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0. AUDITING

PRE-READING

The Framework for the Preparation and Presentation of Financial Statements identifies four qualitative characteristics of financial statements that make the information provided to users useful. These are:

- 1) Understandability
- 2) Relevance
- 3) Reliability
- 4) Comparability

The ultimate aim is for financial statements to show a true and fair view of (or present in a fair manner) the financial position, financial performance and cash flows of the entity.

The primary outcome of an audit is to check whether the financial statements *do* present a true and fair view. The auditor is required to form an opinion on whether the financial statements present fairly to the user the economic and financial position and performance of the organisation being audited. The focus is not solely on the calculations, but also investigating the professional judgement exercised by the entity

It is important to note that constant referral to previous subject's studies will be required. Especially to identify where accounting procedures and processes can fail, where judgments are made, and where agency theory may disrupt stakeholder motivation.

ASSETS

- a) **An asset** is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.
- b) **A liability** is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.
- c) **Equity** is the residual interest in the assets of the entity after deducting all its liabilities.

The major factor of an asset that is noted is that there is a future economic benefit that is expected to flow to the entity. In the case of an expense, it decreases or uses up the benefits during the accounting period under consideration.

INVENTORY

AASB 102 prescribes the accounting treatment of inventories. The standard defines inventories as assets:

- a) Held for sale in the ordinary course of business;
- b) In the process of production for such sale; or
- c) In the form of materials or supplies to be consumed in the production process or in the rendering of services.
- d)

The standard also identifies "shall be measured at the lower of cost and net realisable value" (AASB 106.9). If measured at cost then this value should include "all costs of purchase, costs of conversion and other costs incurred in bringing the inventories to their present location and condition" (AASB 106.10)

MATERIALITY

The standards specified in other Australian Accounting Standards apply to the financial statements when information resulting from their application is material.

Information is material if its omission, misstatement or non-disclosure has the potential, individually or collectively, to:


- a) influence the economic decisions of users taken on the basis of the financial statements; or
- b) affect the discharge of accountability by the management or governing body of the entity.

1. OVERVIEW OF AUDITING AND ASSURANCE

Audit

A professional service that involves an objective and critical examination of a subject matter with the aim of assessing its credibility, in order to provide assurance through the issue of an objective opinion

- 1) **Objective** – free from bias
- 2) **Critical examination** – questioned in detail (e.g. does it make sense, does it fit the criteria, does it meet our expectations)
- 3) **Subject matter** – financial report, a hospital audits the use of drugs, about a particular thing
- 4) **Assessing its credibility** – does it make sense, is it valid, not always black and white
- 5) **Provide assurance** – a level of confidence, getting a level of certainty (not absolute)
- 6) **Issue of an objective opinion** – based upon your assessment of the above



An audit is an assurance engagement

Assurance

The auditor's ability to provide a degree of satisfaction regarding the reliability of the information provided. The degree of satisfaction achieved is determined by the nature and extent of procedures performed by the auditor, the results of the procedures and the objectivity of the evidence obtained.

- 1) **Degree of satisfaction** – level of confidence
- 2) **Reliability of information** – how reliable is one piece of evidence, how reliable is the group of evidence
- 3) **Nature and extent of procedures** – nature (what I do), extent (how much I do, are you able to gather more evidence, more evidence that points to same direction leads to more confidence (if diff direction, more confusion, less assured))
- 4) **Results of procedures** – findings of the procedures
- 5) **Objectivity of evidence** – if there is possible bias (who provided the evidence?)

Why do we have audits?

- 1) Different users have different access to information. Those who prepare statements have much more greater access than users, leading to **information asymmetry**. As evident, it is brought about by the relationship and stewardship function between the user and preparer
- 2) Audits provide value. They facilitate information user confidence, promote the public interest, meet regulatory obligations and are a key feature of good corporate governance

DEMAND FOR AUDITS

There are three key theories that explain the demand for audits in this day and age;

- 1) **Agency theory**; agents are to act in the best interests of the principals, but do they? Separation of ownership and control means whilst owners entrust managers to run the company on their behalf, their incentives are not necessarily matched. An audit acts to mitigate this agency problem in firms.
- 2) **Information hypothesis**; there is a demand for information for decision making – audit of financial statements leads to better information and thus better decisions. **Consequently, investors will demand this information as it leads them to better decision making.**
- 3) **Insurance hypothesis**; an audit shifts the responsibility to the auditor to mitigate risk.

These theories ultimately suggest that companies would undertake audits regardless of government regulation (and being forced to).

ROLE OF THE AUDITOR

An auditor, to be independent, should be **without bias** in respect of the client under audit and should **appear to be objective** to those relying on the results of the audit.

5. CLIENT EVALUATION AND PLANNING THE AUDIT

Think of the fundamental principles – what if we're not competent to do the audit? For instance, BHP comes to a small audit firm. Is it appropriate that they accept? Will it result in compliance with the fundamental principles?

→ Confidentiality (can we keep their information confidential?)

→ Objectivity (are we going to be biased if we are auditing their competitor? What if we are differently motivated?)

ACCEPTING AND CONTINUING AUDIT ENGAGEMENTS

The engagement partner shall be satisfied that appropriate procedures regarding the acceptance and continuance of client relationships and audit engagements have been followed, and shall determine that conclusions reached in this regard are appropriate.

ASA 220.12

Audit firms are required to have procedures for acceptance and continuance of clients, and we need to make appropriate conclusions.

→ **Quality Control:** If we accept a client, we automatically owe a duty of care. Can we meet the requirements outlined in Pacific Acceptance? We may be liable under negligence if we accept.

CLIENT ACCEPTANCE

CLIENT FOCUS

1. Evaluate the integrity of management

Communication with previous auditor

- **NOTE: To ensure confidentiality is not threatened, we need permission from the client to contact previous auditor. Reluctance to speak to the previous auditor is in itself a sign of potential wrongdoings.**
- More information
- Particular issues

Enquire of third parties (banks, solicitors, others)

- Special circumstances

Review previous experience (previous material errors)

- Clients in industry
- With prospective client

2. Identify special circumstances and unusual risks

Who are the users of the financial statements

- Why are they being prepared?
- Who are they being prepared for?
 - Potential investors are a third party, but Esanda Finance may imply a duty of a care is owed to them as well.

Legal and financial stability

- Auditors have 'deep pockets'. They are likely to be sued if the company fails, be careful of their economic state.
- Economic environment
- Known issues **(are they being sued; can they meet debt repayments?)**

FIRM FOCUS (ETHICAL AND LEGAL CONSIDERATIONS)

1. Evaluate Independence

- Firm staff at all levels
 - Firm rules and ethical requirements
 - Quality control

Discontinue financial or business relationships
Any staff being recruited?
Stop non-assurance services
Conflict with existing clients?

2. Assess competence to perform audit

- Experience - staffing (HR, development, qualifications)
- Skills
- Need for experts – specialists: ASA 620.

3. Ability to use due care

- Ensure quality – staffing, timelines, costs
- Review, supervise work, estimate time
- **Essentially are we able to critically review judgment exercised at every level?**

ENGAGEMENT LETTER

The auditor shall agree the terms of the audit engagement with management or those charged with governance, as appropriate.

ASA 210.9

- Example – **ASA 210. Appendix 1**
- Specific to the client and the audit
 - Make expectations clear

The agreed terms of the audit engagement shall be recorded in an audit engagement letter ... and shall include:

- a) The objective and scope of the audit of the financial report;
- b) The responsibilities of the auditor; By outlining the exact responsibilities, audit expectation gap is minimized
- c) The responsibilities of management;
- d) Identification of the applicable financial reporting framework for the preparation of the financial report; and
- e) Reference to the expected form and content of any reports to be issued by the auditor ...

ASA 210.10

CLIENT CONTINUANCE

On **recurring audits**, the auditor shall assess whether circumstances require the terms of the audit engagement to be revised and whether there is a need to remind the entity of the existing terms of the audit engagement.

ASA 210.13

Changes in the client:

- Management and personnel
- Situation – economic, financial, and organisational
 - The company may have grown to a state where the auditor is no longer appropriate. Similarly, if **expansion** into different markets may require more experts, different team. The existing engagement letter would no longer be appropriate.

The objective of the auditor is to plan the audit so that it will be performed in an effective manner.

ASA 300.4

- Aim for appropriate conclusion and opinion. This may be unmodified or not.

The auditor shall establish an overall audit strategy that sets the scope, timing and direction of the audit, and that guides the development of the audit plan.

ASA 300.7

The first important step is to create the **audit strategy**

- Characteristics of the engagement
- Reporting objectives, timing and communication
- Significant factors, preliminary engagement activities, and knowledge gained on other engagements
- Nature, timing and extent of resources

Developing the **strategy** requires the auditor to consider the resources being used

- The resources to deploy for specific audit areas
 - Sales and Purchases
 - Non-Current Assets
 - Experts
- The allocation of resources - timing and location
- Management, direction and supervision of resources (Pacific Acceptance; supervise junior employees – who is to do this?)



→ Audit Strategy and Plan must be updated and changed as required during the audit

After completing the strategy, the auditor shall develop an **audit plan** that shall include a description of:

- The nature, timing and extent of planned risk assessment procedures (**Assess Risk**)
- The nature, timing and extent of planned further audit procedures at the assertion level (**Evidence about assertions**)
- Other planned audit procedures that are required to be carried out so that the engagement complies with the Australian Auditing Standards (**Evidence to be able to form an opinion**)

ASA 300.9

The first step of the audit planning process is to understand the client and environment.

The auditor shall obtain an understanding of the following:

- a) Relevant industry, regulatory, and other external factors and the applicable financial reporting framework.
- b) The nature of the entity, including:
 - i. its operations;
 - ii. its ownership and governance structures;
 - iii. the types of investments that the entity is making and plans to make, including investments in special-purpose entities; and
 - iv. the way that the entity is structured and how it is financed to enable the auditor to understand the classes of transactions, account balances, and disclosures to be expected in the financial report.

- c) The entity's selection and application of accounting policies, including the reasons for changes thereto ...
- d) The entity's objectives and strategies, and those related business risks ...
- e) The measurement and review of the entity's financial performance.

ASA 315.11

Industry, regulatory, and external factors

- Read business newspapers and industry publications
- Audit team specialisations assist with this

Nature of the entity

- Read media releases, ASX announcements, minutes of board meetings
- Review knowledge of other clients
- Review IT environment
- 'How do they make money', and financing. For example, MFG companies auditor would be concerned about inventory assertions (WIP, Raw Materials etc).

Objectives, strategies and business risk

- Read mission statements, and minutes of board meetings
- Review major asset purchases and expansion information
- For example, expansion would introduce risk that they misjudged the market leading to no sales, again be concerned about inventory – but valuation this time! Look out for write-downs.

Review of financial performance

- Analytical Procedures – ratio analysis (horizontal, vertical, industry)
- Market analysis and expectations (share price)
- Note the numbers are from their information system thus verify it first.

Recall: The Audit Objective

"To obtain reasonable assurance about whether the financial report as a whole is free from material misstatement ... 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."

The **audit plan** is to determine:

- What is to be tested
 - How it is to be tested
 - When testing is to occur
 - How much testing will occur

DOCUMENTATION

Permanent File

- Information useful for future engagements

Current File

- Evidence gathered in the performance of the current year audit
 - Nature, extent and timing of audit procedures
 - Documentation of evidence from procedures
 - Documentation of the conclusion

Keep for 7 years and there's no obligation to make working papers available to future auditor.

FRAUD

AAS requires the auditor to make specific consideration of risk of fraud.

Misstatements in the financial report can arise from either fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement of the financial report is intentional or unintentional.

ASA 240.2

The **primary responsibility** for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

ASA 240.4

→ We are a watchdog, not a bloodhound.

An auditor conducting an audit in accordance with Australian Auditing Standards is responsible for obtaining reasonable assurance that the financial report taken as a whole is free from material misstatement, whether caused by fraud or error.

ASA 240.5

Recall: The Fraud Triangle → “what leads to fraud?”

- Incentives can be within or outside the organisation
- Opportunities include internal controls, and monitoring (lack of, or inappropriate)
- Rationalisation includes ethics and management focus (laissez faire attitude)

The auditor shall maintain professional scepticism throughout the audit, recognising the possibility that a material misstatement due to fraud could exist ...

ASA 240.12

The auditor shall evaluate whether the information obtained from the other risk assessment procedures and related activities performed indicates that one or more fraud risk factors are present.

ASA 240.24

If the auditor identifies a misstatement, the auditor shall evaluate whether such a misstatement is indicative of fraud ... recognising that an instance of fraud is unlikely to be an isolated occurrence – If the auditor ... has reason to believe that it is or may be the result of fraud ... [consider] resulting impact on the nature, timing and extent of audit procedures to respond to the assessed risks

ASA 240.35 and 36

If the auditor has identified a fraud or has obtained information that indicates that a fraud may exist, the auditor shall communicate these matters on a timely basis to the appropriate level of management

ASA 240.40

- **Recall Pacific Acceptance**

If the auditor has identified or suspects a fraud, the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity ... the auditor’s legal responsibilities may override the duty of confidentiality in some circumstances

ASA 240. 43

- Assess the evidence from tests of controls
- What level of assurance is there as to the effectiveness of a control and therefore the underlying assertion?

When different types of evidence support the same conclusion about the effectiveness of a control, the degree of assurance increases. Conversely, when they support different conclusions, the degree of assurance decreases.

- Remember, the auditor will consider qualitative and quantitative factors. If the failure of a control is due to a temporary employee (tenure of 3 days) then this is less significant than if it was an experienced employee.

If the final assessment of control risk allows reliance then decrease the level of substantive procedures.

INFORMATION TECHNOLOGY ENVIRONMENT

Controls

- User controls
- Application controls
- General controls

CAATs

- Use test data
 - Put test data into the system and see what comes out of the system. For example, if you put a sale through and there is a debit to sales then something is wrong. Essentially checks the process.
- Integrated test facility
 - Put real data into our system and look at the output. Our system we know works thus if we get the correct output then the real data is appropriate. Essentially checks the data.
- Parallel simulation
 - Put same data into both our system and their system and compare the two outputs.

In exam → Know that CAAT's relate to the IT environment and what assertion they can test/how to suggest a ToC using a CAAT.

Illustrative Example

1. Understand the controls

- What are they designed to prevent or detect (something to do with business risk)?
- What type of misstatement is the control related to (control risk and thus audit risk)?
 - Account, Class of Transaction, Disclosure
 - Effect on control risk

2. Preliminary assessment of the controls

3. Identify relevant assertions and effect on financial statements

- What is the possible effect on the financial statements?
 - Relate an assertion to the understanding of the control

4. Plan, then execute, audit procedures to test the effectiveness of the control

- Nature, timing and extent
 - For example; Observe the order and inspect the customer balances
- Evaluate evidence gained from testing

Underlying concepts

1. Financial Statement Assertions
2. Audit Risk Model
3. Auditors are to gather sufficient appropriate evidence in order to form and express an opinion
4. Tests of controls procedures are used to determine actual level of CR

The audit strategy indicates that a 'lower assessed level of control risk' strategy has been adopted.

Time spent understanding the internal control structure is the same as the predominantly substantive approach, but there is a **greater time spent testing the controls**.

Do the results agree with the initial assessment? If, in fact, we find that the internal controls are not working effectively, as once thought, then we will need to document and amend our audit approach (Pacific Acceptance). Also note, this will impact the level of planned substantive tests.

9. SUBSTANTIVE PROCEDURES

Irrespective of the assessed risks of material misstatement, the auditor shall design and perform substantive procedures for each material class of transactions, account balance, and disclosure.

- Pacific Acceptance requires us to get evidence for ourselves (which is substantive tests)

The auditor's substantive procedures shall include the following audit procedures related to the financial report closing process:

- a) Agreeing or reconciling the financial report with the underlying accounting records; and
- b) Examining material journal entries and other adjustments made during the course of preparing the financial report.

ASA 330.18 and .20

AUDIT RISK MODEL

$$AR = IR \times CR \times DR$$

Detection Risk

The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

If IR and CR is assessed as high then we have a high risk of material assessment and AR will have preliminary assessment of high.

- The higher AR, the lower we set the level of materiality (accept less errors) and therefore we gather more evidence and more testing.
- Net effect is to lower DR to lead bringing AR down to an acceptable low level

Note if the preliminary assessment of control risk is high, this indicates that they are not able to rely on the client's internal controls will prevent material misstatements arising.

The client's internal controls will not lead to a decrease in risk and therefore the focus must be on the auditor's procedures to substantiate the information contained in the financial statements.

DESIGNING TESTS

Nature

- Analytical procedures
- Tests of **details** of transactions
- Tests of **details** of balances

We are testing the detail behind the transactions/balances. Testing how they came to the result and if it is the correct result (e.g. impairment that affects PPE value). **This is where we need to use professional skepticism about the details.**

Timing

- Depends on level of detection risk
- Performing them before year end is convenient and cost-effective, but this must be weighed up against the associated increase in audit risk that material misstatements will not be detected.
- For example, they have highly effective controls and therefore we can allow a higher level of detection risk, we can then gather evidence before 30 June.
- For example, we can also gather evidence about 30 June before/after 30 June (E.G. look at payments of receivables → If she paid then proves existence and valuation). **If we sell 5 chairs at 1st July then those chairs must have been in inventory at 30th June.**