ACFI3005 – Auditing and Assurance

Summary – Exam

Topic 1 – Introduction to Audit and Assurance

Assurance: a conclusion an assurance practitioner provides about the outcome of an evaluation or measurement of a subject matter against criteria. In an audit, the auditor provides assurance that the report meets the requirements of law and accounting standards, provides true and fair position.

Financial report audit: a type of assurance engagement with the objective of the auditor to express an opinion on whether they think the report is prepared in accordance with a financial reporting framework.

Types of assurance engagements: does not have to be a financial report audit, can be a compliance audit, performance audit, comprehensive audit, internal audit, assurance on CSR disclosure.

Three parties relevant to an assurance engagement: the assurance practitioner, intended users, and responsible party.

Interest of the assurance practitioner: they are the auditor providing assurance, so they want to know the result of the audit because if it is not up to the required standard, their reputation will be at stake.

Interest of the user: the users are the people that the assurance report is prepared for, such as shareholders. They rely on the audit report for their decision making in regards about the entity.

Interest of the responsible party: the responsible party is the person or company who prepared the subject matter being audited. They are interested in the result of the audit because they can use the report to make improvements, and a positive report means that their interested users can rely more on the audits.

Criteria used in a financial report audit: the financial report audit involves evaluation or measurement of the report in accordance with the financial reporting framework. This is the laws and standards that apply to that type of financial report. In Australia, listed companies must abide by the Corp Act 2001, the AASB, and listing rules of the ASX. If the company is listed in another country, foreign ex rules and laws could apply to the financial report.

Performance audit: is concerned with the economy, efficiency, and effectiveness of an organisation's activities. Generally requested by those charged with governance, and is usually conducted by internal auditors. It may also be outsourced externally. From an organisational perspective it is important to perform well across all three dimensions and not allow one to dominate.

Increasing independence of internal auditors: internal auditors can be seen as more independent if they are members of the institute of internal auditors, an international organisation with more than 180 000 members. This organisation gives guidance and standards to aid internal auditors in their work.

Emphasis of matter: the emphasis of matter paragraph draws the attention of the reader to an issue that the auditor believes has been adequately explained in a note to the financial report. Its purpose is to ensure that the reader pays appropriate attention to the issue when reading the financial report.

Investors as a user: they generally read a financial report to determine whether they should invest in, buy, hold, or sell shares in the case of a company. They are interested in the return on their investment and are concerned that the entity will remain a going concern into the foreseeable future. For a large listed company, the investors will be interested in return on investment, and the capacity of the entity to pay a dividend.

Suppliers as a user: read a financial report to determine whether the entity can pay them for goods supplied. For a large listed company, the suppliers will want to know whether the entity will remain a going concern and be able to repay debts when they're due.

Customers as a user: also want to use the financial report to determine whether the entity will remain a going concern. For a large listed company they will want to know this to determine whether they have a secure supply for the goods/services they are purchasing.

Relevant international standards – CSR assurance: ASAE3000/ISAE3000 provides guidance for auditors when assuring CSR and similar reports. It gives guidance on client acceptance, quality control, professional scepticism, professional judgement, planning/performing the assurance engagement, steps in evidence gathering, forming an opinion based on conclusions drawn from evidence gathered.

Regulators of the audit process: the FRC, the Auditing and Assurance Standards Board, the Accounting Professional and Ethical Standards Board, ASIC, ASX, the Companies Auditors and Liquidators Disciplinary Board, CAANZ, CPA Australia and the IPA.

FRC: oversees the process used for setting accounting standards and auditing standards. Monitor and report on matters concerning auditor independence, ensure standard-setter independence.

Auditing and Assurance Standards Board: responsible for formulation of auditing and assurance standards.

APESB: issues and regulates professional and ethical standards.

ASIC: oversees the audit function, regulates auditors, processes annual statements from registered auditors, enforces independence requirements and provides a whistleblowing facility for the reporting of contraventions to the Corp Act.

AUASB: responsible for formulation of auditing and assurance standards. The standards they issue are revised and redrafted to bring them in line with International Standards on Auditing.

Audit expectation gap: occurs when there is a difference between the expectations of assurance and financial report users. The gap occurs when user beliefs do not align with what an auditor has actually done.

Unrealistic expectations causing the gap: auditor provides complete assurance, guarantees future viability, the unmodified audit opinion is an indicator of complete accuracy (with no misstatements, errors or fraud), the auditor will find any fraud, and that they have checked all transactions.

Realistic expectations: the auditor provides reasonable assurance, cannot guarantee future reliability, an unmodified audit opinion indicates there are no significant misstatements, the auditor assesses the fraud risk and tries to uncover any fraud with no guarantee that they will find any, and the auditor only tests a sample of transactions.

Environmental auditing: voluntary and carried out by auditors or specialist consulting firms.

Limited assurance: auditor gathers sufficient evidence to form a conclusion that nothing came to their attention that would lead them to believe that the information being assured is not true and fair.

Topic 2 – Ethics, Legal Liability, Client Acceptance

Ethics: not the same as legal. It is a set of moral principles or values and is usually different for each person. It focuses on what is right or wrong and how and why people act the way they do.
Ethical behaviour: necessary for society to function orderly.
APES110: contains the key code of ethics, but is not legally bound.
Fundamental principles of professional ethics: integrity, objectivity, professional competence and due care, confidentiality, professional behaviour
Integrity: members should be straightforward and honest.
Objectivity: no personal feelings, conflicts of interest or prejudice should bias professional judgement or impair decision process.
Professional competence and due care: professionals should maintain knowledge, keep up to date with regulations and standards, continue education and act diligently.
Confidentiality: refraining from disclosing information to others (except if there is a legal requirement to do so) and using information to their advantage or that of another person.
Professional behaviour: complying with regulations, not harming reputation of the profession, honesty in representations to current and prospective clients, not claiming qualifications not possessed, not undermining the reputation of others.
Independence: ability to act with integrity, objectivity, with professional scepticism. Lack of auditor independence impacts on credibility and reliability of the financial report.
Independence of mind: ability to act independently, make decision free from bias, personal belief and client pressures (actual independence).
Independence in appearance: belief that independence of mind has been achieved.
Threats to independence: self-interest, self-review, advocacy, familiarity, intimidation.
Self-interest threat: occurs if the audit firm/staff have financial interest in audit client. **Examples:** bank account held with client, shares owned in client, loan to/from the client, fee dependence, close business relationship with client.
Self-review threat: occurs where the assurance team need to form an opinion their own work or work done by their firm. **Examples:** assurance team member has recently been an employee/director of the client, preparing information or performing services for the client and then assuring it.
Advocacy threat: can occur when an audit firm or assurance staff act (or believed to act) on behalf of assurance client, can lead to questioning of auditor's objectivity. **Examples:** encouraging others to buy client's shares or bonds, representing client in negotiations with a third party, representing client in legal disputes.
Familiarity threat: occurs when close relationship exists/develops between assurance firm and client, or firm and client personnel. Causes loss of objectivity. **Examples:** long association between firm and client/client personnel, close personal relationships between assurance firm staff and senior client personnel, acceptance of gifts from client (other than minor tokens), acceptance of hospitality from client (other than minor gestures).
Intimidation threat: can occur when assurance team feels threatened by client staff/directors. Leads to team unable to act objectively, fearing negative consequences. **Examples**: threat that client will use different assurance firm next year, undue pressure to reduce audit hours to reduce fees.
Safeguards to independence: mechanisms that have been developed by the accounting profession, legislators, regulators, clients and accounting firms. Used to minimise the risk that a threat will surface, and to deal with a threat when one becomes apparent.
Engagement letter: prepared by auditor, acknowledged by client, form of contract, explains scope and timing, confirms auditor's right of access to information.
Safeguards created by profession, legislation or regulation: quality control standards, code of ethics, legislative requirement to be independent.
Safeguards created by client: corporate governance, policies and procedures.
Safeguards created by accounting firms: quality control procedures, client acceptance and continuance.
Independence declaration: auditors must give directors a written declaration of their independence, for inclusion in the director's report.
Relevant relationships: auditor cannot have investment, and cannot owe more than $5000 to client (other than housing loan on normal terms).
Conflict of interest: where members of audit team are not capable of exercising objective and impartial judgement (as judged by a reasonable person). The auditor must take reasonable steps to ensure this does not exist.
Breach of independence requirement: if auditor is aware of an existing relationship and doesn't take all reasonable steps to discontinue the audit. Relationships include immediate family members being an officer or audit-critical member of client.
Measures to reduce COI: member of audit firm cannot become director, secretary, senior manager of a client until 2 years after ceasing employment with audit firm, rotation of audit partners after 5 successive years (at least a 2 year break), director's report needs to include names of each officer who was a former partner/director of current audit firm.
Auditors and shareholders: audit report addressed to them, attendance at AGM, formal responsibility for auditor appointment. If company fails, they stand to lose most of their investment.
Auditors and Board of directors: represents shareholders, exec and non-exec directors, large companies have committees made up of different directors to deal with specific issues. It is the directors' responsibility to ensure that the financial report is prepares so as to provide a true and fair view.
Auditors and audit committee: special committee on board of directors, acts on behalf of board in financial reporting and audit matters, top 500 listed companies must have audit committee, top 300 must follow ASX guidelines.
Internal auditors: viewed by auditor as part of client, can reduce scope of testing if internal audit function is effective. Depends on internal auditors objectivity, technical competence, due professional care, communication with external auditors.
Litigation crisis: one of the major problems facing the accounting/auditing profession due to cost (payouts) and loss of skilled people to the profession.
Legal liability: auditor can be found negligent and liable for damages under tort law if it is established that a duty of care was owed by the auditor, duty of care was breached, and a loss was suffered as a result.
Negligence: failed in performance of audit by being careless/breaching duty of care. Case law shows change in definition of reasonable care and skill over time as standards change.
Contract: failed duty of care implicit in acting as auditor and explicit in engagement letter.
Key cases: London and General Bank Ltd (1895), Kingston Cotton Mill (1896), Pacific Acceptance (1970), HIH Royal Commission Report (2003), Centro Properties Group (2011-12)
Contributory negligence: if directors are also negligent, each party is held accountable in proportion to their guilt.
Legal liability to third parties: third party users include anyone other than client and shareholders that uses financial report to make a decision. Third parties must rely on tort law and show that duty of care was breached.
Foreseeability: auditor should reasonably foresee that someone belonging to a particular group was going to rely on the statements.
Proximity: auditors owe a duty of care to existing shareholders collectively, not to potential shareholders.
Privity letter: a letter from the auditor acknowledging third party's reliance on the audited report. The third party requests the privity letter from auditor.
Steps to avoid litigation: hire competent staff and train regularly, comply with ethical and auditor regulations, implement policies and procedures (client acceptance, staff allocation, ethical and independence issue identification and rectification, adequate work documentation, gather adequate and appropriate evidence to support opinion), meet with audit committee, follow up on weak internal controls.
Client acceptance/continuance: assess client integrity, assess firm's ability to meet ethical requirements and service client, prepare client engagement letter.
Client integrity: reputation, reason for switching auditor, attitude to risk/internal controls, interpretation of acc rules, willingness to give full access to information, and pay fair amount. Auditor should decline client if threat insurmountable.