

AUDIT AND ASSURANCE SERVICES

TOPIC 1: Overview of Audit and Assurance

1. Define and explain the meaning of the terms audit and assurance, objectives of an Auditor and the purpose of an audit.

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.

- objective – bias is minimised
- critical examination – the subject matter’s validity is questioned in detail – not just accepted at face value
- subject matter – you are evaluating a particular thing (e.g. financial statements)
- assessing ... credibility – it is an assessment of the subject matter’s credibility/integrity, not right/wrong
- provide assurance – gives a level of confidence about the integrity of the information to the user – can NEVER have 100% confidence, always a risk that there is a flaw
- issue of an objective opinion – forming a conclusion about the credibility of the information and matching it against the subject matter.

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.

- degree of satisfaction – level of confidence
- reliability of information – trust placed in the information related to the subject matter, NOT accuracy because can never be completely accurate
- nature and extent of procedures – what was done to gather evidence regarding the subject matter, when it was done, how it was done and who did it
- results of the procedures – the findings of what was done – ensuring the evidence corroborates the information on the subject matter presented
- objectivity of evidence – if there is possible bias in the evidence (e.g. who it was obtained from)

An audit is an assurance engagement.

In conducting an audit of the 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; and
- (b) To report on the financial report and communicate as required by the Australian Auditing Standards, in accordance with the auditor’s findings.

In summary, the auditor is setting out to achieve enhanced credibility of information disclosed to increase reliability for the users of the financial statements.

Accounting is a representation of the economic situation of an entity for a period which managers are required to represent to users –these representations by managers are known as assertions about the economic actions and events of an entity. The auditor’s task is to obtain evidence to validate these assertions and ensure economic events are appropriately communicated to users so that they can use the information with reasonable assurance that it is free of material misstatements.

In a financial statement audit, the auditor is giving an opinion as to whether the financial statements “present fairly” or give a “true and fair view” of the entity being audited. The auditor’s opinion is not a guarantee – presents fairly or a true and fair view are both based on the condition that immaterial misstatements may not be detected in the course of the audit. Therefore, the auditor is providing a reasonable level of assurance that the FS are credible and can be relied on.

2. Explain and discuss why audit and assurance services exist and the underlying theories behind the demand for audits (why demand for audits might exist without regulatory mandate)

Information Asymmetry – the preparer of the information has more knowledge about the business’s financial position than external parties. Thus, the role of the information preparer is to bridge the information asymmetry gap by providing this information to external parties in the form of financial statements.

Also because it is mandated

Users of the information provided in FS are relying on this information – they need confidence that the appropriate information is in fact being provided to them, and an audit provides this confidence.

- Value from Auditing and Assurance Services
- Facilitates information user confidence
- Promotes public interest
- Meets regulatory requirements
- Feature of corporate governance

The **demand for audits** really comes from three theories, these are:

- Agency theory
- Information hypothesis
- Insurance hypothesis

Agency theory: the **separation of ownership and control** has resulted in an **information asymmetry problem** for the owners of the organisation. Principals (SH) engage agents (managers) to use the resources of the organisation in the most appropriate way, however managers do not necessarily have the same incentives as owners. Agency theory is based on the **assumption that each party will act in their own self-interest.**

Managers have the incentive to act in their own self-interest by manipulating earnings figures to earn bonuses (which is worrying for owners), and as a result owners will 'price protect' themselves by lowering remuneration packages etc., which is worrying for managers if they're actually are acting in the best interests of the owners. For this reason, it is in the interests of **both parties to obtain an independent audit** to check the FS prepared by management and provide reasonable assurance that it is true and fair to the users of the FS.

Information hypothesis: the **audit improves the quality of information**, which provides benefits through the **reduction of risk and improvements in decision making**. Investors will demand this information because it is useful for decision making and will assist them in assessing the risks and returns associated with their investments. The audit will reduce estimation risk (the uncertainty associated with the realisation of future CFs). There will also be value within the firm to assist in improving financial data for internal decision making (it can detect errors and motivate employees to exercise more care in preparing records in anticipation of an audit).

Insurance hypothesis: appeals to 2 different groups.

Investors/creditors who might demand an audit to show that the company is being prudent to insure against losses.

- The ability to shift financial responsibility for reported data to an auditor lowers the expected loss from litigation or related settlements to managers, creditors, and other professionals.
- However, it is unlikely that this is a major reason for a demand in auditing in Australia because significant changes in the legal environment have reduced the legal exposure for auditors considerably.

A diverse set of regulators who can potentially insulate themselves from criticism by directing blame at the auditors.

- For example, the HIH Insurance crash – the focus on auditors conveniently deflected criticism of the Australian Prudential Regulation Authority, which also had oversight responsibilities in relation to HIH.

The audit expectation gap, the purpose and objectives of the Audit, and the difference between accounting and auditing

The idea of the Audit Expectation Gap has been developed to explain the difference between what the financial statement users expect of an audit, compared to the actual service provided by the auditor. It has been generally acknowledged that some users hold the view that the audit opinion has the effect of guaranteeing the financial statements – they believe that an audit is a guarantee against poor management behaviour, questionable business decisions, and corporate failure. This view is not correct, as corporate failure does not always equate to an audit failure, but does highlight the difference between user expectations and the actual role of the auditor.

There are **2 expectations gaps**:

The gap between the **expectations of users** and what **auditors can be reasonably expected to accomplish** ('reasonableness gap')

The gap between what society can reasonable expect auditors to accomplish and the services that are actually being delivered by the profession ('**performance gap**'). The performance gap comprises deficient performance and deficient standards.

The audit is NOT a

Guarantee that that financial statements are correct

Prof that the company is 'good' or a 'good investment'

There to fix 'errors'

There to find 'fraud'

To say 'all the figures are right'

This is because the auditor simply cannot review every single transaction – this is unrealistic and impossible.

The audit IS there to review the information and assess the creditability of that information, and in doing so it MAY detect errors and fraud ("misstatements").

3. Explain the impact of recent corporate history on audit role and function

Corporate Collapses and GFC

The corporate collapses between 2000 and 2002, combined with the more recent Global Financial Crisis (GFC) have put the spotlight on the audit function within the accounting discipline. The media, governments and financial statement users have been critical of auditors, arguing that they have not completed audits in an appropriate manner.

The value of the audit was questioned: of particular concern has been the issue of objectivity, lack of care taken in reviewing and assessing the financial statements, and a general failure to add credibility to the statements.

Issues are:

- Earnings management to meet targets
- Corporate governance failure
- Fraud
- Auditor role failure
- Issue of independence from the client

Reforms

The factors noted above have led to a number of reforms in relation to the audit of financial statements. These have come from a number of sources and not all are expressly relevant to the audit profession in Australia.

Corporate Law Economic Reform Program – CLERP 9

- Deals with registration of company auditors
- Additional disclosure in the director's report
- General and specific auditor independence requirements
- Restrictions on auditors being employed by an audit client
- Auditor rotation for listed companies

2. Sarbanes-Oxley Act in the United States

- Provisions regarding auditor independence, corporate governance, internal control assessment, conflicts of interest, and enhanced financial disclosure. Rules based.
3. Ramsay Report on Auditor Independence

The reforms have had the following aims which should be considered in relation to the definition of an audit:

- **Enhanced independence** of auditors to the client
- Encourage **greater objectivity**
- Expand requirements of the auditor, including **attending the annual general meeting** of the client
- **Enhanced understanding of the role** of corporate governance

4. Describe the environment in which assurance practitioners operate, including audit standard setting in Australia

Australian Auditing Standards

The recent events that have impacted on the financial statement audit as noted above has also lead to a greater focus on auditing standards. In Australia, the Auditing and Assurance Standards Board (AUASB) oversees the development of Australian Auditing Standards (ASAs). Their objective is to enhance the relevance, reliability, and timeliness of information provided to users of audit and assurance information. This involves the review and application of appropriate International Standards (IASs) that are issued by the International Auditing and Assurance Standards Board (IAASB) within the auspices of the International Framework for Assurance Engagements issued by the International Federation of Accountants (IFAC). In general the Australian Auditing Standards comply with the ISA, however in some instances specific Australian provisions are also included (AUASB uses the ISAs of the IAASB as a base).

The FRC (Financial Reporting Council)

Oversees the setting of accounting and auditing standards in Australia

Responsible for oversight of the AUASB and the AASB and for approving its strategic direction

TOPIC 2: The Financial Statement Audit

1. Discuss the role of the auditor in relation to the audit of the financial report

Assurance engagement is '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**'.

With respect to a financial statement audit, the auditor expresses an opinion to the SH on whether the financial report, which is an evaluation of the financial position, financial performance and CFs of the company, has been prepared by the directors in accordance with the requirements of an appropriate financial reporting framework (Australian accounting standards and the Corporations Act 2001).

There **are 2 types of assurance engagements:**

Reasonable assurance engagement (an **audit**)

- Objective is the reduction in assurance engagement risk to an acceptably low level to form the basis for a positive form of expression of the conclusion. It provides the highest level of assurance possible.
- “In our opinion, the internal controls are working and there are no material misstatements”.

Limited assurance engagement (a review)

- Objective is the reduction in risk to a level that is acceptable, but where that risk is greater than for a reasonable assurance engagement, to form the basis for a negative form of expression of the conclusion.
- “Based on our work, nothing has come to our attention – can’t come to a conclusion because not enough data to give a reasonable assurance engagement”.

2. Identify and discuss the benefits and limitations of a financial report audit

The main benefits identified are:

- **Access to capital markets**
 - With an audit to add credibility to the financial reports, it is likely that companies will enjoy a greater access to funds.
- **Lower cost of capital**
 - As an audit adds credibility to the financial reports, banks and other creditors may offer more favourable borrowing terms because of the reduced information risk resulting from audited financial statements.
- **Deterrent to inefficiency and fraud**
 - Knowledge that an independent audit is to be performed is likely to result in fewer errors in the accounting process and reduce the likelihood of employee misappropriation of assets. The fact that management’s financial statement assertions are to be verified reduces the likelihood that mgmt will engage in fraudulent financial reporting. This benefits SH because of higher profits.
- **Enables control and operational improvements**
 - Based on observations made during an audit, the independent auditor can suggest how controls could be improved and how greater operating efficiencies within the organisation can be achieved.

The main **limitations** identified are:

- **A time lapse exists**
 - There is a lapse of time between the end of the reporting period and the presentation of the auditor’s report. The auditor is required to undertake a review of subsequent events but this doesn’t create full ‘up to date’ financial statements as of the date of the auditor’s report.
- **Audit testing occurs on selective samples**
 - Auditors are unable to test all of the financial reports, thus audit testing based on selective samples has limitations owing to sampling risk (the risk that a sample draw from a population may not be representative of that population).
- **Professional judgement exists in the assessment of materiality**

- An audit requires both qualitative and quantitative considerations – both of which require considerable professional judgement on the auditor’s behalf. There are no universally agreed upon guidelines for determining materiality.
- **Highly specialised areas are involved**
 - Auditors may be required to form a professional judgement in areas that are highly specialised or that are not dealt with adequately by the accounting standards or auditing standards. Substantial disagreements between mgmt. and auditors during an audit often relate to specialised areas or contentious accounting issues.
- **Audit report format creates limitations**
 - The auditor is required to report within a standard format of auditor’s report, as prescribed by ISA 700. The standard format of the auditor’s report may not fully reflect the complexities involved in the audit process and the decision of the audit opinion. The standard report format may not give enough information.

3. Discuss the explicit and implicit assertions in financial statements

The financial reports prepared by management include assertions. While readers of the financial reports may not see these assertions explicitly in the reports, they nonetheless exist. For example, by including the item of ‘Cash’ in the Balance Sheet, the management asserts that the cash actually does exist and that the amount is correct. Sitting behind these assertions are also assertions that all cash transactions during the year have been recorded, that the cash is actually owned by the entity, and that any appropriate disclosures have been made.

The auditor formulates an opinion on the FS as a whole on the basis of evidence obtained through the verification of assertions related to individual account balances, transaction classes or presentation and disclosure.

Assertion: Representations by management and those charged with governance, explicit or otherwise, that are embodied in the financial report, as used by the auditor to consider the different types of potential misstatements that may occur.

These assertions are identified and classified under 3 categories:

Classes of transactions (e.g. profit and loss statement focus, sales and purchases)

- **Occurrence:** transactions and events that have been recorded have actually occurred and pertain to the entity.
- **Completeness:** all transactions and events that should have been recorded have been recorded.
- **Cut-off:** transactions and events have been recorded in the correct accounting period.
- **Accuracy:** amounts and other data relating to recorded transactions and events have been recorded appropriately.
- **Classification:** transactions and events have been recorded in the proper accounts.

Account balances (e.g. balance sheet focus, assets, liabilities and equity)

- **Existence:** assets, liabilities and equity interests exist.

- **Rights and obligations:** the entity controls the rights to assets, and liabilities are the obligations of the entity.
- **Completeness:** all assets, liabilities and equity interests that should have been recorded have been recorded.
- **Valuation and allocation:** assets, liabilities and equity interests are included in the financial report at appropriate amounts, and any resulting valuation or allocation adjustments are appropriately recorded.

Presentation and disclosure (e.g. current vs non-current, disclosure in notes to accounts)

- **Occurrence, rights and obligations:** disclosed event, transactions and other matters have occurred and pertain to the entity.
- **Completeness:** all disclosures that should have been included in the financial report have been included.
- **Classification and understandability:** financial information is appropriately presented and described, and disclosures are clearly expressed.
- **Accuracy and valuation:** financial and other information is disclosed fairly and at appropriate amounts.

4. Describe the environment in relation to auditor appointment and their obligations in conducting an

Auditor Appointment

A company (with the exception of small proprietary companies) must have its FS audited in accordance with s. 301 of the Corporations Act. It must have the financial report for a financial year audited in accordance with Division 3 and obtain an auditor's report.

Directors of public and large proprietary companies are required to appoint an auditor within one month of incorporation, unless members have appointed one at the GM (s.327)

Directors of a small proprietary company are only required to have their FS audited if ASIC or SH holding at least 5% of the voting power request them for a particular year.

The duration of the first appointment is only until the first AGM, during which the members will appoint an auditor.

An auditor holds office until their death, removal or resignation (s.329), they cease to be capable of acting as an auditor, and also if the company goes into liquidation. Companies that are required to have their financial statements audited must be audited by a registered company auditor under s. 1279 of the Act. For the majority of companies, the appointment of the auditor is done by the audit committee on behalf of the SH.

Auditor removal and resignation

An auditor may only be **removed from office by resolution of the company at a GM**, for which special notice has been given (s.329) at least 2 months before the meeting is held. It must send a copy of the notice to the auditor and lodge it with ASIC, and the auditor is then given 7 days to make representation in writing. When an auditor

is removed from office at a GM, the company may appoint another auditor at that meeting by a resolution passed by at least $\frac{3}{4}$ majority, or at an adjourned meeting. For auditors of a company (other than a proprietary company) to resign, they must **apply to ASIC for consent**, stating their reasons. The company must be notified in writing of the application (s.329), and if ASIC gives its consent, the auditor may resign after giving written notice to the company. The resignation of an auditor of a proprietary company does not require consent from ASIC.

Registration of Auditors

Must apply to ASIC to be registered under s.1279 of the CA.

The CA requires auditors to be competent. S. 324 of the CA states that a registered company auditor must be appointed to audit a company (they must have a certain level of training and experience).

S. 1280 lists the requirements to be able to act as an auditor, some of which are: membership of the ICAA, CPA Australia, the NIA or other prescribed body; practical experience in auditing; being a fit and proper person.

Registration aims to ensure auditor competence and audit quality.

Rotation of Auditors

If an individual plays a significant role in the audit of a listed company for **5 consecutive financial years**, then the individual is not eligible to play a significant role in the audit of the company for a later financial year.

Duties of the Auditor

Broadly the duties that exist are:

- To use reasonable care and skill

Must use reasonable care and skill at all times in carrying out the audit and forming the audit opinion. It is subject to the interpretation of the circumstances of each case, and is a matter of professional judgement. They must take reasonable care and skill before they believe that what they certify is true.

- To be independent

The CA reinforces the requirement that the auditor for a company must be independent by disqualifying certain categories of person or firm (s. 324) connected with the company. Auditors are entitled to seek assistance from the company's directors, officers, and accountants in carrying out their function, however they should not rely on information obtained in this manner without exercising reasonable care and diligence, applying their own tests and independent judgement as required.

The auditor must not only be independent, but also we seen to be independent.

- To report to members and the ASIC

Auditors are required to provide an auditor's report to members of the company concerning the FS audit, and the matters on which auditors must express their opinions are specified in s. 308 (e.g. to give a true and fair view of the financial affairs of the company). S. 308 also requires the report to describe any defect or irregularity in the FS, and the auditor must report on the following implied conditions if there is

any deficiency or failure to comply: whether the auditor has obtained all the information, explanation and assistance required, whether proper financial records have been maintained.

Opinions expressed in the auditor's report must be in accordance with ASA 700, and the audit opinion conclusion is 'whether the financial report is prepared, in all material aspects, in accordance with the applicable financial reporting framework'. The auditor conducting a FS audit must notify ASIC as soon as possible if there are reasonable grounds to suspect that there has been a contravention of the Corporations Act (assuming the contravention has not been adequately dealt with by the directors).

- **To comply with duties required by the profession**

The auditor has a professional responsibility to take all reasonable steps within their power to ensure that accounting standards, which have the full force of law under the CA, are consistently applied in the preparation and presentation of the report. They also are required to comply with all auditing standards and any ethical/legal requirements.

Auditor Role and Relationships

It is essential that students studying auditing understand the different role played by the auditor to that of the accountant in relation to financial reporting. The accountant's role is to measure and record transactions, classify and summarise the data, and prepare the financial statements according to the requirements of the Corporations Act and Australian Accounting Standards.

The **auditor's role** involves **no recording of transactions, and no statement or financial report preparation**. The auditor does not alter the statements and no active role in the accounting process of the organisation.

The **auditor's role** is **to obtain and evaluate evidence** in relation to the financial statements prepared and presented by the client. Their role at the end of evidence gathering and evaluation is to ensure that the **financial information has been presented fairly in accordance with the financial reporting framework**. The auditor is then required to **express an opinion** as to this and supply this opinion in an audit report to the entity. In completing this role, the auditor may **make suggestions, discuss alternative reporting options and accounting judgements, and provide feedback** to the entity. This however does not extend to altering, assisting in preparation or advising on financial reporting matters.

The **entity is responsible for its own operations**. Although the auditor will review those operations as part of the evidence gathering in order to form an opinion, ultimately it is the management of the organisation who are responsible to the shareholders and other stakeholders regarding the performance and position of the company.

The auditor maintains professional relationships with 4 important groups:

- Shareholders
- Board of directors and audit committee
- Internal auditors
- Management

