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## Chapter 1 – Introduction and overview of audit and assurance

### 1.11 What does ‘assurance’ mean in the financial reporting context? Who are the three parties relevant to an assurance engagement?

An **assurance engagement** (or service) is defined as ‘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 for Assurance Engagements*, para. 8; *International Framework for Assurance Engagements*, para. 7).

In the financial reporting context ‘assurance’ relates to the audit or review of an entity’s financial report.

An audit provides reasonable assurance about the true and fair nature of the financial reports, and a review provides limited assurance. The audit contains a positive expression of opinion (e.g. ‘in our opinion the financial reports **are** in accordance with (the Act) including giving a true and fair view...’), while the review contains a negative expression of opinion (e.g., ‘we have **not** become aware of any matter that makes us believe that...the financial reports are **not** in accordance with (the Act)... including giving a true and fair view..’).

An auditor may also perform agreed upon procedures for a client, but these do not provide any assurance. The client determines the nature, timing and extent of procedures and no opinion is provided to a third-party user.

The **assurance practitioner** is an auditor working in public practice providing assurance on financial reports of publicly listed companies, or other entities. Intended **users** are the people for whom the assurance provider prepares their report (e.g. the shareholders). The **responsible party** is the person or organisation (e.g. a company) responsible for the preparation of the subject matter (e.g. the financial reports).

### **1.12 What qualities must an ‘assurer’ have in order for you to feel that their statement has high credibility?**

An assurer must have the knowledge and expertise to assess the truth and fairness of the information being presented by the preparers. Auditors of financial reports need to be trained accountants with detailed knowledge about the complex technical accounting and disclosure issues required to assess the choices made by the financial report preparers. When undertaking an audit, the auditor should use **professional scepticism, professional judgement and due care**.

Auditors should be **independent** of the client. Independent auditors have no incentives to aid the entity in presenting their results in the best possible light. They are concerned with ensuring that the information contained in the financial report is reliable and free from any significant (material) misstatements (error or fraud). A user needs to believe that the auditor is acting independently. This means that not only should auditors be independent (i.e. not have any undue personal or financial incentive to protect the client), auditors should avoid doing anything that would cause a reasonable person to doubt their independence.

### **1.13 Why do audit firms offer consulting services to their audit clients? Why don’t they just do audits and let consulting firms provide the consulting services?**

The arguments in favour of audit firms providing other services to their audit clients relate to the benefits to be derived by all parties. The audit firm has very detailed knowledge about the client and can use that knowledge to recommend actions or products that would suit the client’s needs. In some cases, the auditor could identify a potential problem that the client had not identified. To the extent that the audit firm uses its knowledge to provide better advice than could be provided by an external consultant, the client will benefit. Shareholders of the client and other interested parties will benefit from improvements to the client’s business. Finally, the auditors will benefit from additional revenue which can be used to subsidise the audit firm’s investments in knowledge and systems, and streamline the audit.

The main disadvantages of audit firms providing services to their audit clients relate to potential adverse effects on the auditor’s independence. The auditor could be unwilling to provide services which would reduce their audit fees or cause the client to seek another auditor. The auditor could be unwilling to criticise something to the client which was provided by their consulting division. The auditor could be ‘blind’ to potential adverse impacts on the client’s accounting systems from products and services provided by their consulting division. Even if the consulting provided unquestionable benefits to the client, the relationship between the audit firm and the client could become ‘too cosy’, and discourage the client from considering other auditors. Finally, the auditor could be reluctant to qualify the audit report for fear of losing lucrative fees from consulting services. If this occurs, the audit is less valuable because the auditor is less independent.

### **1.14 An assurance engagement involves evaluation or measurement of subject matter against criteria. What criteria are used in a financial report audit?**

An auditor evaluates the contents of a financial report against the standards and laws that apply to that type of financial report. Listed public companies must abide by the Corporations Act, the Australian Accounting Standards (AASB) and the listing rules of the ASX. Certain companies must also abide by additional specific legislation, depending on their industry or legal status. In addition, if a company is listed in another country, foreign exchange listing rules and laws could apply to the financial report.

Auditing standards control the way an audit is conducted, they are not the criteria against which the financial report is evaluated.

### **1.15 Who would request a performance audit? Why?**

A performance audit is an assessment of the economy, efficiency and effectiveness of an organisation's operations. It can be conducted internally (by internal audit) or externally (by an audit firm) and across the entire organisation or for part of an organisation.

Management may request a performance audit of its own company (or part thereof) in order to assess the economy, efficiency and effectiveness of the organisation. Ideally, the audit would identify issues that need to be addressed in order to increase the performance of the division or company. For example, the audit could examine a logistics department. It would assess the cost of running the department, the number of deliveries per input (such as labour hours, vehicle hours, etc.), and indicators of delivery on time to the correct address.

A performance audit could be conducted on a government department or agency as part of the process of accountability to the public. Stakeholders of government entities are usually seen to be more interested in economy, efficiency and effectiveness than in profit, or surplus. Performance auditing can expose poor practices, or even corruption, in an organisation. Performance auditing can provide information on the implementation of government policies. Regular performance auditing of government entities can help build trust between the government and the citizens.

### **1.16 Are internal auditors independent? Which internal auditor would be more independent: an internal auditor that reports to the chief financial officer (CFO) of the company, or an internal auditor that reports to the audit committee?**

Internal auditors are employees of the company, and therefore cannot be completely independent of the company. However, it is possible to increase the independence of the internal audit department through means such as funding, terms of reference, and reporting lines.

A well-funded internal audit department can investigate more issues and spend more time on each investigation, potentially increasing the chance of discovering fraud and other problems. An internal audit department with a small budget is likely to have fewer staff and less qualified staff (because they will be lower paid), and will have to make compromises on the issues to be investigated.

An internal audit department with wide terms of reference has the freedom to pursue the issues which the audit staff believe are most important or create the most risk for the organisation. A department with narrow terms of reference could be limited to investigating only certain matters, or must seek the approval of higher levels of management before commencing any investigation.

If the internal audit department reports to the CFO it is possible that the CFO will prevent some issues from reaching other members of the management team, or the board of directors. Often, the problems will be within the CFO's department, creating a conflict of interest for the CFO when deciding whether to report the issue more widely. An internal audit department that reports directly to the audit committee is outside the normal lines of management and reporting. The audit committee is part of the board of directors. Therefore, reporting to the audit committee increases the chance that the highest level of the organisation is aware of the problems and will approve the investigation. The audit committee also deals with the external auditor. If the internal auditor reports directly to the audit committee it can communicate the

issues to the external auditor and ask them to consider them, where relevant, as part of the financial report audit.

Not all companies have an audit committee. Where the audit committee does not exist, the internal auditor could report directly to the full board of directors.

### **1.17 What is an ‘emphasis of matter’ paragraph? When do you think an auditor would use it?**

As defined in ASA 706 (ASA 706 (5)):

Emphasis of Matter paragraph means a paragraph included in the auditor’s report that refers to a matter appropriately presented or disclosed in the financial report that, in the auditor’s judgement, is of such importance that it is fundamental to users’ understanding of the financial report.

The emphasis of matter paragraph is included in the audit report immediately after the opinion paragraph.

An emphasis of matter paragraph draws the attention of the reader to an issue that the auditor believes has been adequately and accurately explained in a note to the financial report. The purpose of the paragraph is to ensure that the reader pays appropriate attention to the issue when reading the financial report. The audit report remains unqualified and the user of the financial report can still rely on the information contained in the financial report (ASA 706; ISA 706).

The emphasis of matter paragraph is not used when the entity has not disclosed the issue in its report. The auditor can use an ‘other matter’ paragraph to introduce another matter that the auditor believes should be disclosed.

The usual circumstance which would warrant an Emphasis of Matter paragraph in the auditor’s report is the existence of a significant uncertainty, the resolution of which may materially affect the financial report.

From ASA 706:

A1. Examples of circumstances where the auditor may consider it necessary to include an Emphasis of Matter paragraph are:

- An uncertainty relating to the future outcome of exceptional litigation or regulatory action.
- Early application (where permitted) of a new accounting standard (for example, a new Australian Accounting Standard) that has a pervasive effect on the financial report in advance of its effective date.
- A major catastrophe that has had, or continues to have, a significant effect on the entity’s financial position.

ASA 706 stresses that the inclusion of an Emphasis of Matter paragraph in the auditor’s report does not affect the auditor’s opinion. An emphasis of matter can be included in an unqualified auditor’s report or a qualified auditor’s report (see example in ASA 706).

### **1.18 Compare the financial report users and their needs for a large listed public company with those of a sporting club (for example, a football club).**

The users of the financial report issued by a large listed public company include shareholders, customers, suppliers, employees, lenders, competitors, and government agencies. They need information which will help them evaluate the future financial performance of the company (including profitability, liquidity and solvency), whether the company has overseas operations and the nature of their activities in those countries (to evaluate exposure to foreign exchange risk, risk to the company of a change in economic conditions in those countries, and whether it is apparently supporting countries with dictators), likely lack of compliance with various laws and regulations, whether the company (and its industry) need government support. Investors are concerned with the value of their investment, employees with their job security, customers with whether the company is likely to remain in business long enough to honour warranties, suppliers with whether they will be paid, lenders with the risk to their loans, competitors with the health of their rivals, and government agencies will be interested in taxes, tariffs, industry support, and economic growth.

Users of a sporting club's financial report are likely to be interested in the financial condition and performance of the club (its solvency) and whether it is investing in physical facilities, player payments etc. They might be interested in whether the sporting club supports local businesses and community groups. Although sports clubs are often companies limited by guarantee and have members, the members are usually unable to trade their interest in the club. Therefore, users of a sporting club's financial report are not concerned about profitability for its own sake, but whether it helps the club pay its players and expand its facilities. Creditors and lenders will be interested in the likelihood that they will be repaid. Government will be interested with sporting and community concerns.

### **1.19 What standards or guidelines are relevant to the assurance of corporate social responsibility disclosures?**

In addition to the auditing standards (ASA), the AUASB issues Standards on Assurance Engagements (ASAE). The IAASB provides an equivalent set of ISAE. ASAE 3000 (ISAE 3000) establishes requirements and provides explanatory guidance for undertaking and reporting on assurance engagements other than audits or reviews of historical financial information covered by Australian Auditing Standards or Standards on Review Engagements. For example, assurance engagements regarding:

- Environmental, social and sustainability reports;
- Information systems, internal control, and corporate governance processes; and
- Compliance with grant conditions, contracts and regulations.

In addition, the IAASB has issued ISAE 3410 (ASAE 3410) on the Assurance of Greenhouse Gas Emissions. The IAASB believes that with the increasing attention given to the link between GHGs and climate change, many entities are quantifying their GHG emissions for internal management purposes, and an increasing number are also preparing a GHG statement:

- As part of a regulatory disclosure regime;
- As part of an emissions trading scheme; or
- To inform investors and others on a voluntary basis. Voluntary disclosures may be, for example, published as a standalone document; included as part of a broader sustainability report or in an entity's annual report; or made to support inclusion in a "carbon register."

The IAASB states that the focus is on an entity's GHG statement, it does not include requirements or guidance on assuring emissions offsets. The ISAE will also be of assistance to financial statement auditors when considering the carrying value of emission trading rights in a financial statement audit.

(See <http://www.ifac.org/IAASB/ProjectHistory.php?ProjID=0081> for further information)

The AccountAbility organisation also provides guidance for sustainability assurance. AccountAbility issues AA1000AS (2008), which is an assurance standard for management, performance and reporting on sustainability issues by evaluating the adherence of an organisation to the AccountAbility Principles.

(See <http://www.accountability21.net/> for further information).

The International Organization for Standardization (ISO) issues quality control standards in several areas. The 14000 series addresses various aspects of environmental management. These include the requirements and guidelines for environmental management systems (EMS). They also address specific environmental aspects, including labelling, performance evaluation, life cycle analysis, communication and auditing.

ISO 19011:2002 provides guidance on the principles of auditing, managing audit programmes, conducting quality management system audits and environmental management system audits, as well as guidance on the competence of quality and environmental management system auditors.

It is applicable to all organizations needing to conduct internal or external audits of quality and/or environmental management systems or to manage an audit programme. The application of ISO 19011 to other types of audits is possible in principle provided that special consideration is paid to identifying the competence needed by the audit team members in such cases.

(See <http://www.iso.org> for further information).

### **1.20 Explain the system of reviewing the quality of audits done by registered company auditors.**

The two main bodies that regulate auditors are ASIC and the CALDB.

ASIC registers auditors, processes annual statements from registered auditors, enforces independence requirements and provides a whistle blowing facility for the reporting of contraventions of the Corporations Act. ASIC conducts an audit inspection program to report on audit quality and make recommendations for continued improvement. ASIC visits a selection of firms annually to gain an understanding of their policies and procedures in relation to their independence, audit quality, methodologies and training programs.

The Companies Auditors and Liquidators Disciplinary Board (CALDB) responds to an application by ASIC that an auditor has breached the Corporations Act or the ASIC Act. The CALDB will be involved when it is believed an auditor has not carried out their duties properly, is not a fit and proper person, is subject to disqualification or should not remain registered for some other reason. In response, the CALDB may cancel or suspend the individual's registration, give the individual a warning or ask them to make an undertaking to improve their conduct.

White (2008) describes ASIC's audit inspection program. The inspection process concentrates on an audit firm's compliance with auditing standards, and their independence and quality control systems. The process includes:

- reviewing and undertaking limited testing of the firm's independence and quality control systems
- interviewing the leaders of the audit firm, human resources personnel and selected partners and staff
- examining the firm's audit methodology for compliance with auditing standards
- reviewing the conduct of aspects of selected audit and review engagements.

The program finishes with an exit meeting and ASIC sends the audit firm a confidential report of their findings. ASIC publishes a public report summarising all their findings.

(White, L. 'Audit Inspections: What is the role of ASIC's audit inspection team', *Charter* (May 2008), volume 79, No. 4: 66.)

(See [asic.gov.au](http://asic.gov.au) for further information)

### **1.21 What is the relationship between the FRC and the AUASB?**

The FRC oversees the process for setting auditing standards. The AUASB sets the auditing standards and reports to the FRC. The FRC appoints the members of the AUASB. The ASIC Act prevents the FRC from becoming involved in technical issues around the standard-setting process, which are handled by the AUASB.

**1.22 Explain the ‘audit expectation gap’. Why do you think auditors do not give users what they want?**

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and the users of the financial reports. If a gap exists, it means that the users’ beliefs do not align with what the auditor’s performance in the audit. . A gap usually occurs when the users of financial reports want *more* than the auditor provides. The users could be unrealistic in their views. Some examples of unrealistic expectations are:

- the auditor provides complete assurance
- the auditor guarantees the future viability of the entity
- an unmodified audit opinion means that the accounts are completely accurate
- if any fraud exists, the auditor would definitely find it
- the auditor has checked every transaction.

In reality, the auditor:

- provides reasonable assurance only,
- does not guarantee the future viability of the entity,
- provides an unmodified opinion when the auditor believes there are not material misstatements in the financial report
- does not guarantee that no fraud exists, although the auditor will take reasonable steps to try to uncover any fraud,
- tests only a sample of transactions.

Auditors do not give users what they want because the users’ expectations are unreasonable. However, users’ expectations could be reasonable, but beyond what current standards require. This suggests that audit standards could be improved and strengthened in order to meet user expectations in the future.

In addition, it is possible that some auditors do not give users what they require because the auditors are not following the standards. In these cases, the auditors are potentially liable to be sued or face prosecution.

## **PROFESSIONAL APPLICATION QUESTIONS**

### **1.23 Audit reports**

**Required:**

- (a) Explain the relevance of the paragraphs ‘Directors’ responsibility for the financial report’ and ‘Auditor’s responsibility’ in the audit report to the audit expectation gap.**

These paragraphs highlight to readers that the directors of the company and the auditors have separate and distinct responsibilities. The directors are responsible for maintaining the accounting systems and preparing the reports, and the auditors are responsible for conducting an audit of these reports by evaluating their contents against the criteria of the accounting standards and relevant legislation. The auditor’s responsibilities do not include preparing the reports and the auditor must use judgement when choosing procedures and evaluating the evidence.

- (b) Find the lines in the audit report that express the auditor’s opinion – is it an unqualified or modified audit opinion?**

The paragraph is headed ‘Auditor’s opinion’. It states that in the auditor’s opinion the reports are consistent with the relevant legislation including giving a true and fair view of the financial position and performance of the company. This means that the opinion is unqualified and unmodified.

- (c) Find the lines in the review report that express the auditor’s conclusion – is it an audit opinion? Is it a positive or negative statement?**

The auditor expresses a conclusion, not an opinion, in the review report. It is not an opinion because they did not conduct an audit. The statement is a negative one – ‘we have **not** become aware... is **not** in accordance’.

- (d) Make a list of the other differences between the audit report and the review report.**

Other differences include:

Interim report refers to AASB 134 on interim reporting, reference to IFRS in audit relates to adoption of those standards in the annual report.

Audit report refers to audit of remuneration (the company does not make these disclosures in half-yearly report)

Close reading of the description of the work done by the auditor will reveal that the procedures used for the interim report review are less comprehensive than those done for the full year audit (also see reference to ASRE 2410 in interim review). This is the main difference between the reports and why the audit report contains an opinion and the review report expresses a conclusion.

## 1.24 Non-assurance services

### Required

**Obtain a copy of the NAB's 2011 annual report and find the disclosures on page 153. How much was Ernst & Young paid for the non-assurance, or other, services?**

Extract from NAB's 2011 Annual report, p 153:

NAB shows separately the amount paid for audit fees, the amount paid for audit-related fees, and the other fees. The audit-related fees are for work which is reasonably related to the audit, but not the audit fee itself. The category 'other fees' is for any consulting type work done by the auditor. The note to the disclosure explains that the auditor could be required by a regulation or law to attest to the accuracy of the information.

The total amount of \$16,205,000 paid to Ernst & Young Australia by the group in 2011 was divided into audit fees and other fees.

The total audit fees for the Group in 2011 to Ernst & Young Australia were \$11,508,000

The amount of non-audit service fees which relate to a regulatory requirement for attestation by the auditor was \$3,522,000. The non-audit service fee that was not due to a regulatory requirement was \$234,000. The other fees paid by the group were \$941,000.

NAB also paid \$6,414,000 in fees to overseas practices of Ernst & Young. Of this amount \$6,245,000 was audit fees and the rest were audit related fees.

## 1.25 Types of assurance engagements

**What is a financial report review? Why would a review be appropriate for a set of half-yearly financial reports?**

A review provides limited assurance. The auditor does adequate work to report whether or not anything came to their attention, which would lead them to conclude that the information being assured is not true and fair.

To be able to comment on the appropriateness of a review for half-yearly reports, the differences between an audit and a review (and annual and half-yearly reports) should be identified.

Assurance: reasonable vs. limited

Opinion: positive vs. negative

Procedures: nature, timing and extent – review procedures are a subset of those performed for an audit

Reports: annual reports vs. half-year – AASB 134 requires a limited set of disclosures for half-yearly (interim) reporting, and ASRE 2410 requires a limited level of work for a review of interim reports.

Conclusion: Half-yearly reporting is more limited than annual reporting and thus a lower level of assurance is appropriate.

## **1.26 Corporate sustainability reporting assurance**

### **Required:**

#### **(a) Who wrote the report?**

Ernst & Young

#### **(b) What level of assurance is provided?**

Ernst & Young identify in the first main paragraph of the report that they have carried out a

‘limited assurance engagement in order to state whether anything has come to our attention that causes us to believe that the subject matter detailed below and as presented in the NAB 2012 Annual Review and *Dig Deeper* papers, has not been reported and presented fairly, in all material respects, in accordance with the criteria below.’

Ernst & Young explain at the end of the first page (Assurance Practitioner’s Responsibility) that have not sought to gather all the evidence that would be required if they were providing a reasonable level of assurance. This statement is designed to warn the reader that there is a lower level of assurance provided than for a financial statement audit, and that the auditor has not done as much, or the type of, work as would be done for a higher level of assurance (such as that provided in a financial statement audit). Ernst & Young explain the specific type of testing that was not done, e.g. testing controls. They go on to explain the type of work they did do in the section ‘Work performed’.

Note the wording of their conclusion, including the use of the words ‘nothing’ and ‘not’:

#### **LIMITED ASSURANCE CONCLUSION**

Based on our limited assurance procedures, nothing has come to our attention that causes us to believe that the Subject Matter has not been reported and presented fairly, in all material respects, in accordance with the criteria above.

## 1.27 Big 4 vs. non-Big 4 Assurance providers

**Required:**

- (a) Find the websites for (a) a Big 4 audit firm and (b) a mid-tier audit firm. Compare them on: (i) the range of services provided; (ii) geographic coverage (i.e., where their offices are located); (iii) staff numbers and special skills offered; (iv) industries in which they claim specialization; (v) publications and other materials provided to their clients or the general public; (vi) marketing message.**

The solution will depend on the accounting firm chosen and the date of the analysis. However, the answers should show for the Big 4: greater geographic coverage, larger numbers of staff and broader range of skills offered, greater claims to specialisation and industry coverage, more publications available (particularly from the international offices), more consistent and sophisticated marketing.

## 1.28 Corporate Sustainability Reporting Assurance Standards • • 2 3 5

**Providers of corporate sustainability assurance reports often state that the work was performed in accordance with a methodology based on AA1000AS.**

**a) What is AA1000AS?**

- AA1000AS (2008) is published by the AccountAbility organisation, and provides guidance for sustainability assurance. AA1000AS (2008) is an assurance standard for management, performance and reporting on sustainability issues by evaluating the adherence of an organisation to the AccountAbility Principles.
- (See <http://www.accountability21.net/> for further information).

**(b) Compare the AA1000 principles of completeness, materiality and responsiveness with the financial report qualitative criteria of relevance, reliability, comparability, understandability, and truth and fairness. Which set of characteristics would be more difficult for an entity to comply with?**

The AA1000 Assurance Standard is based on assessment of reports against three Assurance Principles:

**Materiality:** does the sustainability report provide an account covering all the areas of performance that stakeholders need to judge the organisation's sustainability performance?

**Completeness:** is the information complete and accurate enough to assess and understand the organisation's performance in all these areas?

**Responsiveness:** has the organisation responded coherently and consistently to stakeholders' concerns and interests?

From the text discussion of financial reporting:

**Relevance:** Information will be relevant if it has an impact on the decisions made by users regarding the performance of the entity.

**Reliability:** Information will be reliable when it is free from material misstatements (errors or fraud).

**Comparability:** Users need to be able to trace an entity's performance to identify any trends that may influence their perception of how well the entity is doing. Users also need to be able to benchmark the performance of the entity against other similar organisations to assess its relative performance.

**Understandability:** Users need to understand the information presented in order to make appropriate decisions.

**Truth and fairness:** Truth and fairness' or 'presented fairly' refers to the consistent and faithful application of accounting standards when preparing the financial report.

**Conclusions:**

- AA1000AS does not require the information provided to be that information likely to be needed by users to make their decision, although it does require the information to be complete enough for the user to assess and understand the organisation's performance in these areas, and material, which is defined as covering all the areas of performance that stakeholders need to judge the organisation's sustainability performance.
- AA1000AS does not require the information to be reliable, but it does require enough accuracy for users to assess and understand the organisation's performance in these areas.
- AA1000AS does not require the information to be comparable across years and organisations, but does require the organisation to respond consistently to stakeholders' concerns.
- AA1000AS does not require the information to be understandable, but does require the organisation to respond coherently to stakeholders' concerns.
- AA1000AS does not require the report to be true and fair, but in financial reporting this is often interpreted as consistent application of the financial accounting standards. There are few standards in sustainability reporting and those that do exist are not mandatory.

### **1.29 Big-4 vs. non-Big-4 Assurance providers**

**In times of economic recession would you expect the demand for audits to increase or decrease? Would you expect clients to shift from large (Big 4) auditors to mid-tier auditors or from mid-tier auditors to Big 4 auditors?**

Financial report audits are mandatory for most companies, so overall demand is largely fixed or determined by economic conditions affecting the number of companies. However, for organisations that are not required by legislation to have an audit, there are two opposing pressures in times of economic recession. First, cost-cutting would result in fewer audits. Second, organisations with less credible financial reports will face most difficulty in borrowing during a credit squeeze. This suggests that demand for auditing will increase in difficult times, because an audit will increase the credibility of the reports and thus increase access to external finance.

Also, shifting from a mid-tier auditor to a Big 4 auditor would increase both costs and financial reporting credibility for a company. Therefore, it can be argued that firms with greater need to reduce costs will shift 'down' from Big 4 auditors to mid-tier

auditors, but firms with greater need for credibility (and financial advice) will shift 'up' from mid-tier auditors to Big 4 auditors.

### 1.30 Expectations gap

**Discuss the expectations gap that could exist for the audit of Securimax. Consider the existence of any special interests of the users of Securimax's financial reports.**

The expectations gap is the difference between the expectations of financial report users and the auditor's performance.

Special users for Securimax could include:

- Government agencies, including Department of Foreign Affairs and Trade, who would be interested in the purchases by foreign governments and individuals of this type of security vehicle.
- Competing companies and/or governments who would be interested in sensitive information about the construction of the vehicles and the identity of the purchasers.
- Wollongong local government and NSW State Government, who would be interested in the financial viability of the business and its impact on local employment and economic activity.
- Suppliers of technological equipment – it is possible that the Terrain Master uses specialised components. These suppliers would be interested in the financial viability of the business and the likelihood of its timely payment for goods purchased on credit. Such equipment could be made to specialised order with limited alternative customers. The suppliers would have large investments to support the manufacture of these specialised components.
- Other potential customers
- Usual relationships would exist with lenders, shareholders, employees.

Discussion:

Consider how well Securimax's financial reports would provide the information that these users would require, given the highly sensitive and confidential nature of the manufacturing process. Management is responsible for preparing the reports, but the users may look to the auditors to make sure that the required information is provided. Also consider how well the audit process would be able to meet the users' needs for this information.

### 1.31 Being an auditor

**Required:**

**(a) Write a letter to Kim explaining the concept of reasonable assurance, and how reasonable assurance is determined. Explain why an auditor cannot offer absolute assurance.**

There is a gap between Kim's expectations and the level of auditor performance. An audit provides reasonable assurance, not absolute assurance. The audit enhances the reliability and credibility of the information included in a financial report but is not a guarantee that the financial report is free from error or fraud, or that the company will not fail. Partly, this is because of the nature of financial reporting. It requires

judgements about accounting estimates and the choice and application of various accounting methods. There is usually not one 'right' answer for a company's profit. The auditor cannot guarantee the profit reported by the company is 'right', only provide assurance about the appropriateness of the accounting method selection and application and the accounting estimates. Another reason the assurance is not absolute is the nature of the audit process. Auditors cannot review every transaction and account balance, therefore they use sampling (which could mean that representative items are not selected for testing). Some transactions and balances are difficult to gather reliable evidence about, clients can conceal evidence, and auditors have a limited time frame in which to complete the audit.

**(b) Explain in the letter to Kim the concept of 'professional scepticism' and how it is not the same as assuming that managers are always trying to deceive auditors.**

Professional scepticism is required of an auditor. It is an attitude that requires the auditor to remain independent of the client and its staff. The auditor has a questioning mind and thoroughly investigates all evidence presented by their client. This does not mean that they regard the client as a liar, but that they need to do more than simply take the client's word about anything. Usually, there will be confirming evidence which supports the client's statements (e.g. copies of contracts, minutes of meetings, etc.). Evidence gathered from independent third parties is generally regarded as more reliable than that gathered from the client. Managers will not always try to deceive auditors, but auditors must take the responsibility of gathering evidence to verifying managers' statements. The auditor needs to be alert to the fact that some managers will try to deceive auditors sometimes.

### **1.32 Company auditor registration**

**Required:**

**Visit the ASIC website and locate the guidance for meeting the regulatory requirements for company auditor registration. Summarise those requirements and explain what is required for registration for anyone with a completed accounting degree.**

ASIC, Regulatory Guide 180, Auditor Registration (September 2012), available at:  
[http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg180-published-28-September-2012.pdf/\\$file/rg180-published-28-September-2012.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rg180-published-28-September-2012.pdf/$file/rg180-published-28-September-2012.pdf)

**Table 1: Eligibility requirements for registration as a registered company auditor**

Qualifications: s1280(2)(a)	Skills: s1280(2)(b)	Capable, fit and proper: s1280(2)(c)
<p>You must:</p> <ul style="list-style-type: none"> <li>• have the prescribed academic qualifications <b>AND</b> have completed a prescribed course in auditing; <b>OR</b></li> <li>• have other qualifications and experience that ASIC considers equivalent to both these requirements.</li> </ul>	<p>You must:</p> <ul style="list-style-type: none"> <li>• satisfy all the components of an ASIC-approved competency standard (see RG 180.3–RG 180.5); <b>OR</b></li> <li>• have the prescribed level of practical experience <b>OR</b> experience that ASIC considers equivalent.</li> </ul>	<p>You must:</p> <ul style="list-style-type: none"> <li>• be capable of performing the duties of an auditor; <b>AND</b></li> <li>• be a fit and proper person to be registered as an auditor.</li> </ul>

The ASIC document explains how each of the qualifications, skills and personal attributes will be assessed. For example, the competency standards that are approved are explained on page 31:

### Competency standards we have approved

RG 180.77     On 24 November 2004, we approved the competency standard produced by the CPAA and the ICAA (CPAA/ICAA audit competency standard). We have not approved any other competency standards as at 30 September 2007.

Further (and most recent) information about these standards can be found on the websites of the professional bodies.

### 1.33 ASIC and CALDB

#### **Required:**

**Write a report to Riley explaining (i) ASIC's audit inspection program and (ii) the Companies Auditors and Liquidators Disciplinary Board and how it operates.**

Refer to review question 1.20 for a discussion of review of audit quality ASIC and its role in referring auditors to the CALDB.

Useful articles describing the ASIC inspection program and the role of the CALDB are:

White, L. 'Audit inspections', *Charter*, (May 2008), Volume 79, No. 4, p. 66.

Newman, S. 'Uncovering the mysteries', *Charter*, (February 2008), Volume 79, No. 1, pp. 62-63.

Newman (2008) reports that ASIC has found evidence that the Big 4 auditors have higher audit quality than mid-tier audit firms. However, ASIC has found significant weaknesses in audit documentation during its inspection program at both Big 4 and mid-tier audit firms. ASIC will use its regulatory powers to refer an auditor to the CALDB for disciplinary action, where appropriate.

### **1.34 Demand for assurance**

**Required:**

**Using the theories outlined in this chapter on the demand for audit, explain some reasons why these clients took this action.**

The three theories discussed in the chapter are agency theory, the information hypothesis and the insurance hypothesis.

Agency theory suggests that there are incentives to hire an auditor to assess the truth and fairness of the information contained in the financial report. The auditor reports to the members on the truth and fairness of the financial report prepared by the manager. The good quality managers are willing to have the audit of their reports because it allows them to distinguish themselves from poor quality managers (auditing is a bonding activity). Shareholders are willing to pay the audit fee (i.e. the audit fee is paid by the company, reducing the profit available to distribute to the shareholders) to monitor the managers (who are their agents). Good quality auditors are more highly valued for this bonding and monitoring function than poor quality auditors. Andersen's lowered their quality through their involvement with Enron, leading some companies to prefer another auditor. It has been suggested that companies taking early action to dismiss Enron could have protected their share price by retaining their financial reporting credibility. Ultimately, all Andersen's clients had to find another auditor.

The information hypothesis suggests that financial report users value higher quality information. Higher quality auditors are associated with higher quality financial reports. Therefore, when Andersen's quality was called into question by their association with Enron, their client companies that valued higher quality auditors switched to another auditor.

The insurance hypothesis suggests that investors insure against their losses from company failure by purchasing an audit. When Andersen's credibility was damaged by the Enron affair, there was doubt about their ability to survive and provide the insurance for such losses. The insurance factor is 'impounded' into share prices, so when the insurance cover is lost the share price should fall. This means that companies that were more sensitive to the loss of the insurance cover were more likely to dismiss Andersens early.

### **1.35 Performance and compliance audits**

**(a) Discuss the relevant criteria against which the Auditor-General will check TCCL's compliance with the terms of the funding agreement.**

TCCL must comply with the Department's 'Guidelines for procurement of medical equipment' when purchasing the accelerator. We are not provided with this document, but it is likely to contain rules about approved suppliers, the tendering/purchasing process (including the type of supplier/equipment documentation required), and so on. The auditor will gather evidence about TCCL's purchases of the linear accelerators and assess whether the guidelines were followed. If the guidelines are specified with a great deal of detail, the audit will focus on ensuring that these guidelines were

followed as specified. If the guidelines are expressed loosely (e.g. 'the firm should obtain a number of quotes'), the auditor will need to use more judgement to assess compliance than if the guidelines are expressed precisely (e.g. 'the firm will obtain 3 quotes'). The auditor will have to decide if the number of quotes obtained in those circumstances is sufficient to satisfy the loosely expressed guidelines. Are two quotes sufficient? If three quotes are required, the auditor could decide that two quotes are not sufficient, unless there are extenuating circumstances (e.g. there are only two possible suppliers worldwide).

**(b) Identify two criteria the Auditor-General can use to examine how well hospitals manage waste.**

The performance audit examines economy, efficiency and effectiveness. The Auditor General would consider criteria across all three dimensions. Some possibilities include:

Economy – cost of disposing of waste, cost of employees in waste disposal area, cost of transport of waste, tipping fees etc. – partition into general and clinical waste

Efficiency – waste by weight, volume, and/or cost per patient, per department or ward (general and clinical)

Effectiveness – Extent of achievement of hospital's planned improvements; Total reduction in general and clinical waste (volume, cost, method of disposal); effectiveness at sorting general and clinical waste.

## **Case Study Cloud 9**

### **1. What are the main differences between a financial report audit, an environmental audit and an efficiency audit?**

All audits provide some level of assurance to a user about the evaluation or measurement of a subject matter against relevant criteria. Financial report audits and environmental audits are conducted by auditors external to the organisation and report to external third party users. Efficiency, or performance, audits are usually conducted by internal auditors on behalf of, and report to, management of the organisation. Financial reports provide a reasonable level of assurance and the audit report contains an opinion by the external auditor about the fair presentation of the financial reports and their compliance with the Corporations Act and Accounting Standards. Environmental audits are usually limited assurance engagements, and the auditor expresses a conclusion rather than opinion. There are no binding auditing standards for efficiency or environmental audits, although there are guidelines such as AA1000AS for environmental audits, and all members of the accounting professional bodies, including internal auditors, are expected to comply with professional ethical standards. Environmental audits could be conducted by consultants who are not auditors. Efficiency audits are concerned with economy and efficiency of operations rather than compliance of an external report with standards.

### **2. What is the difference between reasonable assurance and limited assurance?**

Reasonable assurance is the highest level of assurance. It means that the auditor has conducted audit procedures and gathered sufficient and appropriate evidence to provide an opinion on the truth and fairness of the financial reports. The auditor states, in an unqualified opinion, that they believe that the reports do provide a true and fair view of the financial position and performance of the client. Limited assurance is a lower level of assurance. The auditor performs a more limited set of audit procedures and gathers less evidence. The auditor provides an opinion stated in the negative form. They state that they have found no evidence which makes them believe that the financial reports do not provide a true and fair view of the financial position and performance of the client. Reasonable assurance is provided in an audit, limited assurance is provided in a review.

### **3. Why would Chip ask that Ron have the financial report for McLellan's shoes audited rather than reviewed?**

Chip would ask that Ron have the financial report for McLellan's shoes audited rather than reviewed because the audit provides a higher level of assurance that the financial reports give a true and fair view of the financial position and performance of the business. The risk that the audit opinion is inappropriate is lower than the risk that a review conclusion is inappropriate. Chip would feel more confident about the information being provided if it is audited rather than reviewed.

**4. What factors should Ron consider when selecting an accounting firm to complete the McLellan's Show audit?**

Ron would be purchasing a service from an audit firm. Therefore, Ron would consider the benefits being offered by each firm and the price being charged. Auditors generally charge based on the amount of work being done (which would be affected by the size of the business and its complexity) and the difficulty in performing the work. For example, if the auditor was unable to use their normal audit software because it was incompatible with the business's systems, they might be forced to use more expensive techniques to conduct the audit. The audit firm would evaluate the type of business and the type of accounting records being kept before quoting their price. Ron should consider how well he is likely to be able to work with the auditors, how easy they are to contact and whether he believes they understand his requirements, and how much time they would require at his business. Many clients would like the audit to be conducted as quickly as possible so that it doesn't interfere too much with their normal operations. Ron might also consider whether he is likely to be given useful advice by the auditors, although as he is trying to sell the business he is unlikely to seek advice on how to improve his systems. Some clients try to 'purchase' the right opinion. Auditor's professional ethics prevent them from being involved in 'opinion shopping', which is the practice of clients going to a number of audit firms seeking the opinion which would be most favourable.

## **Research Question**

### **Required:**

- (a) In your view, what should be contained in an audit report that conveys realistic explanations of the auditor's role and the assurance provided by the audit report?**

The question asks for the student's view. The student should propose a standard audit report format with justification for each section. The factors to be considered include: report length, location of the audit opinion, plain or technical language. If the student regards the current audit report as the most appropriate, justification should still be provided and the student should discuss how the report conveys realistic expectations of the auditor's role and the level of assurance provided. The students should provide evidence of different possible audit report formats as part of their discussion.

- (b) Do you believe that auditors are correct in dismissing users' expectations as 'unrealistic'? Should auditors be trying to meet these expectations by rethinking their role and changing their approach?**

The arguments supporting auditors' current practices and the users' alternative expectations should be researched and discussed. Are there any arguments to support the auditors' position that could not be regarded as merely defending existing practices? Are there any arguments to support critics who suggest that auditors should be doing more? Recent changes to the law suggest that regulators are willing to reconsider the auditor's role (e.g. banning certain non-audit services, requiring an independence declaration, requiring audit partner rotation). If auditors proactively adopt these types of changes, is it possible that more draconian regulatory changes could be avoided?