Auditing & Assurance – Week 2 Notes – Ethics, Legal Liability & Client Acceptance

1. **Fundamental principles of professional ethics**

Integrity	The obligation that all members of the accounting professional bodies be straightforward and **honest.**
Objectivity (unbiased)	The obligation that all members of the professional bodies not allow their **personal feelings** or prejudices to **influence** their professional judgement.
Professional competence and due care	The obligation that all members of the accounting professional bodies **maintain their knowledge and skill** at a require level.
Confidentiality	The obligation that all members of the professional bodies **refrain from disclosing information** that is leaned as a result of their employment to people outside of their workplace.
Professional behaviour	The obligation that all members of the professional bodies **comply with rules and regulations** and ensure that they do not harm the reputation of the profession.
Due care	The obligation to **complete each task thoroughly**, document all work and **finish on a timely basis.**

2. **Auditor Independence**
   - **Independence** is the **ability** to act with **integrity, objectivity and with professional scepticism** (questioning mind).
   - Lack of auditor independence **impacts on credibility and reliability** of the financial report.
   - The auditor must be, and be seen to be, independent.

2(a) **Independence of mind** – the ability to act independently, ability to make a decision free from bias, personal belief and client pressures. (The way auditor do their work, collect information)

2(b) **Independence of appearance** – belief that independence of mind has been achieved. Dress up professionally, presentable.

Auditor Independence Threats – see textbook **pg60** for example for each and how to safeguards	
Self-interest	The threat that can occur when an accounting firm or its staff has a **financial interest in an assurance client**. (Hold shares in the company).
Self-review	The threat that can occur when the assurance team need to **form an opinion on their own work** or work performed by others in their firm.
Advocacy	The threat that can occur when a firm or its staff **acts on behalf of its assurance client.** (Stay away from providing legal service)
Familiarity	The threat can occur when a **close relationship exits** or develops **between assurance staff and the client staff.**
Intimidation	The threat that can occur when a member of the assurance team feels **threatened by client** staff or directors.

Auditor's independence safeguards

Safeguards created by the profession, legislation or regulation	• Quality control standard • Code of ethics • Legislative requirement to be independent
Safeguards created by client	• Corporate governance • Policies and procedures (independent directors)
Safeguards created by accounting firms	• Quality control procedures • Client acceptance and continuance

3. **Auditors relationship with others**

Shareholders	• Audit report addressed to them • Attendance at client's AGM • Formal responsibility for auditor appointment
Board of Directors	• Represents shareholders • Executive (director and also an employee) and non-executive directors. • Large companies have committees made up of several directors to deal with specific issues.
Audit Committee	• Audit committee is a sub-committee of the board of directors. The audit committee enhances auditor independence and ensures that the financial report is true and fair and that the external auditor has access to all records and other evidence required to form their opinion. • Acts on behalf of board of financial reporting and audit matters • Top 500 must have audit committee and top 300 must follow ASX guidelines • Aid to auditor independence • Non-executive directors, majority independent • Financial accounting knowledge desirable • Meets with external and internal auditors
Internal Auditors	• Viewed by external auditor as part of client • External auditor can reduce scope of testing if effective internal audit function • If intend to use the work of internal audit function they should consider various internal audit characteristics such as objectivity, technical competence, due professional care and communication with external auditors. • Employees of client these days are more like risk management auditor. • If want to rely on internal auditor's work, must ensure all 4 points below are met.

Objectivity	Refers to how the internal audit function fits within the client's organisational structure. This is important as it established the level of independence of the internal audit function from the rest of the organisation. The more independent, then more reliance can be placed upon.
	Refers to the skills, training and ability of the internal audit team. External auditor may consider the background and qualifications,

Technical competence	training undertaken, the extent of experience and whether the internal audit staff are appropriately qualified for their roles.
Due professional care	Refers to documentation, planning and supervision of the internal audit function. The external auditor is interested in the level of planning undertaken by internal audit. Also want to see evidence of the procedures undertaken by internal audit in formulating their conclusion.
Communication with external auditors	Communication between internal and external auditors is achieved through the scheduling of regular meetings, the external auditor have access to internal audit documentation as needed, and the external auditor informing internal audit of any issues affecting their work that arise through the course of the external audit. Important for them to freely communicate without interference from client management.

4. **Legal Liability**
   - External auditor must exercise **due care**, be diligent and applying standards and documenting work.
   - Auditor can be **found negligent and liable** for damages under tort law if it is established that:
     - A **duty of care** was owned by the auditor
     - There was a **breach of duty of care**
     - A **loss was suffered** as a consequence of that breach

	• Liability under either contract or tort law • Negligence: failed in performance of audit being **careless and breaching duty of care** • Contract: Failed **duty of care** implicit in acting as auditor and explicit in engagement letter • Case law shows change in definition of ‘reasonable’ care and skill over time as standards change.
	• London and General Bank Ltd – Auditor has a duty to report to the shareholders, not the directors of the company. Auditor however is not bound to do more than exercise reasonable care and skill in

Legal liability to clients	making inquiries and investigations. Auditor are not insurance, is assurance. (Audit expectation gap) • Kingston Cotton Mill – Duty of auditor to bring to bear on the work he has to perform that skill, care and caution, which is reasonably competent, careful and cautious auditor would use. “Auditor is a watchdog, but not a bloodhound (forensic dogs) ” • Pacific Acceptance – duty to use reasonable care and skill, check and see for themselves rather than for rely on client management and staff, audit the whole year, closely supervise and review the work of junior staff, properly documented procedures used, warn and inform the appropriate level of management, take further action where suspicion is aroused that a misstatement may be occurred, guided by professional standards. • HIH Royal Commission Report – independence is a critical element in establishing the credibility and reliability of an auditor’s report, free from any interest that is incompatible with objectivity, independent and objective audit, conducted with an appropriate degree of professional scepticism, is required. Auditors’ independence declaration. • Centro Properties Group – auditor must have duty of care to their client. Executive and non-executive directors were being sue.
Contributory negligence	AWA case – If directors are also negligent, each party is held accountable to their guild. The case states that auditor informed director that internal control is not sufficient but director take no action. So director held for responsibilities as well.
	• No contract between auditor and third parties, they must rely on tort law and show duty of care.
	• Caparo – reasonable proximity (closeness) between auditor and third parties. Auditors owe a duty of care to stakeholders as **a group** and not to individual shareholders, which make it more difficult for an auditor to be successfully sued by a third party. [No Case] • Candler – auditors liable to third parties that the auditors **know their client will show the accounts to**. [No case]

Legal Liability to third parties	• Scott Group – auditors liable to third parties that they can **reasonably foresee** may rely on the financial report of their client. [Yes case]
	
	• Columbia Coffee and Tea – audit firm had **manual stating** they acknowledge that third parties would rely on audited accounts. [Yes case]
	
	• Esanda – Judge argues against Columbia finding; Australian High Court ruled that for a third party to establish duty of care, they must show:
	    o The report was prepared on the basis that it would be communicated to a third party.
	    o The report was likely to be relied upon by that third party.
	    o The third party ran the risk of suffering a loss if the report was negligently prepared.
	    o The parties can request privity letter. (Acknowledges that the third party intends to rely on the audited financial report). [No case]

Avoidance of litigation (Safeguard)	• Hiring competent staff
	• Training staff and updating their knowledge regularly
	• Ensuring compliance with ethical regulations
	• Enduring compliance with auditing regulations
	• Implementing policies and procedures to ensure:
	    ➢ Appropriate procedures are followed when accepting a new client
	    ➢ Appropriate staff are allocated to clients
	    ➢ Ethical and independence issues are identified and dealt with on a timely basis
	    ➢ All work is fully documented
	    ➢ Adequate and appropriate evidence is gathered before forming an opinion.
	• Meeting with a client's audit committee to discuss any significant issues identified as part of the audit.
	• Following up on any significant weakness in the client's internal control procedures in a previous year's audit.
	• Dealing with privity letter requests in accordance with the guidance provided in 1014 Privity Letter Requests.

5. **Client acceptance and continuance**

Step 1 :
 	
Assess client integrity
	• Reputation of client, management, directors, key stakeholders.
	• Client's reason for switching auditor.
	• Client's attitude to risk exposure and management.
	• Client's attitude to using internal controls to mitigate risk.
	• Appropriateness of the client's interpretation of accounting rules.
	• Client's willingness to allow auditor full access to information required to form an opinion.
	• Client's attitude and willingness to pay fair amount for audit work.
	• Auditor can obtain information from:
	    o Prior auditor (with client's permission. APES 10)
	    o Client personnel,
	    o Third parties
	    o Key competitors
	    o Review of press articles
	
	Access client integrity because if the director is not integrity, the opinion that director give you is lack of integrity and dishonest, which lead to much harder to audit. If you don't trust the director, how you want to do your audit and give opinion? Accounting require a lot of judgement.

Step 2 : Assess audit firm's ability to meet ethical requirements, service client	• Consider if any threats to fundamental principles arise from appointment (APES 110 s.210) • Auditor must ensure it has sufficient staff available with required knowledge to complete audit (professional competence and due care). • Consider potential independence threats, safeguards and remedies. • Decline appointment if threat insurmountable. (too great to be overcome) • Is the job profitable?
Step 3 : Prepare client engagement letter.	• Prepared by auditor, acknowledge by client. • Form of contract that can expand on obligations in Corporations Act. • Explains scope of audit, timing of various aspects of audit, overview of client responsibilities. • Confirms auditor's right to access to information. • Sets fees.

Auditing & Assurance – Week 3 Notes – Risk Assessment 1

1. **Stages of an Audit**

<table>
<tr>
<td>Risk Assessment Phase</td>
<td>Involve gaining an understanding of the client
Identifying of risk factors
Developing an audit strategy and setting planning materiality.
Risk and materiality assessment.</td>
<td rowspan="3">Risk of material misstatements
Fraud – intentional
Error - unintentional
Either overstated or understated.

Have to check fraud triangle to determine if it is a fraud.</td>
</tr>
<tr>
<td>Risk Response Phase

(Chapter 8-11)</td>
<td>Performing test of controls
Detailed substantive testing of transactions and accounts, concentrating effort here the risk of material misstatement is great.</td>
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<tr>
<td>Reporting Phase

(Chapter 12)</td>
<td>Evaluation of the results of the detailed testing in light of the auditor’s understanding of their client and forming an opinion on the truth and fairness of the client’s financial report.
In short, conclusion and forming an opinion.</td>
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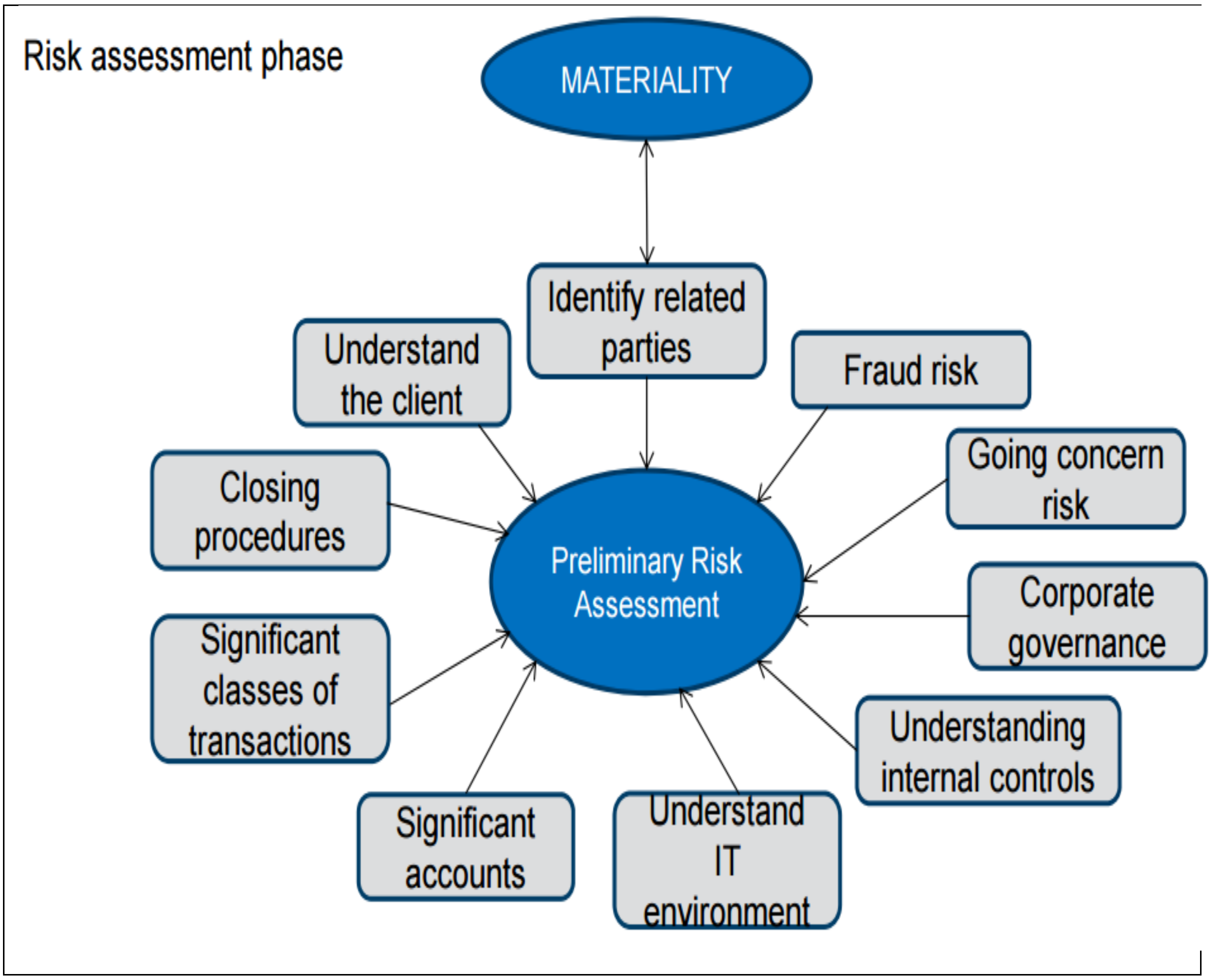


2. Process used in gaining understanding of a client

- According to ASA 315; ISA315, gaining an understanding of the client is necessary to **assess the risk** that the financial report contains a **material misstatement** due to:
  - The **nature** of the client's business
  - The **industry** in which the client operates
  - The **level of competition** within that industry
  - The client's **customers and suppliers**
  - The **regulatory environment** in which the client operates.

Some business are more risky – R&D, high-tech companies (recognition issues)

2(a) Gaining an understanding of a client – Entity Level	
Major customers	To identify if those customers have good reputation, are on good terms with client and are likely to pay the client on a timely basis.
Major suppliers	Determine whether they are reputable and supply quality goods on a timely basis. Consideration is given to whether significant levels of good are return.

International transactions	If client is an importer or exporter, stability of the country client's trade with, stability of foreign currency, effectiveness of any risk management policies.
Capacity to adapt to changes in technology	If is not, there is risks falling behind competitors and losing market share which in the longer term can affect the going concern assumption.
Warranties and Discounts	If provide warranties, auditor need to assess the likelihood that goods will be returned and the risk the client has underprovided for that rate of return. Discount given or receive are reviewed to check on client's bargaining power with its customers and suppliers.
Client reputation and operations	A company with a poor reputation places future profits at risk. Check on the number of location it operates, the more spread out, the harder to effectively control and coordinate its operations.
Sources of financing	Assessment is made on client's debt sources, the reliability of future sources of financing the structure of debt and the reliance on debt versus equity financing.
Ownership structures	Amount of debt funding relative to equity, the use of different forms of shares and the differing rights of shareholder groups. Dividend policy
Client relations with employees	Nature of employment contracts and the client's relations with its employees. The auditor will consider how a client pays it employees, the mix wages and bonuses.

2(b) Gaining and understanding of a client – Industry level	
The level of competition	The more competitive the client's industry, the more pressure placed on the client's profits. Economic downturn, weakest companies in highly competitive industries face financial hardship and possible liquidation.
Client reputation	Client reputation relative to other companies in the same industry. If the client has a poor reputation, customers and suppliers may shift their business to a competing form, threatening their client's profits.
Level of government support	If the industry faces significant competition internationally or the industry is new and requires time to become established. Support may be receive from government if the industries produce items in line with government policy such as solar heating.
Level of government regulation	Regulations can affect a client's viability and continued profit ability. Auditor will consider the level of taxation imposed on client.
Level of demand for client good/services	If client's products are seasonal, profits may suffer. If a client sells swim suit sales will fall during cool summer. If client operates in an industry subject to changing trends, such as fashion, the client risks inventory obsolescence if it does not keep up and move quickly.

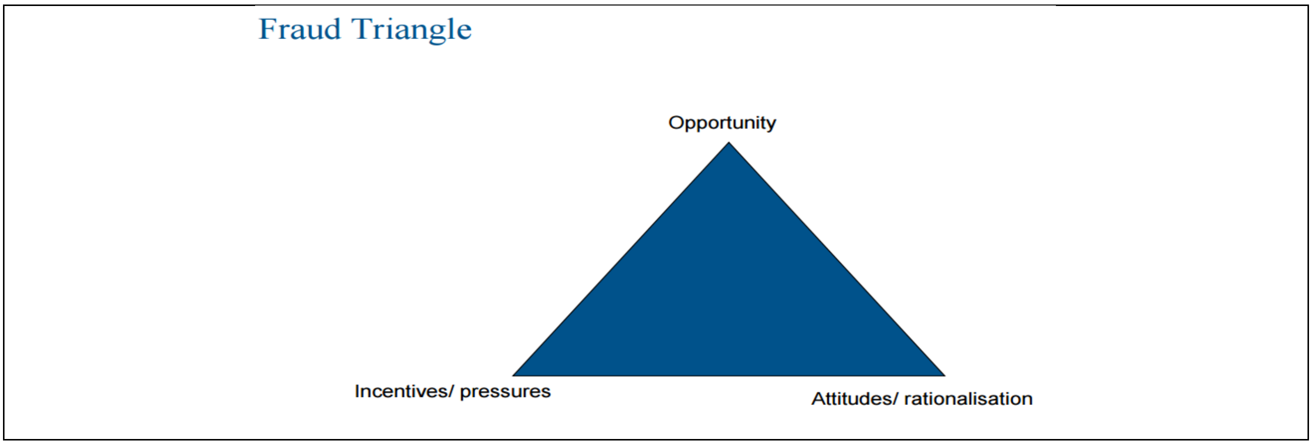
2(c) Gaining an understanding of a client – Economy level	
Economic upturns	Companies are under pressure to perform as well as or better than competitors.
Economic downturns	Companies may decide to 'take a bath' which means that companies may purposefully understate profits so can demonstrate an improvement in profit in following year. Also there is a chance to maximise write-offs as a fall in profits can easily be explained to the share market.
Interest rate change	Susceptibility to these changes and its ability to withstand economic pressures.
Currency fluctuations	

3. **Fraud Risk**

- Define as an **intentional act** though the use of deception to obtain an unjust or illegal advantage.
- Auditors must assess risk of a material misstatement due to fraud (ASA240, ISA 240).
- When assessing fraud, auditors will adopt an attitude of **professional scepticism.**
    - Maintaining an independent questioning mind
    - Search thoroughly for **corroborating evidence** to validate information provided by the client
    - Don't just rely on past experience with client.
- Indicators (red flag) of possible fraud:
    - High turnover of key employees, key finance personnel refusing to take leave, overly dominant management, poor compensation practices, inadequate training programs, complex business structure, No, or ineffective internal audit, high turnover of auditors, unusual transactions, weak internal controls.
- Two types of fraud

Financial Reporting Frauds	**Misappropriation of assets frauds**
• Improper asset valuations • unrecorded liabilities • Delaying expenses • bringing forward revenues • Fictitious revenues, understating expenses • Inappropriate application of accounting principles	• Using company credit card for personal items • Failure to remove ex-employees from payroll • Unauthorised discounts or refunds to customers. • Theft of stock or other assets

Preventing and detecting fraud rests with those charged with governance at the client**.** **Prevention** refers to the use of controls and procedures aimed at **avoiding fraud**. **Detection** refers to the use of controls and procedures aimed at **uncovering a fraud** should one occur.



Incentives and pressures to commit a fraud
➢ Auditor will consider incentives and pressures faced by their client to commit a fraud. ➢ If an auditor becomes aware of any of these risk factors, in isolation or combination, they will plan their audit to obtain evidence in relation to each risk factor. ➢ Examples of incentives and pressures that increase the risk of fraud includes: • Client operates in a **highly competitive industry**, significant **decline in demand for the client's products or services**, **falling profits**, threat of **takeover**, threat of **bankruptcy**, ongoing **losses**, **rapid growth**, **poor cash flows combined with high earnings**, pressure to **meet market expectations**, planning to **list on a stock exchange**, planning to **raise debt or renegotiate a loan**, about to enter into significant **new contract**, a significant proportion of **remuneration tied to earnings**.
Opportunities to perpetrate a fraud
➢ After identifying one or more incentives or pressures to commit a fraud, auditor will assess whether a client has an opportunity to perpetrate a fraud. ➢ Example of opportunities that increase the risk that a fraud that may have been perpetrated: • Accounts that rely on **estimates** and judgement, high volume of transactions close to **year-end**, **significant adjusting entries** and reversals after year-end, significant **related party transactions**, **poor corporate governance** mechanism, **poor internal controls**, **high turnover of staff**, reliance on **complex transactions**, **transactions out of character for a business.**
Attitude and rationalisation to justify a fraud
➢ Together with the identification of incentives or pressures to commit a fraud and opportunities to perpetrate a fraud, an auditor will assess the attitudes and rationalisation of client management and staff to fraud. ➢ Attitude refers to ethical beliefs of right and wrong and rationalisation refers to an ability to justify an act. ➢ Examples of attitudes and rationalisations used to justify a fraud include: • A poor tone at the top (from senior management) • The implementation of an effective internal control structure is **not seen as a priority** • An **excessive focus on maximisation of profits** and/or share price • A **poor attitude to compliance** with accounting regulations • Rationalisation that other companies make the same inappropriate accounting choice.

4. **Going concern risk**
   - Going concern is the **viability** of a company to remain in business for the foreseeable future.
   - Auditor must consider whether it is appropriate to assume that client will remain a going concern (ASA 570; ISA 570)
   - Assumption: Going concern justifies **valuing assets on basis they will continue to be used** for the purposes of conduction a business and **liabilities paid when due**.
   - Remaining a going concern is the responsibility of the client.
   - Auditor must **obtain sufficient appropriate evidence** to assess validity of going concern.
   - Auditors makes professional judgement about going concern risk, based on risk indicators.
   - ASA 570; ISA 570 has list of going concern **risk indicators**, examples include:
     - Significant debt/equity ratio
     - Long term loans due, no alternative finance
     - Prolonged losses, inability to pay debts when due
     - Loss of significant customer, supplier problems
     - High staff turnover, loss of key personnel, strikes
     - Problem obtaining raw materials, inputs
     - Poor growth planning, inadequate risk management
     - Being under investigation for non-compliance
     - Competitive pressures, drought.

   - Auditors is required to assess client efforts to identify going concern risk factors.
   - Auditors **should obtain evidence of effect of risk factors** on client and its ability to continue as going concern.
   - **If going concern is in doubt, undertake audit procedures.**
     - Assess cash flow, revenues, expenses, interim results
     - Review debt contracts, board meeting minutes
     - Discussions with client management and lawyers

   - **Going concern risk – mitigating factors**
     - Auditor should consider factors that mitigate(reduce) going concern risk such as:
       - Letter of guarantee from parent company
       - Availability of assets of segment of business for sale for cash
       - Ability to raise funds through share issue or borrowing
     - Consider adequacy of **client disclosures** in financial report about going concern issues.
5. **Corporate governance – if in appropriate, can impact numbers in financial report**