Chapter 1

Assurance and auditing: an overview

Learning objectives

1.1 Understand the framework for assurance engagements and the types of assurance engagements that can be provided.
1.2 Define auditing and appreciate the fundamental principles underlying an audit.
1.3 Appreciate the attributes of accounting information and understand the reasons giving rise to demand for assurance.
1.4 Explain the concept of the expectation gap, especially in the areas of auditors' report messages, corporate failures, fraud and communicating different levels of assurance, and appreciate the relationships between the auditor, the client and the public.
1.5 Appreciate the role of auditing standards and their authority under the *Corporations Act 2001*.
1.6 Obtain an overview of other applications of the assurance function, including compliance engagements, performance engagements, comprehensive engagements, internal auditing and forensic auditing, as well as providing assurance on subject matter other than historical financial information.

Major chapter sections

The framework for assurance engagements and the types of assurance engagements
Auditing—definition and fundamental principles
Attributes of accounting information and the demand for assurance
The auditor–client–public relationship and the expectation gap
The role and authority of auditing standards
Other applications of the assurance function

Lecture plan

When students arrive at the first lecture, they usually have little understanding of what assurance and auditing entail. We find that the first class is very important for capturing students' attention and stimulating their interest in the subject. (Generally, they have also not read Chapter 1 before the first class.)

It is important to summarise the many things that are currently happening with the auditor's role, especially with the demand for an expanded information set, and with those in charge of resources being made more accountable for their actions.

You can also introduce some of the recent initiatives of the profession, such as the revised form auditor's report, to show how auditors are attempting to communicate better with their constituency. This provides the opportunity to emphasise how important the auditing and assurance profession is currently perceived to be with regard to the role it plays in society, and to set the scene for what students can expect during the course. You should outline the learning objectives for this chapter and walk the students through the flowchart of the overall auditing and assurance framework.
[Use slides 1-2 to 1-3]

LO 1.1: Understand the framework for assurance engagements and the types of assurance engagements that can be provided.

With increasing demands for assurance to cover a wide range of subject matters, the International Auditing and Assurance Standards Board (IAASB) recently released a revised framework for assurance engagements. This framework covers audits as well as reviews of historical financial information, and also other assurance engagements, such as assurance on corporate social responsibility reports or greenhouse gas reports, both of which are increasingly demanded by society. This framework provides independent and expert auditors with criteria against which to examine reports.

This section helps students understand the fundamentals of auditing and assurance before tackling the course. It also shows how the framework relates to both financial report audits and other assurance services.

The section:
- provides an explanation of *assurance engagement* and its five elements
- outlines the need for members of the profession to be independent; that is, without interests that may create risks of material bias with respect to the quality or content of information, and to exercise professional judgment and professional scepticism to maintain the quality of assurance services.
- Slide 1-6 contains a diagrammatic depiction of the parties to an insurance engagement, which can be found at Figure 1.2 of the textbook.

[Use slides 1-4 to 1-9]

Types of assurance standards
To help students gain a deeper understanding of assurance, this section looks at the types of assurance standards and pronouncements. It reviews the two different types of assurance: *reasonable assurance engagements* (an audit) and *limited assurance engagements* (a review). This synopsis of *audits* and *reviews* will be useful for students to compare and contrast.

This section also outlines the difference between attestation and direct engagements.

[Use slides 1-10 to 1-13]

LO 1.2: Define auditing and appreciate the fundamental principles underlying an audit

We have used and expanded on the definition in A Statement of Basic Auditing Concepts here because it nicely captures the major components and the important parts of the audit process (outlined on slide 1-15), rather than simply stating the objective. Students should be encouraged to compare this definition with the one contained in the Auditing and Assurance Standards Board (AUASB) glossary/ISA Glossary of Terms. It should be pointed out that these definitions are similar, although the profession's definition is more technical and does not use the word assertion (recognising that there are direct engagements as well as attestation engagements).

[Use slides 1-14 and 1-15]

Fundamental principles underlying an audit
To understand the evolution of auditing as a discipline, it is important for students to understand the principles that have dictated such developments. Students, who are the future of the auditing profession, are expected to be instilled with these principles and adhere to them when working in the profession.

The section will examine the:
- fundamental ethical principles
- fundamental auditing principles.

[Use slides 1-16 to 1-18]

LO 1.3: Appreciate the attributes of accounting information and understand the reasons giving rise to demand for assurance

If students are to thoroughly understand the audit process as it relates to accounting information, it is crucial for them to appreciate the role of accounting information and the process of communication through financial reports.

This section highlights the fundamental characteristics of information that enables objective financial reporting:
- relevance
- faithful representation.

This section also highlights the enhancing characteristics of information that enables objective financial reporting:
- comparability
- verifiability
- timeliness
- understandability.

[Use slide 1-19]

Demand for assurance
It is worthwhile spending a reasonable amount of time during the first lecture discussing why there is a demand for assurance beyond the legal requirements. It is important that students have a basic understanding of the agency relationship that leads to auditing.

[Use slides 1-20 to 1-22]

Benefits of assurance
There are benefits of assurance related to the improved relevance and reliability of the assured information and the consequential reduction in information risk. This should result in reduced cost of capital. Financial analysts should also make more accurate and informed recommendations. Both of these benefits should result in an improved allocation of investment resources over the range of investment opportunities.

There are other benefits resulting from an assurance engagement, in addition to increasing users' confidence in reported information. These include recommendations to improve efficiency and effectiveness and a positive influence on the behaviour of people with audited entities.

[Use slides 1-23 and 1.24]

LO 1.4: The auditor–client–public relationship and the expectation gap

Students should be introduced to the relationship between the auditor, the client and the public.

The expectation gap and the information gap
Exposing students to the expectation gaps that can occur and where expectation gaps commonly occur at an early stage of the course usually encourages them to be more critical in their thinking as they proceed through the course. A diagrammatic representation of the expectation gap is provided in Figure 1.5 on slide 1-27, and the information gap, which is related to the recent auditor reporting improvements, in Figure 1.6 on slide 1-29.

[Use slides 1-25 to 1-30]

LO 1.5: The role and authority of auditing standards

Students should be introduced to the various auditing standards and guidance standards: auditing standards (ASAs/ISAs); and Guidance Statements (GSs). Under the *Corporations Act 2001*, Australian Auditing Standards have legislative backing. The implications of this should be briefly introduced.

[Use slide 1-31]

Auditor's responsibilities under the *Corporations Act 2001*
The emphasis in most auditing and assurance courses is on audits undertaken in accordance with the *Corporations Act 2001*, which is arguably the most comprehensive assurance service, and one from which techniques gained can be applied to all assurance services. It is therefore worthwhile drawing students' attention to this application of the assurance function (letting students know that this will be covered in more detail in Chapter 2).

[Use slides 1-32 and 1-33]

LO 1.6: Other applications of the assurance function

The uses of audit evidence-gathering methods are not confined to an expression of opinion on financial reports. This section takes the students through their other uses.

These include commentaries on:
- compliance engagements
- performance engagements
- comprehensive engagements
- internal audits
- forensic audits.

These assurance services are discussed in more detail later in the course, so this should be no more than a very brief introduction.

[Use slides 1-34 and 1-35]

Summary
We provide a summary slide of the main learning takeaways in this chapter.

[Use slide 1-36]

SOLUTIONS

REVIEW QUESTIONS

1.1 According to ASA 200.A3 (ISA 200.A3), management and, where appropriate, those charged with governance are responsible for:

- the identification of the applicable financial reporting framework, within the context of any relevant laws or regulations
- the preparation and presentation of the financial report in accordance with that framework
- an adequate description of that framework in the financial report.

In Australia, it is the board of directors that is responsible for the financial report of companies.

1.2 Paragraph 26 of the *Framework for Assurance Engagements* (*International Framework for Assurance Engagements*) identifies three parties in an assurance engagement:

- assurance practitioner (auditor)—in Australia this would be a member of a recognised accounting body (CPA Australia, Chartered Accountants Australia and New Zealand [Chartered Accountants ANZ] r the Institute of Public Accountants [IPA]), and one who is bound by the profession's Code of Ethics
- responsible party—the responsible party is the person or persons responsible for the subject matter. For example, in Australia it is the board of directors that is responsible for the preparation of the financial report or the implementation and operation of internal control for a company
- intended user—the intended user is the person or persons expected to use the assurance practitioner's report. Often the intended user will be the addressee of the report by the assurance practitioner, although there will be circumstances where there will be other identified users.

1.3 Assurance is defined as satisfaction as to the reliability of information provided. The degree of satisfaction achieved depends on the nature, extent and results of the procedures performed by the auditor and the objectivity of the evidence obtained. The *Framework for Assurance Engagements* (*International Framework for Assurance Engagements*) says that a practitioner can provide two levels of assurance for an assurance engagement: reasonable assurance and limited assurance. A reasonable assurance engagement is commonly termed an audit. Therefore, the relationship between an audit and assurance services is that an audit is one type of assurance engagement that can be offered.

1.4 According to ASA 200.11 (ISA 200.11), the objectives of the auditor in undertaking an audit of a financial report 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 (ASAs), in accordance with the auditor's findings.

1.5 The fundamental principles underlying the objectives of an audit are:

- Knowledge: The auditor shall possess a sufficient understanding of the entity and its environment to appropriately plan and perform the audit, interpret audit findings, and report on the financial report.
- Responsibility: The auditor shall take responsibility for the auditor's opinion, maintaining an adequate level of involvement in the audit engagement, properly supervising any assistants, and evaluating the work of experts or others upon whom reliance is placed.
- Quality control: The auditor shall follow quality control procedures—including consultation with others as necessary—that support the issuance of an auditor's report that is appropriate in the circumstances.

- Rigour and scepticism: The auditor shall plan and perform an audit with thoroughness and with an attitude of professional scepticism, critically assessing with a questioning mind the validity and reliability of evidence, and recognising that circumstances may cause the financial report to be materially misstated.
- Professional judgment: The auditor shall exercise professional judgment, within the bounds of the fundamental principles and the applicable professional requirements, in fulfilling the auditor's responsibilities.
- Evidence: The auditor shall obtain sufficient appropriate evidence to afford a reasonable basis for expressing an opinion on the financial report.
- Documentation: The auditor shall document matters that are important in providing evidence to support the auditor's opinion.
- Communication: The auditor shall communicate significant matters affecting the entity's financial report to management, to those charged with governance and, while respecting the confidentiality of information, to others where compliance with local laws and regulations requires additional communication in the wider public interest.
- Association: The auditor shall not be associated with, or allow the use of the auditor's name or report to be associated with, information known by the auditor to be misleading, unless the auditor reports on the information and how it is misleading.
- Reporting: The auditor shall report to those that have appointed the auditor to the engagement. The auditor's report shall contain a clear expression of opinion in writing, and set out all information necessary for a proper understanding of the opinion and its basis.

1.6 The two fundamental characteristics of accounting information are:

- Relevance: This requires that the information provided must be useful in assisting financial report users to make and evaluate decisions about the allocation of scarce resources and to assess the accountability of the preparers of these reports.
- Faithful representation: The extent to which the information presented to users represents, without bias or undue error, the underlying transactions and events that have occurred. This requires the information to be complete, neutral and free from error.

1.7 Conflict of interest creates a demand for independent audits as the user perceives an actual or potential conflict with the preparer. For example, management (preparer) could have an incentive to present biased information in a financial report because these reports provide information about their performance and therefore could influence their remuneration.

1.8 Society as a whole, and in particular the following groups, can benefit from financial report audits as follows:

- Users of financial reports are able to have greater confidence in the data on which economic decisions about the entity are based. The increased confidence placed on financial reports will reduce the information risk associated with the trading of securities, which will serve to promote trade and bring about a movement of economic resources to those areas where the greatest net benefits are perceived.
- The entity is likely to be able to obtain funds at a lower cost because of the added assurance users have in the financial report. This would result in higher profits, which might lead to increased dividends to shareholders or might be retained in the business to fund expansion, increase employment opportunities and pay further taxes from the entity's activities.
- Management and employees of the entity are likely to improve their conduct because they know their performance will be under scrutiny during the audit.
- The entity's financial report, accounting system and accounting control might be improved because of suggestions made by the auditor.

1.9 The expectation gap is the difference between the expectations of auditors and the expectations of the assurance report users concerning the role and responsibilities of auditors. It consists of unrealistic expectations on the part of users (reasonableness gap) and inadequate performance by auditors (performance gap). Unrealistic expectations include expectations that ignore limitations inherent in the financial report such as those that require significant professional judgment or estimation, and those where the cost of providing assurance exceeds the probable benefits. Inadequate performance includes both a failure by individual auditors to comply with required auditing standards (deficient performance), and a failure of the auditing standards to meet the legitimate needs of users (deficient standards).

1.10 The IAASB (2011), in their discussion of the expectation gap, identified the concept of an information gap, a gap between the information that is needed to make informed investment decisions and what is available to financial report users through the entity's audited financial report or other publicly available information. Users perceive that there should be more transparency about the entity and its financial report and key areas of audit risk.

It also has been suggested that the expectation gap results, in part, from the manner in which auditors communicate their findings to users of the financial report, which creates a communications gap. This reflects differences between what users desire and understand and what, and how, findings are communicated by the assurance provider. For example, because the standard auditor's report uses generic language to describe the auditor's work effort, users do not get a complete picture about the extent of the auditor's procedures on a particular audit and therefore feel left with a gap between what is actually done and what they perceive is done in connection with the audit.

1.11 Auditing standards prescribe the basic principles and essential procedures that govern the professional conduct of an auditor. They assist an individual auditor by providing a benchmark against which to assess their performance. They also provide the courts with an authoritative benchmark against which to measure an auditor's performance, in the event of an auditor's work being subject to litigation. In addition, the auditing standard-setting bodies are able to improve the quality of auditing practice by updating their standards and informing individual auditors about changes in the audit function.

1.12 Complying with auditing standards is mandatory for all members of the accounting bodies for all audit and assurance engagements under APES 210 and compliance is legally enforceable under Section 307A of the *Corporations Act 2001* for audits of companies.

1.13

(a) Performance audit: Performance audits are a comprehensive activity designed to analyse organisational structure, internal systems, work flow and managerial performance. They are usually associated with issues of efficiency, effectiveness and economy. In short, performance auditing is intended to provide a measure of an entity's operational achievements.

(b) Forensic audit: Forensic auditing involves detecting, investigating and deterring fraud and white-collar crime. As outlined in the chapter, some examples of situations in which forensic auditors have been involved include:

- analysing financial transactions involving unauthorised transfers of cash between companies
- reconstructing incomplete accounting records to settle an insurance claim over inventory valuation
- proving the commission of money-laundering activities by reconstructing cash transactions
- investigating and documenting embezzlement, and negotiating insurance settlements.

(c) Compliance audit: Compliance audits involve the expression of an opinion on an entity's compliance with statutes, regulations or other directives that govern the activities of the entity. Therefore, any example of compliance with any regulation, including compliance with internal control activities, would be appropriate.

DISCUSSION PROBLEMS AND CASE STUDIES

1.14 (Easy)

ASA 200.16 (ISA 200.16) requires that the auditor exercise professional judgment in the planning and performance of the audit of a financial report. This is because the interpretation of relevant ethical requirements and Australian auditing standards cannot be made without the application of relevant training, knowledge and experience in making informed decisions about the courses of action that are appropriate based on the facts and circumstances of the assurance engagement. For example, judgments need to be made about materiality; audit risk; the nature, timing and extent of audit procedures required to obtain sufficient appropriate audit evidence; evaluating evidence; and drawing conclusions based on the evidence obtained.

ASA 200.15/ISA 200.15 requires that the auditor also plan and perform the assurance engagement with professional scepticism, which is an attitude that includes a questioning mind, being alert to conditions that may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

1.15 (Medium)

(a) No. Providing advice on accounting policies and accounting and auditing standards is *not* an assurance engagement. There is no three-party relationship, nor is it clear that there are always suitable criteria. Such assistance would be a consulting activity.

(b) Yes. Audits of financial reports are an assurance engagement providing a reasonable level of assurance.

(c) No. Assisting management and the board to strengthen internal and corporate governance is *not* an assurance engagement, it is a consulting activity. There is no three-party relationship, nor is it clear that there are suitable criteria.

(d) No. Assisting in establishing and training internal audit teams is *not* an assurance engagement. There is no three-party relationship, nor is it clear that there are suitable criteria. Such assistance would be constructed as a consulting activity.

(e) Yes. Checking of compliance with company policies and legislative regulations can be constructed as a compliance assurance engagement.

(f) Yes. Reviews of half-yearly financial reports are an assurance engagement providing a limited level of assurance.

1.16 (Medium)

(a) Because the procedures that RBA will perform are stipulated in the schedule, this will be an agreed-upon-procedures engagement. No assurance can be provided. A report of factual findings will be issued.

(b) RBA cannot provide the auditor's statement requested, even if they conducted an audit rather than an agreed-upon-procedures engagement, as it is not possible to provide certification (as certification implies absolute assurance). The highest level of assurance possible by an auditor is reasonable assurance when an audit is conducted.

1.17 (Hard)

The engagements most likely undertaken for each of these three tasks are as follows:

(a) A review engagement would most probably be undertaken to provide limited assurance on the management accounts for the ended 30 June 2017. This should be sufficient, as Wendy has indicated that she is willing to have less work done on these management accounts.

(b) An agreed-upon-procedures engagement would be undertaken provided that the client, OEL, specifies what they mean by transactions 'within the normal course of operations'. No assurance would be provided, but rather a report of factual findings would be issued, and the client could deduce their own assurance from it, as they are the ones that decided on what needed to be done.

(c) An audit providing a reasonable level of assurance would be required on the financial report at acquisition date of 30 June 2018, as one would expect that more than a limited level of assurance would be required on a financial report prepared for acquisition purposes, and you are told that the CEO considers the financial report at acquisition date to be very important.

1.18 (Medium)

A systematic process means that financial report audits are structured activities that follow a logical sequence with appropriate planning documents and programs.

Undertaking their task objectively means that a financial report auditor must be independent, so that the auditor is able to give an unbiased opinion. This is essential if users are to rely on the auditor's opinion.

Obtaining and evaluating evidence is a major part of the audit, as a financial report auditor is required to gather sufficient appropriate audit evidence by examining the underlying support for assertions or representations contained in the financial report to come to an opinion as to whether the financial report gives a true and fair view.

1.19 (Easy)

Financial reports are prepared in accordance with accounting standards in order to provide information on the financial position and performance of an entity. This information is useful to a wide range of users for making economic decisions. Financial reports also represent the means by which management and governing bodies meet their accounting obligations to report to users. However, the financial reports prepared by management and governing bodies may be biased, as they have an incentive to prepare the reports that reflect their own performance in the best possible light.

The independent audit of these reports enhances their credibility. The purpose of financial report auditing is to provide independent and expert opinions as to whether the financial reports are materially misstated from the basis on which they are prepared (such as accounting standards) based on an examination of evidence underlying the data reported and communicate that to users through the auditor's report.

1.20 (Easy)

Auditors have established a reputation for independence, integrity and objectivity. Thus, the association of an auditing firm with the activity provides assurance that the balloting or voting is legitimate and has been conducted in accordance with the rules of the organisation.

1.21 (Medium)

The entities may have an audit for the following reasons:

(a) Beds for the Homeless, a charity

- To comply with legislative requirements, such as the relevant *Charities Act*
- To meet the requirements of the charity's own constitutions or by-laws
- To provide the board with some confidence over the activities of management
- There is unlikely to be reporting to the donors, although it is possible that the audited financial report might be made available to this group to encourage further donations
- To enable it to obtain credit from a financial institution that requires an audited financial report.

(b) Winterspoon Ltd, a public company

- To comply with legislative requirements of the *Corporations Act 2001*
- To provide shareholders with reasonable assurance of the reliability of the financial report and help ensure the accountability of management
- To enable it to obtain credit from a financial institution that requires an audited financial report.

(c) National Chess Club, a not-for-profit club

- To meet the requirements of the club's own constitutions or by-laws
- To provide the board with some confidence over the activities of management
- To provide the members of the chess club with reasonable assurance of the reliability of the financial report and help ensure the accountability of management.
- To enable it to obtain credit from a financial institution that requires an audited financial report.

(d) Regional Shire Council, a municipal government

- To comply with legislative requirements, such as the relevant local government act
- To provide ratepayers with reasonable assurance as to the reliability of the financial report and help ensure the accountability of management for the use of the rates collected from ratepayers

- To enable it to obtain credit from a financial institution that requires an audited financial report.

1.22 (Easy)

It is unreasonable for investors to expect absolute assurance from an audit. This is due to the inherent limitations of the audit process, such as the need to apply professional judgment in determining the nature, timing and scope of tests, the use of sampling procedures to collect audit evidence, the persuasive rather than conclusive nature of much of the available evidence and the inherent limitations of internal control. Rather, an audit provides a reasonable level of assurance that, in the auditor's opinion, there are no material misstatements in the financial report.

1.23 (Medium)

(a) The statement is true in the sense that the essence of auditing involves checking what someone else has done.

(b) However, the statement that the financial report audit does not add value is untrue if the auditor has fulfilled their responsibilities. An independent financial report audit has social value because of the following:

- Users of financial reports might have greater confidence in the data on which economic decisions about the entity are based. This will therefore reduce the risks associated with their decisions.
- Users of financial reports are able to have greater confidence in the data on which economic decisions about the entity are based. The increased confidence placed on financial reports will reduce the information risk associated with the trading of securities, which will serve to promote trade and bring about a movement of economic resources to those areas where the greatest net benefits are perceived.
- The entity might be able to obtain funds at a lower cost because of the added assurance users have in the financial report.
- Management and employees of the entity might improve their conduct because they know their performance will be under scrutiny during the audit.
- The entity's financial report, accounting system and accounting control might be improved because of suggestions made by the auditor.

1.24 (Medium)

It is unreasonable for Susan to expect absolute assurance from an audit. This is due to the inherent limitations of the audit process, such as the need to apply professional judgment in determining the nature, timing and scope of tests, the use of sampling procedures to collect audit evidence, the persuasive rather than conclusive nature of much of the available evidence, and the inherent limitations of internal control. Rather, an audit provides a reasonable level of assurance that, in the auditor's opinion, there are no material misstatements in the financial report.

Further, while an entity's financial report is normally prepared based on the assumption that it is a going concern and the auditor tests the reasonableness of this assumption, it is unreasonable to assume that this guarantees that the entity will continue in existence. Bankruptcy can occur, for example, due to unexpected circumstances occurring after the auditor's report has been issued.

Also, while the auditor obtains sufficient appropriate audit evidence that there is a reasonable expectation that there are no material misstatements in the financial report due to fraud or error, it is unreasonable to expect that this means that immaterial frauds or errors have not occurred. Further, due to the nature and sophistication of frauds, and the inherent limitations of the audit process, it is also possible that even a material fraud will not be uncovered.

1.25 (Easy)

For audits undertaken under the *Corporations Act 2001*, the auditing standards have legal authority by virtue of the provisions of the *Corporations Act 2001*. Failure to observe these standards may expose an auditor to investigation and disciplinary action from the Australian Securities and Investments Commission (ASIC).

For other audits there is a mandatory obligation for members of the accounting bodies in Australia to comply with the ASAs, which is found in APES 210 *Conformity with Auditing and Assurance*

Standards, issued by the Australian Professional and Ethical Standards Board (APESB). APES 210 states that the basic principles and essential procedures in an ASA are mandatory and they must be complied with in the planning, conduct and reporting of an audit engagement. APES 210 indicates that the standards are to be applied to all financial report audits and to all audits of other financial and non-financial information, adapted as necessary. Failure to follow APES 210 would result in disciplinary action against the auditor by the accounting body of which they are a member.

Therefore, the auditor would need to follow the auditing standards for the audits of both Galaxy Ltd, a public company, and Gold Coast Tennis Club, a not-for-profit entity, although the penalties for non-compliance are more severe under the *Corporations Act 2001*.

1.26 (Medium)

Service provided	**Type of engagement**
Analysis of financial transactions involving unauthorised transfers of cash between companies	Forensic engagement
Reconstruction of incomplete accounting records to settle insurance claims	Not an assurance engagement
Assessment of energy usage patterns and recommendation of energy conservation opportunities	Performance engagement
Reasonable assurance financial reports have been prepared in accordance with applicable accounting standards	Financial report audit
Conformity of employee expense claims with company policy	Compliance engagement
Assisting management in the effective discharge of its responsibilities by providing independent analysis, appraisals, advice and recommendations concerning the activities reviewed	Performance engagement