WEEK 1

CSA pp1-5 GS pp4-21 48-58 ASA 200, 700

Objective 1: Objective of a Financial Statement Audit

An Audit of a Financial Report

3 The purpose of an audit is to enhance the degree of confidence of intended users in the financial report. This is achieved by the expression of an opinion by the auditor on whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial report is presented fairly, in all material respects, or gives a true and fair view in accordance with the framework. An audit conducted in accordance with Australian Auditing Standards and relevant ethical requirements enables the auditor to form that opinion.

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).

6. As the basis for the auditor's opinion, Australian Auditing Standards require the auditor to obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error. Reasonable assurance is a high level of assurance. It is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion when the financial report is materially misstated) to an acceptably low level. However, reasonable assurance is not an absolute level of assurance, because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive.

7. The Australian Auditing Standards contain objectives, requirements and application and other explanatory material that are designed to support the auditor in obtaining reasonable assurance. The Australian Auditing Standards require that the auditor exercise professional judgment and maintain professional skepticism throughout the planning and performance of the audit and, among other things:
- Identify and assess risks of material misstatement, whether due to fraud or error, based on an understanding of the entity and its environment, including the entity's internal control.
- Obtain sufficient appropriate audit evidence about whether material misstatements exist, through designing and implementing appropriate responses to the assessed risks.
- Form an opinion on the financial report based on conclusions drawn from the audit evidence obtained.

11. In conducting an audit of a financial report, the overall objectives of the auditor are:
(a)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;
(b)To report on the financial report, and communicate as required by the Australian Auditing Standards, in accordance with the auditor's findings.

<u>Accountants Vs Auditors</u>

Accounting:

- provides financial information for decision making, control and accountability.

Assurance:

- provides satisfaction as to reliability of provided information.

- various levels (reasonable, limited) depending on nature and extent of procedures and objectivity of evidence

Auditing:

- provides assurance that accounting information is relevant, reliable, comparable, understandable and conveys a true and fair view

Assurance engagement: an engagement in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria. (Framework 7)

Objective 2: Demand for Independent Audit

Requirements of an Audit

- Comply with ethical requirements (ASA 102 and APES 110)
- Conduct audit in accordance with ASAs
- Adopt attitude of professional scepticism (ASA 200 p 157)
- Exercise professional judgment (assumes expertise)
- Gather sufficient appropriate audit evidence to reduce audit risk to an acceptably low level

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- To express an opinion of the financial report
- Obtain sufficient appropriate audit evidence
- Assess risks of material misstatement
- State whether the financial report is prepared in all material respects in accordance with an applicable financial reporting framework

<u>Management's Responsibilities</u>

- Preparing and presenting the financial report in accordance with financial reporting framework (ASA 200.A2)
- This generally requires:
  - maintenance of adequate accounting records
  - maintenance of adequate system of internal control
  - selection and application of appropriate accounting policies
  - development of accounting estimates

Effective use of Financial Statements requires that the educated reader understands the roles of management in preparing financial statements and the Auditors responsibility in terms of auditing them

<u>Demand for Audit</u>

- Conflict of interest – preparers and users
- Improve quality of information for important decisions
- Complexity of information
- Remoteness of owners

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- Agency theory / stewardship hypothesis
- Information hypothesis

- Insurance hypothesis

Annual audits required by Regulation:
- Companies, registered schemes & disclosing entities (excludes small proprietary companies)
- Commonwealth & state government departments, statutory authorities, government companies and business undertakings, municipalities
- Not-for-profit organisations

Providers of Audits:
- Independent auditors
- Must be registered with ASIC to be able to perform audits on reporting entities
- Criteria set out in s.1280 Corporations Act
  - Educational qualifications
  - Work experience
  - Member of ICAA or CPA Australia

Objective 3: How is the Audit Profession Structured

Audit approach: the approach adopted by an audit firm to a specified audit assignment will be a key factor in determining the outcome of the audit. If auditors fail to adopt the correct audit approach then the likelihood of audit failure increases, failure which could lead to a damaged reputation and potentially costly litigation against the firm.
- the substantive procedures approach (time-consuming)
- the balance sheet approach
- the systems-based approach (eg. internal control system)
- the risk-based approach

Corporate Collapse impacts on Auditing
- A clear objective to enhance and maintain the integrity of the profession;
- Clearly address the auditor interest to the public is as important as to the client, such as safeguarding independence by eliminating complex relationship with audit clients;
- Reiterate ethical governance;
- Stronger regulation on auditors and audit;
- Increasing the forensic nature of audit and stronger awareness of corporate fraud;
- Relate audit risks to business risk

Professional Judgment

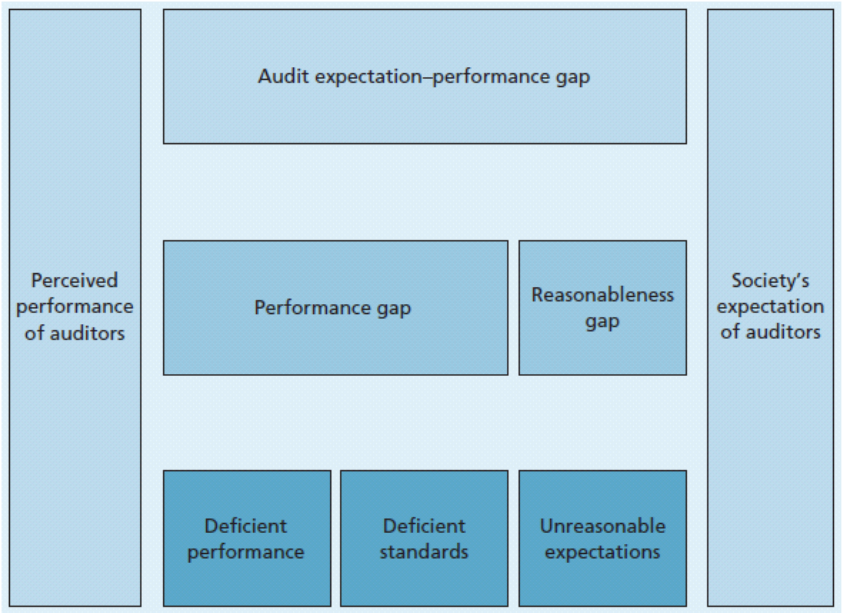
16 The auditor shall exercise professional judgment in planning and performing an audit of a financial report.

Professional Skepticism

15 The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial report to be materially misstated.

Objective 4: Audit Expectation Gap

"the difference between what auditors actually do when they conduct an audit and what shareholders and others think auditor's do, or should do, in conducting the audit" *Report of HIH Royal Commission*



Source: Adapted from B Porter, 'An empirical study of the audit expectation–performance gap', *Accounting and Business Research* 24(93), 1993, p. 50.

① **the reasonableness gap:** the gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish.

② **the performance gap:** the gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve. This can be further subdivided into:

- deficient standards: the gap between the duties that can reasonably be expected of auditors and auditors' existing duties as defined by law and professional promulgations.
- deficient performance: the gap between the expected standards of performance of auditors' existing duties and auditors' perceived performance, as expected and perceived by society.

Four major expectation gas issue:

① the nature and meaning of auditor's report messages

② early warning by auditors of corporate failure

③ the auditor's responsibility for the detection and reporting of fraud

④ the auditor's ability to communicate different levels of assurance.