The Auditing and Assurance Environment

Assurance engagements

People who are responsible for a specific task (called responsible parties or managers) need to account for their performance with respect to that task. There may be many groups who will rely on this accounting for performance as an aid to their decision making.

Example:

- Shareholders relying on financial reports produced by companies' management
- Government agencies relying on reports produced by entities to account for environmental considerations
- Parents relying on information produced by schools or information contained on websites when deciding where to send their children

Assurance engagement is defined as '*an engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria*.'

- Audit report should ensure or guargoingantee quality – but it cannot
- Audits provide us with ***reasonable*** assurance, not absolute assurance
- It is **materially correct** – if there is an error it does not matter to the decision making process
- It is a matter of **professional judgement** as to whether an error should be adjusted – AASB used to dictate that an error of 0-5% would need to be corrected
- Auditor can do nothing more than ***suggest*** changes – reports are changeable only at the prerogative of management

Five elements of assurance engagement:

1. Three-party relationship – assurance practitioner, responsible party, intended users
2. Underlying subject matter
3. Criteria
4. Sufficient appropriate evidence
5. A written assurance report

Types of assurance engagements

- **Reasonable assurance engagements**
  - For assurance services on historical financial information, a reasonable assurance engagement is termed an '**audit'**
  - Language: 'we believe/we certify this to be the case'
  - High level of assurance (albeit not absolute assurance)

- **Limited assurance engagements**
  - For assurance services on historical financial information, a limited assurance engagement is a '**review'**
  - The auditor has been requested by the client to look at one aspect of their operations and provide a report on that section only
  - Language: 'During examination of this area, we did not find any errors that would cause us to be concerned'
- **Agreed-upon procedures**
  - The auditor does not have the discretion to undertake evidence-collection procedures outside those that have been agreed upon
  - The auditor only issues a report of factual findings, in which no conclusion is communicated and which therefore expresses no assurance
  - The assurance framework does not cover agreed-upon procedures engagements, where there is no conclusion conveying a level of assurance
  - Not deemed to be of an assurance nature

Type of engagement	Objective	Evidence-gathering procedures	Assurance report
Reasonable assurance engagement	A reduction in assurance engagement risk to an acceptably low level under the circumstances of the engagement	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: • Obtaining an understanding of the engagement circumstances • Assessing risks • Responding to assessed risks • Performing further procedures using a combination of inspection, observation, confirmation, recalculation, re-performance, analytical procedures and enquiry • Evaluating the evidence obtained	The practitioner's conclusion is expressed in a form that conveys the practitioner's opinion on the outcome of the assessment of the underlying subject matter against the criteria.
Limited assurance engagement	A reduction in assurance engagement risk to a level that is acceptable under the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the underlying subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to a reasonable assurance engagement	The practitioner's conclusion is expressed in a form that conveys whether, based on procedures performed and evidence obtained, any matter has come to the auditor's attention to persuade them that the information has been materially mismatched.

Auditing

Auditing: 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

Objectives:

- To obtain reasonable assurance about whether the financial report as a whole is free from **material misstatement**, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework; and
- To report on the financial report, and communicate as required by the **Australian Auditing Standards (ASAs)**, in accordance with the auditor's findings.
    - Modern day approach = business risk approach
    - The function of audit requires delivery within a specific time period with limited staff and resources → must provide a quality service in that time frame, prioritize

What is an audit?

The objective of an audit of a financial report is to enable the auditor to **express an opinion** (the audit report), as to whether the financial report is prepared, in all material aspects, in accordance with an applicable financial framework.

Scope of audit of a financial report

- The purpose of an audit and the auditor's opinion is to enhance the degree of confidence of intended users of financial information (ASA 200.3)
- The user, however, should not assume that the auditors opinion is an assurance as to the ***future viability*** of the entity nor an opinion as to the efficiency or effectiveness with which management has conducted the affairs of the entity (ASA 200.A1).

Why have audits?

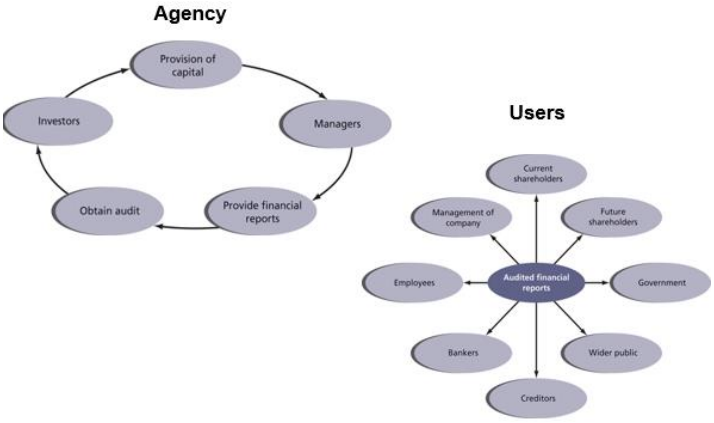
- Conflict of interest – preparers and users
- Consequence
- Complexity of information
- Remoteness of owners

There are three theories which propose reasons why demand for audits might exist without regulatory mandate:

Theory	
Agency theory/ stewardship hypothesis	▪ Separation of ownership and control has resulted in an information asymmetry problem for owners of the organisation

	▪ Each party will act in their own self-interest ▪ Auditors check reports prepared by management and reduce information asymmetry
Information hypothesis	▪ Audit improves quality of information, which provides benefits through reduction of risk, improvements of decisions, and increase in profits ▪ Provides information for decision making – internal and external
Insurance hypothesis	▪ Audits insure investors and creditors against losses ▪ Shifts responsibility for reported data to the auditor

Agency relationships and users



Responsibilities of auditors

Responsibilities of auditors (section 308)	Responsibilities of directors (section 292-306)
› Report to the members of the company on the financial report presented by the directors at the annual general meeting › Report an ***opinion*** as to whether the financial report is in accordance with the law, including **compliance** with accounting standards, and provides a **true and fair** view.	› Prepare annually a financial report and any other information or explanation as is necessary to give a **true and fair** view and ensure that the financial report is audited › Ensure that the financial report is prepared in accordance with the **accounting standards** and gives a true and fair view › Whether there are reasonable rounds to believe that the company will be able to **pay its debts** as and when they become due and payable

Red flag #1 –

- The auditor is examining information on a company's activities related to historical events
- Both directors and auditors signed a declaration that the company is and will be a going concern 12 months into the future
    - Going concern – solvency, ability to pay debts whenever they occur
- How can they be certain? Is this even possible?

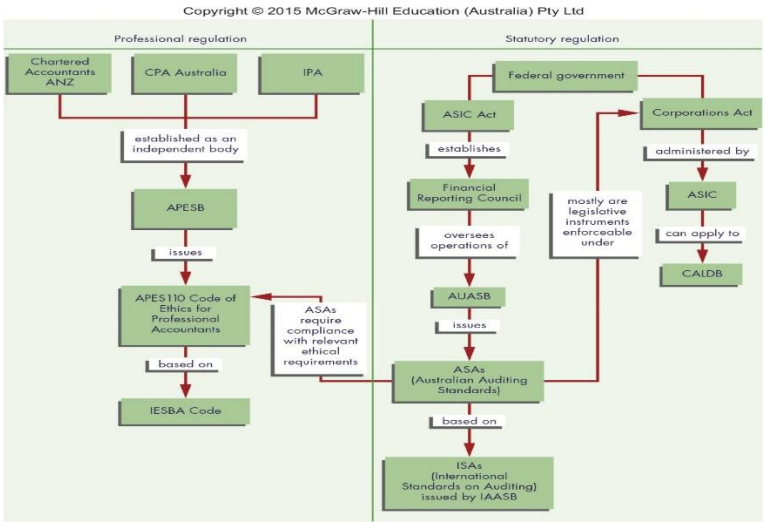
In-lecture exercises

1. **Does the new audit report (2015 version) better address the purpose and scope of the audit?**
    - Potentially yes – the new report is providing more information

- It has been restructured to include more sections to bridge the expectation gap regarding the quality of the audit process

2. **Does the new audit report (2015 version) better address the concept of agency theory and information hypothesis?**
    - Yes, it is helpful in presenting more information
    - However, it is still riddled with technical jargon – does this really satisfy the communication/information barrier? → this will always be a challenge for management
    - Future problems: how much bigger could it get before it loses value?

Regulation of auditing



Statutory regulation	Professional regulation
▪ Australian Securities and Investments Commission (***ASIC***) Act 2001 establishes Financial Reporting Council (***FRC***) which oversees operations of Auditing and Assurance Standards Board (***AUASB***) who issues Australian Auditing Standards (ASAs) based on International Standards on Auditing (ISAs) issued by International Auditing and Assurance Standards Board (IAASB). ▪ The ASAs are mostly legislative instruments enforceable under ***Corporations Act*** administered by ASIC which can apply to Companies Auditors and Liquidators Disciplinary Board (*CALDB*) to determine whether auditors or liquidators have breached the Corporations Act 2001.	▪ Chartered Accountants Australia and New Zealand (ICAA), CPA Australia and Institute of Public Accountants (IPA) established the Accounting Professional and Ethical Standards Board (APESB) as an independent body to set ethical standards to audits and assurance services carried out by members of the professional accounting bodies. ▪ The APESB issues ***APES110*** Code of Ethics for Professional Accountants ▪ ASAs require compliance with relevant ethical requirements