Introduction

The Assurance Framework

In corporations, there's a separation between managers & shareholders. Managers run the company for the owners' benefit. They prepare & issue financial statements for owners to make investment decisions and reward/punish managers according to company performance. Information asymmetry – owners' inability to determine whether financial statements are true and fair as managers may lie about company performance for personal gain (fraud) or misrepresent it due to incompetence. Consequently, agency costs arise as owners under-reward good managers or undervalue the share price of good companies because they believe good performance may not be real, or can't decide which companies are good investments. Agency costs may be reduced by having an independent third party provide assurance as to whether the financial statements are true and fair.

Assurance engagement – an assurance practitioner aims to obtain sufficient appropriate evidence 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. It involves:

- A three-party relationship involving a practitioner, responsible party & intended user
- An appropriate subject matter i.e. the financial statements, and suitable criteria
- Sufficient appropriate evidence – documents, inquiries, physical evidence
- A written assurance report in a form appropriate to a reasonable or limited assurance. Absolute assurance can never be provided due to the nature of accounting e.g. valuation issues, accounting policy choice & judgements, and contingent items, and the time & cost of evidence collection/evaluation. Reasonable assurance (audit engagement) is a high level of assurance where the conclusion is expressed in a positive form i.e. financial statements are/aren't true and fair. Limited assurance (review engagement) is a lower level of assurance where the conclusion is expressed in a negative form i.e. information doesn't suggest that the financial statements aren't true and fair.

An audit of a company's financial statements has the following features:

- Audit is carried out by an independent auditor/audit firm e.g. KPMG
- The auditor is appointed by shareholders with a sole responsibility to express their audit opinion via an audit report; they have no right to change any aspect of it.
- The auditor must determine whether the financial statements comply with accounting standards and present a true and fair view i.e. they're free of material errors in dollar amounts and disclosures, arising from legitimate errors, deliberate misstatement (fraud) and errors in accounting judgements. If errors are found, the auditor asks management to fix it, and if they don't, they change the audit report.

Regulation of Audits

Audits of general-purpose financial statements of Australian companies are governed by the Corporations Act 2001. A company, registered scheme or disclosing entity must have the financial report for a financial year audited and obtain an auditor's report (except small proprietary companies). If an auditor conducts an audit of the financial report for a financial year, or an audit/review of the financial report for a half-year, it must be in accordance with the auditing standards. The detailed rules on how to conduct an audit are contained in Australian Auditing Standards (ASAs) which are legally enforceable and set by the Auditing and Assurance Standards Board (AUASB), a statutory body. Compliance with ASAs is monitored by ASIC.

The auditor considers the whole text of a standard to understand, interpret and apply the mandatory components, including application, operative date, objectives, definitions & requirements. Explanatory material is included in each standard, but it doesn't create/extend mandatory components. Although International Auditing Standards (ISAs) aren't legally enforceable in Australia, all ASAs are based on ISAs, except for some minor differences.

The Audit Risk Model

The purpose of an audit is to provide reasonable assurance that the financial statements of an entity present/doesn't present a true and fair view of its financial performance and position. Audit risk is the risk of giving the wrong audit opinion while engagement risk is the risk of negative consequences if the wrong audit opinion is given e.g. legal action, loss of reputation Lower levels of audit risk means lower levels of engagement risk.

Reducing audit risk is a trade-off: it reduces engagement risk and associated costs, yet it requires more resources (staff costs) to conduct better audits. When designing an audit strategy, the auditor must assess when the benefits of reduced engagement risk are outweighed by the additional costs of more audit work. To reduce audit risk at the lowest cost possible, the auditor should audit as efficiently as possible using a risk-based auditing approach legally mandated by ASAs, where they determine which parts of the financial statements are at most risk of material error and focus the audit effort in those areas.

The audit process:

1) Decide to accept or decline the audit
2) Assess the risk of the client – business risk & internal controls
3) Collect sufficient appropriate audit evidence – tests of controls & substantive procedures
4) Form and issue an audit opinion

Client Acceptance and Engagement Letters

Reasons for an auditor to decline an audit engagement:

- Auditing the client's competitors
- Don't have expertise in the client's industry (industry specialisation)
- Understaffed
- Low fees
- Risky client

Under ASA210, the auditor should only accept an audit engagement if:

a) Management accepts its responsibility for the preparation of the financial report and for the internal control system of the company
b) Management agrees to give the auditor access to all information and people that is needed to conduct the audit

An engagement letter records the agreed terms of the audit engagement, including the objective & scope of the audit, and the auditor & management's responsibilities.

Materiality

Misstatements and omissions are considered material if they, individually/aggregated, could reasonably be expected to influence the economic decisions of users taken based on the financial report. When establishing the overall audit strategy, the auditor determines materiality for the financial report as a whole. Planning materiality (PM) threshold – a % of the financial statement figure that's most important to the user, set by the auditor. It's the maximum aggregate error allowable before financial statements become materially misstated, used to

decide on the nature and extent of audit evidence that will be collected. There's an inverse relationship between PM and risk: the riskier the client, the lower PM should be set (vice versa). PM is usually set at 5-10% of NPAT – higher risk = closer to 5% (vice versa).

Material misstatements can be caused by an individual material error or a number of small errors that, when aggregated, results in a material misstatement. Auditors must keep a list of immaterial errors and evaluate whether, in combination, they result in material misstatements. The lower the level of PM, the smaller the aggregate errors auditors need to find, meaning more evidence must be obtained to reduce audit risk to an acceptable level (more costly). Higher materiality = less costly audits but more audit & engagement risk.

Trivial errors are so far below PM (<3%) it will have no impact on whether the financial report is true and fair, so auditors may simply ignore them. If errors aren't trivial, auditors ask management to change it, and if they don't it is added to a list of uncorrected misstatements. At the end of the audit, the audit partner reviews this list and ask management to fix the errors. If they're fixed, an unqualified opinion is issued, otherwise a qualified opinion is issued if the remaining errors are material in aggregate.

The auditor periodically revises materiality for the financial report (and if applicable, the materiality levels for classes of transactions, account balances or disclosures) when new information arise during the audit that would've caused the auditor to have determined a different amount initially.

Materiality is ultimately based on judgement:
- Quantitative figures are useless for evaluating the materiality of non-numeric disclosures e.g. going concern, related party disclosures
- Statutory disclosures are always material e.g. audit fees, director fees
- Some items may be material even if they're numerically small, but important to users