

The Auditing and Assurance Environment

Audit Function, the Role of Audit Standards and the Audit Profession

- People who are responsible for a specific task (called 'responsible parties') 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.
- 'Assurance' is a broad term to describe any situation where information is prepared by one party and then attested to its accuracy by another party. An 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'. An audit is an assurance engagement.
 - The five elements of an assurance engagement are:
 - A three-party relationship (assurance practitioner, responsible party and intended users).
 - Underlying subject matter.
 - Some criteria to be used in assessment.
 - Sufficient appropriate evidence.
 - A written assurance report.
 - There are different types of assurance engagements. These include:
 - 'Reasonable assurance arrangements' refers to an engagement where an auditor will provide reasonable assurance on the accuracy of some subject matter. A reasonable assurance engagement on historical financial information is termed an 'audit'.
 - The objective of a reasonable audit engagement is to reduce the level of risk in an assurance engagement to an acceptably low level under the circumstances of the arrangement.
 - The practitioner will gather a sufficient amount of appropriate evidence through a systematic engagement process that includes:
 - Obtaining an understanding of the engagement circumstances.
 - Assessing risks.
 - Responding to assessed risk.
 - 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. The language is positive in the conclusion.
 - 'Limited assurance engagements' refers to a situation where limited assurance is given by an auditor on some subject matter. For series on historical financial information, this type of engagement is referred to as 'review'. It is often done to check the accuracy of one component of the business.
 - The objective of a limited assurance engagement is to reduce risk in the assurance engagement to a level that is acceptable under the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement.
 - Practitioners will gain sufficient amounts of evidence through 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 information has been materially misstated.
- 'Agreed-upon procedures' where the auditor does not have the discretion to undertake evidence-collection procedures outside those that have been agreed upon.
 - The auditor will issue only 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. It is not deemed to be of an assurance nature.
- An audit can be defined as 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 result to interested users.
 - The objective of an audit is 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 (through the audit report) on whether the financial report is prepared, in all material respects, in accordance with and 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.
 - 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 auditor's 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).
- Audited statements do not give absolute assurance about the accuracy of financial information. It is a form of quality control; however, it will only give 'reasonable assurance' that is not materially wrong. This means that any error will not impact decisions making.
 - ASA 200 states that 'reasonable assurance' is a high level of assurance. It is obtained when an auditor has received sufficient appropriate evidence to reduce audit risk to an acceptably low level.
 - There used to be quantitative guidelines for materiality. The regulators were concerned with this prescriptive based approach. As such, the new guidelines rely on professional judgement rather than absolute numeric cut-offs. These applied to the accountants preparing the statements which flowed through to the audit process.
- The purpose of an audit can be viewed as to provide certain interested parties with attestation of the reliability of certain information supplied by those entrusted with the property of others.
- In doing this, an audit aims to achieve enhanced credibility of information disclosure and increased reliability for the users of financial statements.
- Modern day audit approaches surround 'business risk'. The key risks of the business are identified and assurance processes are focusing on assessing the impact of these risks. The focus on these risks allows auditors to complete the services given limited resources and time.
- Auditing is not adding additional financial disclosure, it provides credibility to the disclosure of management. Auditors do not have the ability to change accounts. Auditors can suggest changes and have tools to be persuasive to management to change the accounts.
- The responsibilities of an auditor include:

- Expressing an opinion on the financial report.
- Stating whether or not the audit was conducted in accordance with auditing standard.
- An audit should be described, meaning that the procedures used to obtain evidence are stated.
- An auditor's report should state that the auditor believes that sufficient and appropriate evidence has been obtained to form an opinion.
- The driving force behind the demand for audit can be questioned. One can view it as a regulatory cost as regulations mandate the need for audits. Others believe that there would be demand for audit even without the regulatory mandate, suggesting there is value to the audit process. Three theories that support the idea that there would be demand for audit even without regulation are:
 - Agency theory:
 - The separation of ownership and control of an organisation has resulted in an information asymmetry problem for the owners of an organisation (the agency problem).
 - An agency relationship exists when there is a contract under which one or more person engage another person to perform some service on their behalf which involves delegating some decision-making authority to the agent.
 - The problem arises as a result of the risk that managers may not have the same incentives as the owners of the company. Agency theory is based on the assumption that each party will act in their own self-interests.
 - Independent auditors are benefited to both parties of the agency relationship. The managers can communicate to the owners with more confidence. The owners can have more faith in the reliability of management's communication in the form of financial reporting.
 - This is the most widely accepted theory for a demand of audit services outside of regulatory enforcement.
 - Information hypothesis:
 - According to the information hypothesis, the audit improves the quality of information, which provides benefits through the reduction of risk, improvements of decisions, and the increase in profits.
 - Investors will demand this information because it is useful in decision making and will assist them in assessing the risks and returns associated with their investment.
 - The audit will reduce estimation risk (the uncertainty associated with the realisation of future cash flows).
 - There will also be value within the firm to assist in improving financial data for internal decision making (this is achieved by detecting errors and motivating employees to exercise more care).
 - Insurance hypothesis:
 - The insurance hypothesis was suggested as creating additional demand for auditing and appeals to two different groups.
 - The first is investors and creditors who might demand an audit to show that they are being prudent to insure against losses.
 - Part of the responsibility for reported data is shifted to the auditor. This lowers the expected loss from litigation or related settlements to managers, creditors and other professionals in capital markets.
 - Auditors can be seen to have 'deep pockets' as they are the ones left standing after a corporate loss.
 - The second group to benefit from the insurance aspect of auditing are regulators who can insulate themselves from criticism by directing blame toward auditors.
- There are a number of forces at play that regulate and determine practice in the audit environment. The most significant of these are:
 - Professional bodies: The three main industry bodies in Australia are ICAA, CPA Australia and the Institute of Public Accountants (IPA). Membership in one of these