client acceptance/continuance will the auditor accept the client or not?

Preliminary engagement activities

Plan the audit

Consider and audit internal control look at how efficient the internal control is

Audit business processes and related accounts (e.g., revenue generation) look at business process

Complete the audit

Evaluate results and issue audit report

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ex: Auditor of Desert Cart (Amazon)

Assertions:

inventory: completeness (whether all the inv. is included there)
accuracy / rights of ownership

Why is Amazon cheaper than going to stores?

Due to huge amount of inventory

Major prob. Faced?
Amazon don't own the inventory
→ ownership is a problem.

So the auditor will check when does Amazon take ownership.

Assertion examples

②

Learning Objective 01-7

Issue the Audit Report (1 of 7)

For public company audits, the title line of the audit report includes "Independent Registered Public Accounting Firm."

Usually, the report is addressed to the stockholders and board of directors of the company.

The audit report includes sections titled:

"Opinion on the Financial Statements"

- An explanatory paragraph with the auditor's opinion of internal controls, if the report on internal controls is included in a separate report

"Basis for Opinion"

"Critical Audit Matters"

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ex: Auditor of Alaska Fishing Company (Salmon Farming)

Inventory (what will the auditor consider?)

consider the fish that they have, how much of the fish in the farm is disease free?
(how will the auditor know whether the fish is healthy or not?)

→ they have labs that physically checks the health or sickness of the fish
& the auditor will have to check how many fishes are actually there, & how many survived

ex: Auditor: Anglo America (mining company)

Inventory - what?

↳ diamonds, iron ore, coal, gold, & all other things that are mined

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- look at the value of all of them by looking at the quality of each
- auditors will make use of specialists while checking on the quality of items, & determine whether there is anything wrong or not.

③

Assertion example

Learning Objective 01-7

Issue the Audit Report (2 of 7)

Concludes with:

- Signature of the CPA firm providing the audit
- The year the auditor began serving as the company's auditor
- The city and state in which the report was issued
- Date of the report

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Learning Objective 01-7

Issue the Audit Report (3 of 7)

Types of Audit Reports

- Unqualified
- Qualified
- Adverse
- Disclaimer

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Issue the Audit Report (4 of 7)

The auditor may issue an *unqualified* opinion.

The auditor's report (audit opinion) is the main product or output of the audit. The standard unqualified (clean) audit report is the most common type of report issued. In this context, *unqualified* means that because the financial statements are free of material misstatements, the auditor does not find it necessary to *qualify* his or her opinion about the fairness of the financial statements.

Issue the Audit Report (5 of 7)

The auditor may issue a *qualified* opinion.

Suppose an auditee's financial statements contain a misstatement that the auditor considers material and management refuses to correct the misstatement. Or suppose that the auditor is unable to obtain sufficient appropriate evidence regarding a specific account. The auditor will likely *qualify* the report, explaining that the financial statements are fairly stated *except for* the misstatement identified by the auditor.

Issue the Audit Report (6 of 7)

The auditor may issue an *adverse* opinion.

Suppose an auditee's financial statements contain a misstatement that the auditor considers so material that it pervasively affects the interpretation of the financial statements. Given such a situation, the auditor will issue an adverse opinion, indicating that the financial statements are not fairly stated and should not be relied upon.

Issue the Audit Report (7 of 7)

The auditor may issue a Disclaimer:

If a scope limitation is so pervasive that it limits the ability of the auditor to conclude on the financial statements as a whole, the auditor will issue a "disclaimer of opinion," indicating that it is not possible to express an opinion on the fairness of the financial statements.

Auditing Demands Logic, Reasoning, and Resourcefulness

An auditor needs to understand more than just the accounting concepts and techniques.

Auditing is a fundamentally logical process of thinking and reasoning – so use your common sense and reasoning skills! As you learn new auditing concepts, take some time to understand the underlying logic and how the concepts interrelate with other concepts.

Being a good auditor sometimes requires imagination and innovation.

Understanding audit concepts is useful for all business professionals, consultants, etc.!

END OF CHAPTER 1