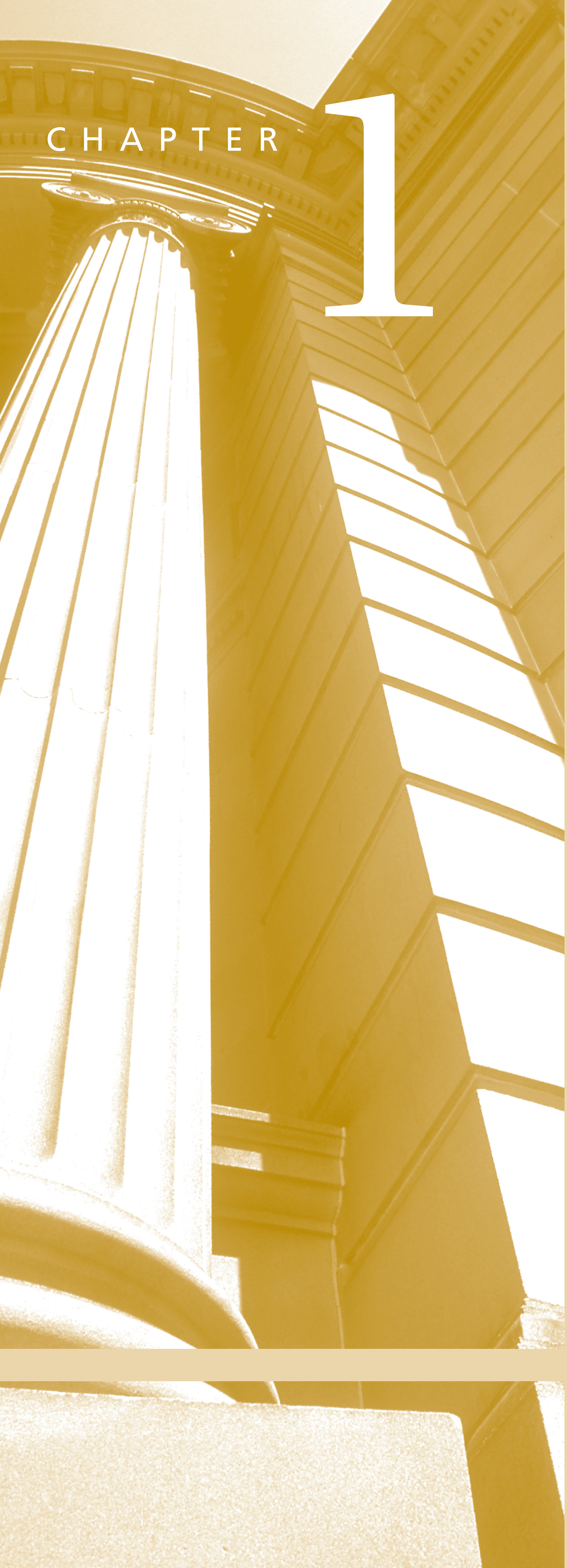
CHAPTER 1



Assurance and Auditing: An Overview

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1. understand the assurance framework;
2. understand the structure of assurance standards and pronouncements;
3. define auditing and other levels of assurance;
4. appreciate the fundamental principles underlying an audit;
5. distinguish between accounting and auditing and understand the relationship between financial reporting and financial report auditing;
6. understand the reasons giving rise to demand for assurance;
7. appreciate the history of the audit function;
8. understand the relationship between the auditor, the client and the public;
9. explain the concept of the expectation gap, especially in the areas of audit report messages, corporate failures, fraud and communicating different levels of assurance;
10. appreciate the role of auditing standards;
11. appreciate audit commitments under the *Corporations Act 2001*; and
12. obtain an overview of other applications of the audit function, including compliance auditing, performance auditing, comprehensive auditing, internal auditing and forensic auditing.

Chapter outline and review of current auditing environment

When we wrote the second edition of this book in 2003 we referred to a crisis of confidence in the underlying financial system, resulting from a number of corporate collapses (for example, HIH Insurance and One.Tel in Australia) and the demise of the auditing firm Arthur Andersen. The auditing profession, an integral part of the financial reporting process, was at a crossroads.

By the time we wrote the third edition in 2005, the auditing profession had gone from strength to strength, with society recognising the need for a strong, independent auditing and assurance profession over this period. To aid this process, a lot of reform activities were undertaken. As we write this revised edition in 2006, the new Force of Law Auditing Standards and the new Code of Ethics for Professional Accountants (APES 110) have been issued and became operational for audits commencing on or after 1st July 2006. We have incorporated changes resulting from these new standards throughout the book. We have also included other initiatives that have been achieved up until the middle of 2006, as well as identify those that are planned over the next couple of years. All of these developments provide the background which helps the reader understand the environment within which auditors work, and will be considered at various stages throughout the text.

While recent developments are relevant to putting the audit into a current context, the main aim of this book is to inform the reader about the nature of audits or, from a broader perspective, assurance services, and about the various stages involved in providing such services. There are some points that need to be made about how the book achieves this.

Entities achieve their goals through the use of human and economic resources. Audits and assurance services exist primarily because there is a separation of those who have an interest in the activities of an entity (for example, shareholders) and those who are responsible for managing the human and economic resources of the entity (for example, management). In order to account for the use of these human and economic resources, entities must issue reports explaining the use of the resources entrusted to their control. These reports can take a number of forms, including financial reports, which are prepared in accordance with accounting standards in order to provide information on the financial position and performance of an entity, and environmental reports, which are prepared in accordance with environmental standards to provide information on the environmental performance of an entity. A primary function of the public accounting profession is to render independent and expert opinions on these reports based on an examination of the evidence underlying the data reported. This examination is commonly referred to as an audit if it involves performing assurance procedures on financial information and as an assurance service if it involves performing assurance procedures on other information.

What initiatives have given rise to the increased level of confidence that is reflected in this edition? They include:

- **Development of a framework for all assurance engagements** In 2004 we saw the approval of the assurance framework. This framework covers both audits of historical financial information (including financial reports) and other assurance services. The auditing standards will be governed by this framework. This is discussed further in Chapter 1.
- **Consideration of the fundamental principles underlying an audit** In 2005 the auditing standard-setters released for discussion a draft set of fundamental principles underlying an audit. These are discussed in Chapter 1.
- **New standards for assurance engagements other than financial report audits** During 2004, we also saw the approval of a standard to cover all assurance engagements other than those on historical financial information. This provided a comprehensive standard which covers all the other assurance engagements that an auditor may be involved in, including engagements providing assurance on historical financial information. This is discussed in Chapters 1 and 14.
- **Developments in the internationalisation of auditing and the regulation of the auditing profession** During the past two years we have seen Australia commit itself to a policy of converging with International Auditing Standards, as well as to a shift in the regulatory structure of the standard-setting function towards a more independent, government-based structure with public oversight. These developments are discussed primarily in Chapters 1 to 3.
- **Corporate governance initiatives** In the second edition of the text we asked you to consider the appropriateness of the corporate governance mechanisms in place at the time. In particular, the expertise and independence of boards of directors

and sub-committees of these boards, and their relationship with external auditors were called into question. There have been a number of initiatives in this area, including corporate governance guidelines issued by the Australian Stock Exchange (ASX) Corporate Governance Council and developments in International Auditing Standards with regard to auditors' communications with those charged with governance. These are outlined primarily in Chapter 3.

- **Ethics initiatives** A number of concerns were raised about the level of ethics being practised, as well as the ethical and leadership responsibilities of both management and auditors. We have seen initiatives taken over the past two years in the International Federation of Accountants' (IFAC) Code of Ethics, which have been incorporated in the Code of Ethics for Professional Accountants in Australia. These developments are outlined in Chapter 3.
- **The independence of auditors** A number of questions have been raised regarding the independence of auditors from management, and over the past two years we have seen a number of initiatives taken in this area. For example, concerns have been raised about the high levels of other (non-audit) services being offered by auditors to their audit clients, which may compromise their independence, as well as about practices such as ex-members of auditing firms taking on management roles with audit clients. There have been a number of regulatory developments in this area, which are outlined primarily in Chapter 3.
- **Initiatives aimed at addressing increased business complexity and globalisation** In the second edition of the text we pointed out that the fact that audit clients are increasing in complexity intensified the general confidence crisis, making the audit more difficult. However, the audit profession has tackled this issue head on, revising its audit risk standards (see the next bullet point) and exposing an auditing standard on the audit of group accounts. The pervasive effect of these new standards is evident in Chapters 5 to 11.
- **New business risk auditing standards** In 2004 the audit profession approved a series of auditing standards which underpinned the business risk approach emphasised in this text, as it relates to financial report audits. Although the second edition was based on the audit approach that informs these new standards and was written in anticipation of these standards, this edition fully incorporates these standards. These three new standards, ASA 315 (ISA 315) 'Understanding the Entity and its Environment and Assessing the Risks of Material Misstatements', ASA 330 (ISA 330) 'The Auditor's Procedures in Response to Assessed Risks' and ASA 500 (ISA 500) 'Audit Evidence' have a pervasive effect throughout the planning, risk assessment and evidence-collection stages of the audit (Chapters 5 to 11).
- **New audit reporting strategies** The audit profession significantly revised its auditing standards on audit reporting for financial reports, including issuing a new standard regarding modifications to the audit report. The proposed changes to audit reports and the reasons for these changes are outlined in Chapter 13.
- **New assurance services initiatives** The development of the assurance framework has placed greater emphasis on the provision of assurance services on information other than historical financial information. These initiatives include developments in the area of limited assurance engagements, which used to be called review engagements, and a range of other assurance services such as reporting on internal controls and environmental and sustainability assurance. These are covered primarily in Chapters 14 and 17.

Progress with initiatives outlined in the second edition of the text is detailed in this new edition. The second edition emphasised first an auditing approach called the business risk approach. This approach is becoming more common in audit practice and has been incorporated in both national and international auditing standards over the past two years. It involves the auditor obtaining greater knowledge of their clients than was required under previous audit approaches, including an increased understanding of their business strategy and methods of dealing with business risks. The auditor then needs to consider the impact of this knowledge and evaluate the business risks on potential misstatements that may occur in the financial report.

The second major initiative of the second edition concerned the extension of the business evaluation, evidence-collection and reporting model from simply a consideration of providing assurance on financial reports to providing assurance on a whole range of other services. This initiative has been supported by developments over the past two years such as the approved assurance framework. Again it is hard to argue against the premise that people need assurance on a whole range of information or services other than financial reports. This may include assurance that the party at the other end of the web address is going to deliver the product or service that you have paid for—of the quality or at the time agreed upon. Or it may be that assurance is required that the sporting memorabilia recently acquired is genuine, or the claims that a business is not hurting the environment are of substance. This new edition outlines the extension of the audit methodology to other services, and reflects recent and likely future developments in this area.

The third major initiative of the previous edition was the growing impact of **globalisation** on the accounting and audit professions. Whereas the first two initiatives have been directly addressed over the past two years, further attention needs to be paid by the standard-setters to the increasingly complex environment confronting the auditor. There is an increasing alignment of national and international accounting and auditing standards. This edition continues to reflect convergence with International Auditing Standards by including references to both Australian and International Auditing Standards and examining the convergence policy of Australia with international standards. With regard to client complexity, over the next few years it is expected that auditing standard-setting bodies will pay greater attention to the increasing client complexity auditors are facing. This is associated with factors such as the increasingly complex client structures auditors are being required to audit, and the increasing complexity of accounting issues they face, such as the move away from historical cost accounting as a basis for preparing financial reports. Some of the guidance being considered is a standard on auditing complex group structures, and a review of guidance on auditing fair values. This text reflects on how issues such as increased globalisation and client complexity are likely to be addressed by the profession.

Relevant guidance

Australian		International	
AUASB	Glossary	Glossary of Terms	
ASA 100	Preamble to AUASB Standards	Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services	
AUS 106	Explanatory Framework for Standards on Audit and Audit Related Services	—	
AUS 108	Framework for Assurance Engagements	International Framework for Assurance Engagements	
AUS 110	Assurance Engagements other than Audits or Reviews of Historical Information	ISAE 3000	Assurance Engagements other than Audits or Reviews of Historical Financial Information
ASA 200	Objectives and General Principles Governing an Audit of a Financial Report	ISA 200	Objectives and General Principles Governing an Audit of Financial Statements
ASA 315	Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement	ISA 315	Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement
ASA 700	The Auditor's Report on a General Purpose Financial Report	ISA 700	The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements
APES 410	Conformity with Auditing and Assurance Standards	—	

AUDITING IN THE NEWS

SNIPPET 1.1

Source: P. Williams, (2002) 'Enron's Aftermath: Negligence and Slippery Numbers', *Australian Financial Review*, 25 March, p. 1.

Enron's aftermath: negligence and slippery numbers

It was just a year ago, in the fading light of the tech wreckage, that corporate America returned to the blue chips of the bourse. Balance sheets were back in vogue.

With the ephemeral Internet stocks cleared away, the star of the show was the energy giant Enron. Its name was emblazoned on the covers of business magazines, feted as a model for the new business paradigm. Investors made fortunes and analysts cheered as Enron madness propelled the stock higher.

Today, the integrity of the whole North American financial system is faltering. Enron and other brilliants such as Global Crossing, Tyco and even the seemingly indestructible GE still cover the front pages. But the news is very different. The Enron model is in tatters as America, from the White House to Wall Street, tries to work out how it all went wrong.

Enron has collapsed and is under investigation by the Justice Department, the Securities and Exchange Commission and about a dozen congressional committees for alleged fraud and deception. Its auditor, Arthur Andersen, has been indicted on charges of obstruction of justice for allegedly shredding the records. The financial world has been treated to the spectacle of Andersen, a true global Goliath, disintegrating as it tries to sell itself piecemeal to crowing rivals. The corporate sector is struggling to sustain investor confidence in the very machinery of American capitalism as scrutiny falls on boards of directors, audit committees, the accounting industry, regulators and the law-makers themselves.

One truism remains: Enron's role as a poster child for the new paradigm. Negligence, slippery numbers, fictitious income statements, insider dealings, conflicts of interest—these are the new bywords for corporate America. As Arthur Andersen goes on trial, the honesty and reliability of corporate America is in the dock too. …

Audit committees, responsible for reviewing the accuracy of a company's financial reports, have been steadily drawing fire. The special, internal Powers report into what went wrong on the Enron board singled out the audit committee, citing cosy ties between committee members and the company. At least one director sat on the board at the same time as being a paid consultant to the company. …

WorldCom, which owns MCI, is under SEC investigation for accounting practices, disputed customer accounts and commissions on corporate business. … The biotech cancer cure firm, ImClone, has been hauled before Congress as allegations mount about conflicts of interest, insider sales and dubious deals.

Wall Street heavy CSFB is barely out of hot water. The company has been accused of abuses in the way it dealt out hot IPOs during the tech boom. The firm paid $US100 million in January to settle investigations into the extortion of huge commissions from clients. A string of CSFB executives have been fined internally amounts from $US250 000 to $US500 000. Even after last year's congressional inquiries into the way analysts rated tech stocks during the Internet crash (when investors lost billions of dollars following their recommendations), Wall Street has paid only scant attention to calls to shape up. …

Arthur Andersen now has the reputation of a repeat offender, with Enron following disasters at Sunbeam and Waste Management. In the case of Sunbeam and former chief executive Al Dunlap—another one-time Wall Street poster boy—the story of fraudulent financial statements and fabricated transactions led to slashed profits, restated earnings, bankruptcy and SEC charges that Andersen paid heavy shareholder settlements for both Sunbeam and Waste Management. …

At the end of January a former chief accountant at the SEC told *Businessweek* that investors had lost probably $US200 billion in earnings restatements and lost market capitalisation after audit failures in the past six years alone.

The excesses of giant corporate payouts, old-boy networks and cross-directorships, insider share sales and duplicitous earnings have left investors reeling. …

The question hanging in the air is whether anyone can be trusted with other people's money anymore.

learning objective 1

THE ASSURANCE FRAMEWORK

In many situations in today's society, people who are responsible for a specific task (called responsible parties or managers) need to account for their performance on that task. There may be many groups who will rely on this accounting for performance as an aid to their decision making. These groups may be either resource providers or third parties to the process (users). There are many examples of such relationships including:

- shareholders relying on financial reports produced by companies' management;
- government agencies relying on reports produced by entities to account for environmental considerations; and
- people relying on information produced by schools when deciding where to send their children.

In order for users to judge the performance of the responsible party they may ask the responsible party to provide them with a report of how resources under their care have been used in achieving the aims of the relationship. However, the report by the responsible party is seen as potentially biased, as the responsible party may have an incentive to prepare a report that reflects their performance in the best possible light. Thus, before the report is made available to the user, the credibility of the report is enhanced by having someone who is both independent and expert (called the auditor or assurance service provider) examine the subject matter in accordance with suitable criteria and report on it.

In 2004 the International Auditing and Assurance Standards Board (IAASB) released 'International Framework for Assurance Engagements' (issued in Australia as AUS 108, 'Framework for Assurance Engagements'). The assurance framework covers both audits and reviews of historical financial information and all other assurance engagements. This initiative therefore recognises the increasing demand for assurance over a wide range of subject matter.

The framework defines an **assurance engagement** as 'an engagement in which a 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' (para. 7). Five elements of an assurance engagement are identified (para. 20):

1 **Three-party relationships**
  - *Practitioner (auditor)* In Australia this would be a member of CPA Australia or The Institute of Chartered Accountants in Australia (ICAA), 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, management is responsible for the preparation of the financial report or the implementation and operation of internal control.
  - *Intended user* The intended user is the person or persons expected to use the practitioner's report. Often the intended user will be the addressee of the report by the practitioner, although there will be circumstances where there will be other identified users.

2 **Subject matter** The subject matter of an assurance engagement can take many forms, such as:
  - financial performance (for example, historical or prospective financial information);
  - non-financial performance (for example, information aimed at efficiency and effectiveness);
  - physical characteristics (for example, capacity of a facility);
  - systems and processes (for example, internal controls);
  - behaviour (for example, corporate governance, compliance with regulation, human resource practices).

Thus, the definition of assurance services is very broad in its coverage and includes both existing assurance services and newly evolving assurance services. The framework also draws a distinction between the subject matter (such as the underlying financial position and performance of an entity) and the report on the subject matter, which is called subject matter information (such as the balance sheets and income statements).

3 **Suitable criteria** Criteria are the standards or benchmarks used to measure and evaluate the subject matter of an assurance engagement. Criteria are important in the reporting of a conclusion by a practitioner as they establish and convey to the intended user the basis on which the conclusion has been formed. Without this frame of reference any conclusion is open to individual interpretation and misunderstanding.

4 **Sufficient appropriate evidence** The engagement process for an assurance engagement is a systematic methodology requiring specialised knowledge, a skill base and techniques for evidence gathering and evaluation to support a conclusion, irrespective of the nature of the engagement subject matter. The process involves the practitioner and appointing party agreeing to the terms of the engagement. Within that context, the practitioner considers materiality and the relevant components of engagement risk when planning the engagement and collecting sufficient and appropriate evidence.

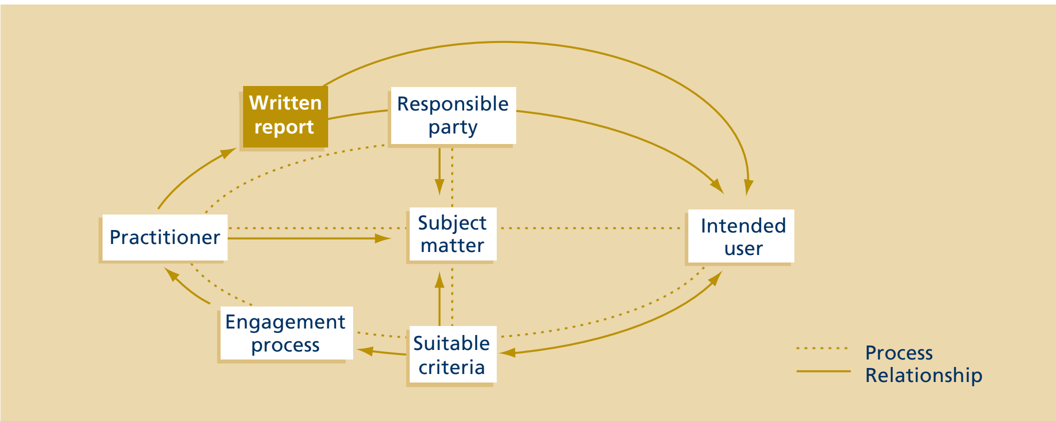
5 **A written assurance report** The practitioner draws a written conclusion that provides a level of assurance about the subject matter.

The practitioner will seek to obtain sufficient appropriate evidence as the basis for the provision of the level of assurance. In conjunction with the nature and form of the subject matter, criteria and procedures, the reliability of the evidence itself can impact on the overall sufficiency and appropriateness of the evidence available.

Figure 1.1 is a diagrammatic summary of the interrelationship of the five components.

There are a number of characteristics that make it appropriate for the profession to provide assurance on a range of subject matter. As mentioned earlier, the profession is leveraging off its reputation as a high-quality professional provider of assurance services. In particular, it is the independence and expertise of the practitioner that are sought after.

FIGURE 1.1 Diagramatic summary of an assurance service engagement



Source: Adapted from ED72 'Assurance Engagements', para. 29; reproduced with the permission of The Institute of Chartered Accountants in Australia and CPA Australia.

Independence

Users derive value from the knowledge that a member of the profession has no interest in the information other than its usefulness. Assurance independence is an absence of interests that create an unacceptable risk of material bias with respect to the quality or content of information that is the subject of an assurance engagement. Independence remains the cornerstone on which the assurance function is based.

Expertise: quality of professional judgment

The exercise of professional judgment permeates the notion of professional service. An assurance service engagement requires the exercise of judgment. The provision of a professional service requires the practitioner to offer only those services (s)he has the competence to complete, exercise due care in the performance of the service, adequately plan and supervise the performance of the service and obtain sufficient relevant information to provide a reasonable basis for conclusions or recommendations. Consideration must also be given to the appropriateness of measurement criteria and the need to communicate the engagement results. Users can obtain assurance from the service only if they are aware of the practitioner's involvement.

It could be argued that professional reputation is the critical factor that adds value to the assurance services offered by the professional accountant. As a profession, we need to protect or even improve the profession's brand name, thus enhancing the value of the assurance services. A further advantage to having members of the accounting profession provide assurance is that accountants are subject to many professional quality controls and disciplining mechanisms, and this should provide assurance to the user about the quality of the inputs and processes to our services, and therefore the quality of the final report, the output. It is through this process that assurance services add value.

Whether the accounting profession is successful in becoming the most appropriate group for providing assurance in a wide range of areas will depend on a number of factors, including whether society sees accountants as experts in the subject matter of the assurance engagement. Financial report auditors are expert in the subject matter of accounting information, and have developed processes and a reputation as high-quality assurance providers. Whether this reputation easily transfers to other areas such as environmental reporting, and possibly as a high-cost provider given the necessity of having high-level quality controls in place associated with being a member of the accounting profession, will be the test of success.

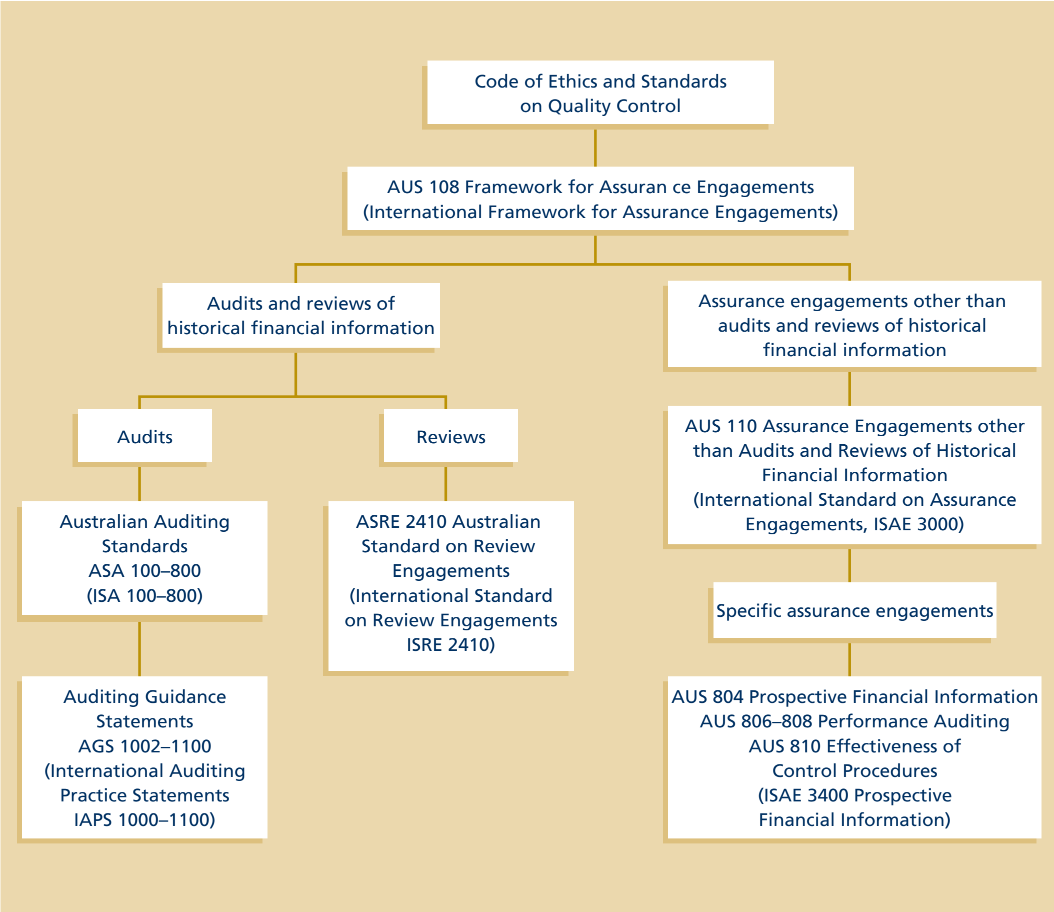
learning objective 2

STRUCTURE OF ASSURANCE STANDARDS AND PRONOUNCEMENTS

The structure of assurance standards and pronouncements in Australia and internationally is outlined in Figure 1.2. The figure gives the international equivalents of the Australian standards and pronouncements in brackets. A few points about Figure 1.2 warrant explanation. First, the Australian Code of Ethics for Professional Accountants (APES 110—internationally the IFAC Code of Ethics for Professional Accountants and the quality control standard ISQC1) is applicable to all assurance firms and engagements. The fact that the profession has a body of ethics and quality control procedures has helped to boost the reputation of the profession. These measures will be discussed in more detail in Chapters 2 (quality control) and 3 (ethics).

Second, the assurance services framework (AUS 108 'Framework for Assurance Engagements') applies to all assurance engagements. It provides a general framework for all assurance services, and

FIGURE 1.2 Structure of auditing pronouncements



defines and describes the elements of an assurance engagement (as discussed under the previous learning objective). The framework also identifies engagements to which the auditing and assurance standards both do and do *not* apply, as will be discussed later under this learning objective.

Third, under the assurance framework, the standards are evidently split between audits and reviews of historical financial information, and other assurance engagements. This demonstrates that audits and reviews of financial reports (which are classed as assurance on historical financial information) are just one type of assurance engagement. However, there is no doubt that they are an important type, since they are the primary service on which the profession has developed its reputation. These assurance services are also underpinned by a detailed infrastructure of standards. With regard to other assurance engagements, fewer standards and pronouncements have been developed. There is currently AUS 110 (ISAE 3000) 'Assurance Engagements other than Audits and Reviews of Historical Financial Information', which contains requirements for all assurance engagements other than those on historical financial information. Standards have also been developed for some specific assurance engagements, these being a standard on future (prospective) financial information (AUS 804/ ISAE 3400) and standards on assurance services for which standards have been developed in Australia but which currently have no international equivalents: performance audits (AUS 806 and AUS 808) and effectiveness of control activities (AUS 810).

Fourth, as outlined above, we know that assurance on historical financial information (financial reports) has a detailed infrastructure of standards which has been developed to support it. This includes standards on client acceptance, planning, risk assessment, evidence gathering, and reporting. These standards will be discussed throughout the text. When an auditor is undertaking other assurance services engagements, they should nonetheless also refer to these standards. AUS 110.03 (ISAE 3000.03) stipulates that the practitioner should comply with all AUSs (ISAs) *which are relevant* when preforming such an engagement.

Fifth, the assurance services framework (AUS 108.11/'International Framework for Assurance Engagements' para. 11) directs that a practitioner can enter into two types of assurance engagements or, effectively, provide two levels of assurance on any particular type of assurance engagement. These two types of assurance engagements are **reasonable assurance engagements** and **limited assurance engagements**. For assurance services on historical financial information, a reasonable assurance engagement is termed an audit, and a limited assurance engagement is termed a review. The objective of a reasonable assurance engagement (audit) is a reduction in assurance engagement risk to an acceptably low level, and this is associated with a positively expressed assurance opinion (such as that the financial information is true and fair). The objective of a limited assurance engagement (review) is a reduction in assurance engagement risk to a level that is acceptable in the circumstances—but where the remaining risk is greater than with a reasonable assurance engagement—and this is associated with a negatively expressed assurance opinion (such as that nothing has come to the auditor's attention to persuade them that the information has been materially misstated). The difference between a reasonable and limited assurance engagement is summarised in Figure 1.3.

The system of providing two levels of assurance is currently supported by AUS 106 (no international equivalent). While AUS 108 ('International Framework for Assurance Engagements') provides a framework for all assurance services, AUS 106 provides a framework only for audit and audit-related services. The two standards' terminology is slightly different—a result of AUS 106 not being updated with the new terminology from the assurance framework. In June 2004, the AUASB indicated that they will withdraw the existing AUS 106 at a later date. However, because it contains additional information on matters such as agreed-upon procedures engagements, it is being retained for the present. AUS 106 identifies specific levels of audit and audit-related services, as outlined in the following definitions.

- **Audit** is defined in AUS 106.05 as the provision of a service where the auditor's objective is to provide a **high level of assurance**. This may be done by issuing a positive expression of opinion that enhances the credibility of a written assertion(s) about an accountability matter ('attest audit'); or by providing relevant and reliable information and a positive expression of opinion about an accountability matter where the party responsible for the matter does not make a written assertion(s) ('direct reporting audit'). In the glossary to the assurance standards (AUASB Glossary-ISA 'Glossary of terms') reasonable assurance is defined as a **high but not absolute level** of assurance. Thus high assurance and reasonable assurance are commonly taken to be equivalent terms.
- **Review** is defined in AUS 106.07 as a service where the auditor's objective is to provide a **moderate level of assurance**, being a level of assurance lower than that provided by an audit. This may be done either by issuing a negatively expressed statement of assurance that enhances the credibility of a written assertion(s) about an accountability matter ('attest review'); or by providing relevant and reliable information and a negatively expressed statement of assurance about an accountability matter where the party responsible for the

FIGURE 1.3 Differences between reasonable assurance and limited assurance engagements

Type of engagement	Objective	Evidence-gathering procedures	The assurance report
Reasonable assurance engagement	A reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement, as the basis for a positive form of expression of the practitioner's conclusion. (AUS 108.11)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: • obtaining an understanding of the engagement circumstances; • assessing risks; • responding to assessed risks; • performing further procedures using a combination of inspection, observation, confirmation, recalculation, reperformance, analytical procedures and inquiry (such further procedures involve substantive procedures, including, where applicable, obtaining corroborating information, and tests depending on the nature of the subject matter, of the operating effectiveness of controls); and • evaluating the evidence obtained. (AUS 108.51 and .52)	Description of the engagement circumstances and a positive form of expression of the conclusion. (AUS 108.58)
Limited assurance engagement	A reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion. (AUS 108.11)	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes obtaining an understanding of the subject matter and other engagement circumstances, but in which procedures are deliberately limited relative to a reasonable assurance engagement. (AUS 108.53)	Description of the engagement circumstances, and a negative form of expression of the conclusion. (AUS 108.59)

Source: Appendix to AUS 108 'Framework for Assurance Engagements'.

matter does not make a written assertion ('direct reporting review'). In the glossary to the assurance standards (AUASB Glossary-ISA 'Glossary of terms') moderate assurance is equated with **negative assurance** and hence the term 'limited assurance'. Thus moderate assurance, negative assurance and limited assurance are commonly taken to be equivalent terms.

- **Agreed-upon procedures** is defined in AUS 106.04 as where the auditor's objective is to issue a **report of factual findings** to the parties that have agreed to the procedures being performed, in which no conclusion is communicated and which therefore **expresses no assurance**. However, it provides the user with information to meet a particular need, from which the user can draw conclusions and derive their own level of assurance as a result of the auditor's procedures.

AUS 106 and AUS 108.11 ('International Framework for Assurance Engagements', para. 11) state that the framework, and therefore all assurance pronouncements, do not cover agreed-upon procedures engagements, the compilation of financial information engagements, the preparation of tax returns where there is no conclusion conveying a level of assurance or management consulting services. An auditor who undertakes such engagements is required to apply procedures and an appropriate level of professional skill and care. This may involve having due regard to auditing pronouncements insofar as they are relevant or adaptable to the work being undertaken. However, this work is not deemed to be of an assurance nature.

Appendix 1 to AUS 106, which is adapted and reproduced as Figure 1.4, distinguishes in diagrammatic form first between 'audit and audit-related services' and 'other services' and then between the different types of 'audit and audit-related services'.

As can be seen from the discussion of both 'audit' and 'review', it is necessary also to distinguish between **attest reporting** and **direct reporting**. An attest engagement requires the auditor to issue an opinion on written assertions made by others. This form of engagement is also commonly referred to as an **assertion-based engagement** (AUS 108 'International Framework for Assurance Engagements'). The audit report on general purpose financial reports is an example of an attest audit. Throughout this text there is discussion of the assertions made by management in financial reports. These assertions are the responsibility of management, and they declare their responsibility for these assertions in a management representation letter, which is discussed in more detail in Chapter 12. The auditor provides a written report (the audit opinion) that expresses a conclusion about the reliability of the assertions.

A direct reporting engagement requires the auditor to provide assurance on an accountability matter on which the responsible party has not made a written assertion. For example, an audit report could be issued on the adequacy of internal control. Where management does not issue a report on the adequacy of internal control, and therefore the auditor is required to report directly on its adequacy, the engagement is classed as a direct engagement. If, however, management has stated an opinion on the adequacy of internal control, and the auditor is required to attest to this statement, it is an attest engagement.

Quick review

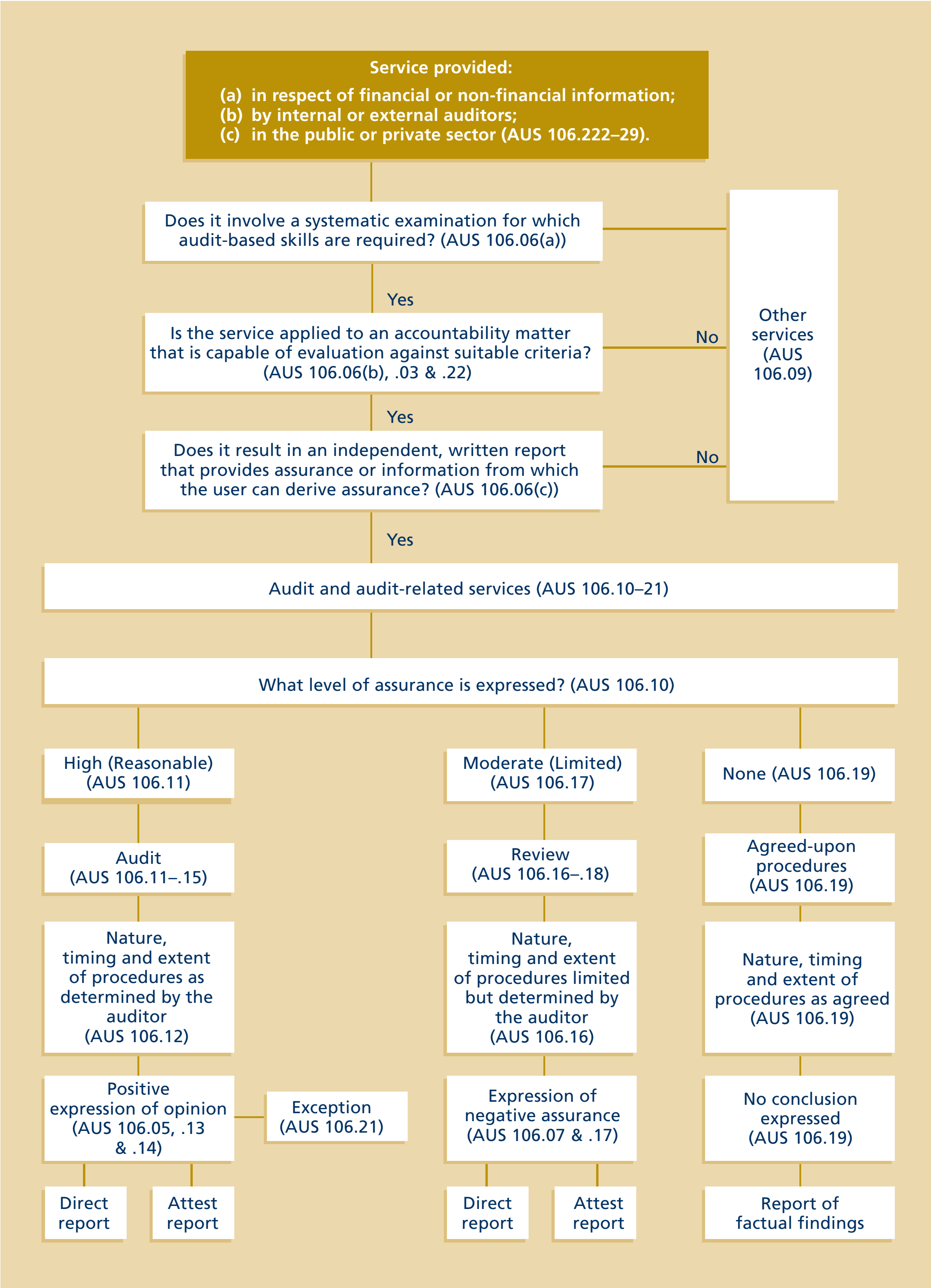
1. Audits provide a reasonable (high) level of assurance and practitioners report on this with a positive expression of opinion.
2. Reviews provide a limited (moderate) level of assurance and practitioners report on this with a negative expression of opinion.
3. Agreed-upon procedures report factual findings and no level of assurance is expressed.
4. Auditing pronouncements are applicable to audit and audit-related services, but not to 'other service' engagements, such as consulting engagements, where the auditor's objective is to assist or advise the client on any aspect of business management.
5. An audit and a review can be either an attest engagement, where an auditor issues an opinion on written assertions made by others, or a direct reporting engagement, where the auditor expresses an opinion on an accountability issue on which written assertions have not been made.

learning objective 3

AUDITING DEFINED

In today's environment, the type of assurance engagement that is most common is an audit of historical financial information. Part of the reason for this is because the requirement for an audit is contained in many pieces of legislation, including the *Corporations Act 2001* that governs the audit of annual financial reports for reporting entities. This means that public companies listed on stock exchanges must have their annual financial reports audited, and it is for this activity that the audit and assurance profession is best known.

FIGURE 1.4 Explanatory framework for standards on audit and audit-related services



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Interestingly, **auditing** or the audit of financial statements is no longer defined in the AUASB Glossary. In the International Glossary of Terms the objective of the audit of financial statements is defined as 'to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework'. As such, an audit of financial statements is one of the types of assurance engagements that can be undertaken.

While this definition describes the objective, it does not describe the process. A useful definition is that developed by the American Accounting Association (AAA) in *A Statement of Basic Auditing Concepts* (ASOBAC). It defined auditing as:

> *A systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.*

The important parts of this definition are:

- **Systematic process** Audits are structured activities that follow a logical sequence.
- **Objectivity** This is a quality of the methods by which information is obtained and also a quality of the person doing the audit. Essentially it means freedom from bias.
- **Obtaining and evaluating evidence** This is a matter of examining the underlying support for assertions or representations.
- **Assertions about economic actions and events** This is a broad description of the subject matter that is audited. An assertion is essentially a proposition that can be proved or disproved.
- **Degree of correspondence ... established criteria** This means an audit establishes the conformity of assertions with specified criteria.
- **Communicating results** To be useful, the results of the audit need to be communicated to interested parties by either oral or written means.

This broad definition reflects the essential nature of all assurance engagements as investigative processes sufficient to encompass the many different purposes for which an assurance service might be conducted.

The function of auditing as an activity should be viewed as part of the general proposition that subject matter (such as financial information) is generally of more value to the various groups that use it if it has been examined and reported upon by an independent third party. The quality of that information is enhanced by the added credibility given through the audit function. This ultimately impacts on the process of resource allocation, with the added credibility given to the subject matter enhancing the effectiveness of communication within the economic system.

The subject matter of the audit can take many forms, for example the financial report of a private or public entity, compliance with prescribed rules or regulations, the cost of a government program or the efficiency or effectiveness with which resources have been used. The nature of the audit process and the criteria used by an auditor to form and express an opinion depend upon the objectives of the audit.

Quick review

An audit is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users.

FUNDAMENTAL PRINCIPLES UNDERLYING AN AUDIT

learning objective 4

Underlying the audit process is a basic framework of auditing principles that guide the development of auditing as a discipline. However, a comprehensive theory of auditing has not yet been devised. There have been several notable attempts to provide a conceptual basis from which auditing could proceed and, while each makes a contribution, no comprehensive framework has yet been formulated. In many respects, the lack of progress on this front reflects the mix of theoretical and policy issues that have influenced supporting disciplines such as accounting.

Given that auditing standards adopted internationally and in Australia are reportedly principles-based, it has always been a concern that these principles have not been properly enunciated. To address this concern, in 2005 the IAASB and AUASB released for discussion a draft consultation paper in which they outlined possible fundamental principles underlying an audit.

Fundamental principles were described as encompassing the high ideals of professional conduct and the essential qualities underpinning every ISA audit. In preparing this draft of the principles, it was ensured that the principles accorded with the assurance framework discussed earlier. Conceptually, fundamental principles should:

- underpin the objective(s) of an audit, and help drive the conduct of the auditor in using professional judgment to meet the professional requirements of the auditing standards;
- be easily understood both by auditors and other readers of auditing standards;
- be universally applicable to all audits; and
- entrench the expectations that auditors are expected to accept and abide by.

The expectation is that auditors will not depart from or override these principles. These principles comprise (a) the fundamental principles of professional ethics, and (b) the fundamental principles that underlie the objective of an audit undertaken in accordance with auditing standards and pronouncements. They are as follows:

Fundamental principles of professional ethics

- **Integrity**
  An auditor should be straightforward and honest in all professional and business relationships.
- **Objectivity**
  An auditor should not allow prejudices or bias, conflict of interest or undue influence of others to override professional or business judgment.
- **Professional competence and due care**
  An auditor has a continuing duty to maintain their professional knowledge and skill at the level required to ensure that a client or employer receives the advantage of competent professional service based on current developments in practice, legislation and techniques. An auditor should act diligently and in accordance with applicable technical and professional standards in all professional and business relationships.
- **Confidentiality**
  An auditor should respect the confidentiality of information acquired as a result of professional or business relationships and should not disclose any such information to third parties without proper and specific authority unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of the practitioner or third parties.
- **Professional behaviour**
  An auditor should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Fundamental principles underlying the objective of an audit

- **Knowledge**
  The auditor should 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 should take responsibility for the audit 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 should follow quality control procedures, including consultation with others as necessary, that support the issuance of an audit report that is appropriate in the circumstances.
- **Rigour and scepticism**
  The auditor should 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 should exercise professional judgment, within the bounds of the fundamental principles and the applicable professional requirements, in discharging the auditor's responsibilities.
- **Evidence**
  The auditor should obtain sufficient appropriate evidence to constitute a reasonable basis for expressing an opinion on the financial report.
- **Documentation**
  The auditor should document matters that are important in providing evidence to support the audit opinion
- **Communication**
  The auditor should 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 require additional communication in the broader public interest.
- **Association**
  The auditor should not be associated with or allow the use of the auditor's name or their 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 should report to those who have appointed the auditor to the engagement. The auditor's report should contain a clear expression of opinion in writing and set out all information necessary for a proper understanding of the opinion and its basis.

Quick review

1. Current auditing standards are principles-based, although these principles have not been clearly enunciated.
2. The standard-setting bodies have released for discussion a draft set of fundamental principles. These cover both ethics and the objectives of an audit.

3 The fundamental principles of professional ethics are:
- integrity
- objectivity
- professional competence and due care
- confidentiality
- professional behaviour

4 The fundamental principles underlying the objective of an audit are:
- knowledge
- responsibility
- quality control
- rigour and scepticism
- professional judgment
- evidence
- documentation
- communication
- association
- reporting

ATTRIBUTES OF ACCOUNTING INFORMATION

5 learning objective

To understand the audit process as it relates to accounting information, it is important to appreciate the role of accounting information and the process of communication through financial reports. The definition of auditing provided on page 16 was formulated within the context of *A Statement of Basic Accounting Theory* (ASOBAT), produced by a committee of the American Accounting Association, which defined accounting as: '... the process of identifying, measuring and communicating economic information'.

The definition of auditing, combined with this definition of accounting, clearly links the auditing function with the communication of accounting information. It is relevant, therefore, to consider some aspects of accounting information: the characteristics of that information represent a variable in the environment in which the audit function occurs.

The fundamental objective of financial reporting in its broadest sense is defined in the Australian Accounting Standards Board (AASB)/International Accounting Standards Board (IASB) 'Framework for the Preparation and Presentation of Financial Statements' issued in 2004. This Framework identifies the objective of financial reports as the provision of information useful to a wide range of users for making economic decisions. In meeting this objective, general purpose financial reports also represent the means by which management and governing bodies meet their accountability obligations to report to users by providing information about the performance, the financial position and the financing and investing activities of the entity.

The functions served by financial reporting comprise economic decision making, control and accountability. The potential users of financial reports include current and potential investors, creditors, employees and their representatives, customers, the government and the public. Some of these users do not have direct access to accounting information nor do they have the power to demand it. In those circumstances, such users rely on general purpose financial reports for information relevant to their needs. To enable the financial reporting system to meet the fundamental objectives of financial reporting, the information should possess several interrelated characteristics.

The characteristics that are identified in the Framework include:

1 **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. The information in a financial report is, therefore, directed to meeting the common information needs of a range of users to assist them in predicting the outcomes of past, present or future events, and/or confirming or correcting past evaluations. One of the important aspects of the definition of auditing provided above is the determination of the degree of correspondence between assertions about economic actions and events and established criteria. In terms of general purpose financial reporting, the established criteria are those directed towards the provision of relevant information. In that context, accounting standards represent a financial reporting framework directed toward providing relevant financial information. The relevance of information is also a function of its timeliness, and it should be available when it is needed.

2 **Reliability** The reliability of financial information is 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 that the facts be impartially determined and reported, since biased information is not acceptable to financial reporting. The information should be neutral and not be designed to lead users to conclusions that serve particular needs, desires or preconceptions of report preparers. The reliability of information in a financial report also requires that such information be capable of reliable measurement before it can be recognised in the financial report as compared with disclosure in the notes to the financial report. Accounting standards also play a role in providing measurement techniques to be used in the preparation of reliable financial information.

3 **Comparability** The usefulness of information requires that its presentation in a financial report results in users being able to compare aspects of an entity at one time and over time, and between entities at one time and over time. Comparability requires that like things are measured and reported in a consistent manner within an entity and over time for that entity, and that there is consistency between entities.

4 **True and fair presentation** The application of the qualitative characteristics and of appropriate accounting standards (suitable criteria) will normally result in financial reports that convey a true and fair view. The audit will provide assurance of this result.

Quick review

1 The accounting attributes of relevance, reliability, comparability and a true and fair presentation provide the basis for the audit function.

2 For general purpose financial reports, accounting standards represent a financial reporting framework directed towards providing relevant financial information, and play a role in providing measurement techniques to be used in the preparation of reliable information.

learning objective 6

DEMAND FOR ASSURANCE

The attributes of information (relevance, reliability, comparability and true and fair presentation) provide a basis for the assurance function. Users of assurance services require some assurance as to the quality of information in terms of those attributes. The role of auditing (and assurance) is seen as being especially important to reliability and relevance. With regard to financial report audits, the role of the auditor is to be satisfied that the general purpose financial report represents what it purports to represent without bias, and that the contents are verifiable. As an independent expert, there is also an expectation that the auditor is satisfied as to the relevance of the information for assessments of the performance, financial position, financing and investing and compliance of the reporting entity. This role arises because most financial report users are not in a position to produce financial accounting information personally or to establish the credibility of the process by which such information is prepared and presented to them. The need for the independent financial report audit arises, therefore, because of the following conditions:

- **Conflict of interest** Because the user (e.g. the owner) perceives an actual or potential conflict with the preparer (management). Management could have an incentive to present biased information in a financial report because these reports are a means to convey information about management's performance. This conflict creates uncertainty as to the objectivity of the information preparer. An independent, third-party examination will reduce the possibility of bias and enhance the credibility of the information.
- **Consequence** When a user is contemplating using information to make decisions of consequence, the quality of that information is of direct concern.
- **Complexity** The subject matter and the process by which the data (e.g. transactions) is converted into information (e.g. financial reports) is complex and, as it becomes more complex, the possibility of error is increased. The average user of that information does not possess the required level of expertise to judge the quality of information.
- **Remoteness** The separation of owner and manager, and therefore user and preparer, whether due to physical, legal or time and cost constraints, prevents the user from assessing information quality.

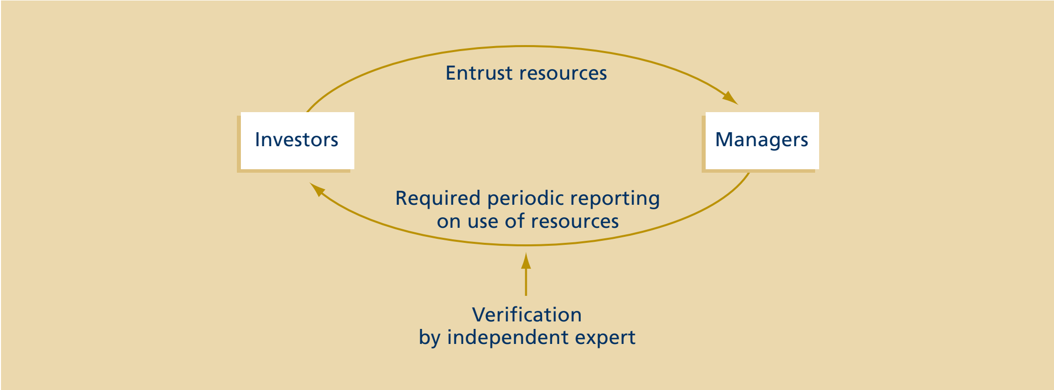
These four conditions have given rise to the following three hypotheses to explain the demand for auditing (Sundem et al., 1996; Wallace, 1980) and these hypotheses could equally be used to understand the demand for assurance:

1 **Agency theory** (Stewardship hypothesis) In an agency relationship, investors, as principals in the relationship, entrust their resources to managers, who act as their agents or as stewards of the resources. However, in this relationship a potential conflict of interest arises (management should be trying to maximise returns to investors but have an incentive to consume or reallocate resources for their own benefit). In an attempt to monitor their activities, managers are asked to account for the level and performance of resources under their control by producing periodic financial reports. Because of the potential conflict of interest outlined above, the complexity of the subject matter and the remoteness of the investors from the managers, the financial reports may be biased. The use of an agreed-upon reporting framework, generally accepted accounting principles (GAAP), is one attempt to reduce the bias, and getting assurance on these reports from an expert who is independent of management also increases the confidence in the information that is communicated. This is shown in Figure 1.5 overleaf.

   To try to align the interests of managers with those of shareholders, maximising shareholder wealth, a common practice in today's environment is for managers to be rewarded through schemes such as bonuses based on profit and share option schemes. As rewards may be influenced by the financial information that they produce, management again may have incentives to bias the financial reports. This provides even further demand for assurance in today's society.

2 **Information hypothesis** An assurance service is a means of improving the quality of information. For example, investors require information to make an assessment of expected

FIGURE 1.5 **Simple diagram of agency relationship between managers and investors**



returns and risks associated with their investment. An assurance service is also valued as a means of improving financial and non-financial data for internal decision making, detecting errors and motivating employees to exercise more care in preparing records.

The information hypothesis also states that investors benefit through the increased confidence of external users of the information. For example, a study by Blackwell et al. (1998) showed that for private companies seeking funds from lending institutions, the costs incurred in audit fees were more than recompensed by the increased savings associated with lower interest rates when compared with the interest rates charged to similar companies that weren't audited.

3 **Insurance hypothesis** The insurance hypothesis states that demand for assurance occurs from those who may suffer loss when things go wrong. For example, if an organisation goes into liquidation and has no resources to pay its debts, it may be possible to recover some of the losses from the auditor (the circumstances in which this is possible are discussed in Chapter 4). As auditors are required to have insurance against such potential losses, this has given rise to a 'deep-pockets' effect in that the auditor is seen to have a greater ability to pay. As audit firms will be very concerned with maintaining their reputation, any legal action undertaken against them that may damage this reputation will be treated very seriously.

There is overlap between the hypotheses, in particular the agency theory and information hypothesis. When providing evidence on stewardship and monitoring, the assurance provider is also providing information of a particular type to aid the decision-making process of principals to the contract. While the information hypothesis may be the major reason for many of the assurance services other than financial report auditing, the insurance hypothesis will be less likely to explain all these engagements. While this hypothesis was originally derived to explain demand for financial report audits, it may also be applied to other specific assurance services, such as expert opinions given in takeover situations. However, where the level of assurance sought is something below an audit, implying that it is acknowledging that the assurance services provider will use a reduced set of evidence-gathering procedures, it is unlikely that insurance will be a major determinant of demand.

Quick review

1 The four conditions which result in a need for financial report audits are conflicts of interest, the importance of the decision, the complexity of the subject matter and the remoteness of users from managers.

2 The following three hypotheses, which incorporate these conditions, have been used to explain the demand for financial report audits:

- agency theory (stewardship hypothesis)
- information hypothesis
- insurance hypothesis

3 The generation of information (and thus assurance) will be a major determinant of demand for many other assurance engagements, while the insurance hypothesis is unlikely to explain demand for assurance provided at something other than the audit level.

HISTORY OF THE AUDIT FUNCTION

7 learning objective

Audits have been performed at least since the thirteenth century. The exact origin of audits of financial reports is unclear. However, it is known that in England as far back as 1298 the Chamberlain of the City of London was subject to audit. Those audits were intended to assure the absence of fraud, emphasising arithmetical correctness and compliance with the authority given to the custodian. While its origins are ancient, development of the audit function has occurred most rapidly in the last century.

The development of auditing in Australia, New Zealand and North America has its origins in the British system. Australia and New Zealand have been particularly influenced by UK development because of the derivation of their legal systems from the British system.

Independent audits prior to 1900

Prior to 1900 in the UK, public companies were formed under a law enacted in 1844. The *Joint Stock Companies Act* required registration of all new companies with 25 or more members. The *Companies Act* of 1845 included a provision that required incorporated companies to have their annual financial report audited. This development was considered necessary because of the demands for increased capital as a result of the Industrial Revolution. Capital could now be raised from shareholders who would have no part in managing the firm. Consequently, the need for managers to report periodically to those who had contributed the capital became apparent. The Act required the auditor to examine and report on the balance sheet presented by the company to its shareholders. At this stage the auditor was in most cases a non-accountant, with the main objectives being to report on the company's solvency and to detect fraud and error. While the requirement for compulsory audits was suspended under the *Joint Stock Companies Act* of 1856, with audits remaining optional until 1900, the legislation facilitated the spread of companies and the development of an accounting profession in the UK.

In Australia during the nineteenth century, the rate of industrial expansion was not as great as that in the UK. It was only toward the last quarter of the century that commercial enterprise became well established. Any statutes were based on the prevailing British legislation. For example, following legislation in Great Britain in 1879 requiring banking companies to appoint an auditor, the requirement for all publicly held companies to be audited began appearing in the Companies Acts of various Australian states. In general, the requirement was for the auditor to provide an opinion on whether the balance sheet was a 'full and fair' balance sheet, properly drawn up so as to exhibit a 'true and correct' view of the state of affairs of the company. This report had to be read before the company in a general meeting. As in the UK, the primary audit objective was the detection of fraud and error.

A similar situation existed in the USA during this period. The audit function exported from Britain to the USA adopted the British form of reporting even though there were no comparable statutes. The absence of statutory requirements for audits to be submitted to shareholders resulted in nineteenth-century audits that varied from balance sheet audits to full, detailed examinations of all accounts of companies. An auditor was engaged usually by management or by the board of directors of a company, and the report was addressed and directed to these insiders rather than to shareholders. Reports to shareholders on the representations of management were not common. Instead, company management was interested in being assured by the auditors that fraud and clerical errors had not occurred. Even today, the state laws under which US companies are formed generally do not require audits. Rather, audit requirements generally arise from requirements of stock exchanges, regulations of the Securities and Exchange Commission and general acceptance of the usefulness of an independent auditor's opinion on financial representations.

1900 onwards

Legislative influences

From these beginnings, the concept of an audit developed to the stage where by the early 1900s professional accountants became prominent as auditors, and verification of financial record accuracy and attestation to financial report credibility were added to the detection of error and fraud as audit objectives. The 1900 *Companies Act* in the UK reintroduced the requirement for every company to have an audit.

During the 1930s and 1940s the continued improvements in financial accounting and reporting in the UK and the acceptance by management of the responsibility for prevention and detection of fraud and error produced a change in emphasis. Detection of fraud and error became a secondary objective of auditing. The emergence of the verification and attest function was formalised by the 1948 *Companies Act* in the UK, and has carried through into subsequent provisions.

The development of the profession in terms of skill and status carried through into Australia. However, the absence of a strong organised profession, and the consequent lack of native sources of authority, saw standards from other countries being used to fill existing voids. Up until the end of World War II the significant professional influence came from the adoption of auditing concepts from the UK. Australian companies' legislation also followed that which was developed in Britain. The Companies Acts of the various states were, however, sufficiently different as to make it difficult to generalise, although several key requirements can be listed. These various Acts required auditors to report to shareholders on every balance sheet laid before the company in general meeting in the following terms:

1. whether or not they had obtained all the information and explanations they required; and
2. whether, in their opinion, the balance sheet was properly drawn up so as to exhibit a true and correct view of the state of the company's affairs according to the best of their information and the explanations given to them, and as shown by the books of the company.

The Victorian and Western Australian Acts of this time also required an opinion on the profit and loss account or the income and expenditure account, indicating whether they reflected a true and correct view of the results of the business of the company for the year. The Acts in New South Wales and Queensland required that auditors state whether, in their opinion, the register of members and other records required to be kept were properly kept. It became apparent during the 1950s that because of revisions and re-enactments in each state at different times, the disparity between Companies Acts did not provide adequate protection for investors. As a result, the *Uniform Companies Act* evolved in 1961. This Act formed the basis of statutory audit requirements in Australia for 20 years, until replaced by the *Companies Act 1981*, which was implemented on

1 July 1982. The 1981 Act achieved greater uniformity as it was one Act legislated initially in the Australian Capital Territory and, under the provisions of a co-operative agreement, adopted by each state (except the Northern Territory) as its Companies Code through the operation of state Companies (Applications of Laws) Acts.

In 1989, the Commonwealth Parliament introduced the *Corporations Act* as a national law governing companies; this did not require state co-operation. Due to constitutional issues, the legislation and the national scheme did not come into force until 1 January 1991. The Acts under that scheme were collectively given the name 'the *Corporations Law*'. References to the *Corporations Law* throughout this text refer to the provisions of the 1991 legislation, as amended. The specific provisions of the *Corporations Law* (and its predecessor legislation) relating to financial reporting and auditing have influenced the nature and direction of the financial report audit function in Australia. This was further amended in 2001, and is now referred to as the *Corporations Act 2001*. A more detailed discussion of audit commitments under the *Corporations Act 2001* is contained later in this chapter and also in Chapter 3.

Professional influences

A further influence on the development of the audit function in Australia has been the role of the two professional accounting organisations in Australia. The formal role of the accounting profession in the development of auditing in Australia is evidenced by the promulgation of professional statements on auditing. Pronouncements relevant to the audit function first occurred during 1956 with the establishment by the ICAA of the Australian Chartered Accountants Research and Service Foundation. During a five-year period the foundation produced six technical bulletins relating to aspects of the conduct of a professional practice. While not authoritative, these bulletins provided guidance to accountants in public practice. For example, Bulletin No. 2 dealt with the audit of stock-in-trade and Bulletin No. 5 with audit working papers. The next significant development took place in 1969 when the ICAA established a new Accounting Principles Committee that developed several statements that were included in the Members' Handbook. For example, this committee produced Technical Bulletins F2, 'Internal Control in a Computer-based Accounting System', and F3, 'The Audit of Computer-based Accounting Systems'. These documents were based on similar documents produced by the Institute of Chartered Accountants in England and Wales. In 1971 the Council of the ICAA established an Audit Practices Committee that also produced several statements on auditing. The ongoing role of the profession in this area through the activities of CPA Australia and the ICAA is dealt with later in this chapter and in Chapter 2.

Recent developments

The profession is now heavily influenced by and reflects the increasingly global nature of the business world and the international affiliations of the larger accounting firms. The globalisation of the business world, and the accounting profession, is a current issue that is discussed later in this chapter. This trend is reflected in developments such as the increasing importance of the International Federation of Accountants (IFAC), which is discussed in Chapter 2. In 2005 its member accountancy bodies total 161, representing 119 countries, including Australia. One of the standing committees of IFAC is the International Auditing and Assurance Standards Board (IAASB), whose aim is to develop standards and issue guidelines on generally accepted auditing practices. Australia is represented on that committee. The International Standards on Auditing issued by the IAASB provide the basis for the auditing standards of most member countries.

Changes in the audit objectives

The change in the traditional audit objective from fraud detection and prevention to a determination of the truth and fairness of the reported financial position and results of operations of an entity is reflected in the audit process itself.

The period prior to 1900 required the audit process to include the detailed verification of every transaction. During the period from 1900 to the 1930s the objective of auditing was modified to include a determination of the fairness of reported financial position and results of operations as well as detection of fraud and error. During this period there was some recognition that a complete transactions audit was not appropriate, and that an accounting system and organisational structure could be harnessed to assist in the orderly production of accounting records. During the 1940s the audit objective was specified by the profession as the determination of the fairness of the reported financial position and results of operations of an entity.

This objective has not changed significantly since then, as reflected in the current Australian auditing standard, ASA 200 (ISA 200). This identifies the objective of the audit as the expression of an opinion by the auditor as to whether the financial report is prepared, in all material respects, in accordance with an identified financial reporting framework.

Approaches to auditing since the 1940s

The objective of establishing whether the financial information is fairly presented (or true and fair) in all material respects resulted in a change to the audit approach of verification of all transactions. To be able to provide assurance of fairness with a materiality consideration meant that not all transactions had to be tested.

Four audit approaches have evolved over time. These approaches are outlined below.

Balance sheet approach

The **balance sheet approach** concerns itself with the accounting equation, that is:

Proprietorship = Assets − Liabilities

Given that proprietorship is made up of capital and profit, and that capital remains fairly static in most cases, then profit will equal the increase in net assets (assets minus liabilities). Therefore, the balance sheet approach is to audit the assets and liabilities, such as cash, accounts receivable, accounts payable and non-current assets and liabilities.

This traditional approach to audit involves the audit of financial report balances with little emphasis on profit and loss account items, limited planning of the audit and a limited use of analytical procedures. Because the audit examination is based on the balances outstanding as at year-end, the examination is concentrated at or around the client's year-end. This approach assesses internal control in only a limited capacity. As outlined in Chapter 9, this audit approach is currently used for many small-business audits, where internal controls may be weak, but is rarely used for large entities.

Transactions cycle approach

For large entities it was recognised that a **transactions cycle approach** was more cost effective than the balance sheet approach for the following reasons:

- The number of items in ending balances, while still less than the number of transactions that affect the balances, was relatively large.

- The accounting system for processing major classes of transactions was generally well designed and produced more reliable accounting data because management in a larger company has to rely extensively on the accounting data to monitor and control the business.
- There were generally enough employees (needed because of the volume of transactions processed) to achieve effective separation of duties.

In these circumstances, by testing the processing of transactions, the auditor could restrict the testing of balance sheet accounts that would otherwise be necessary. This involved testing the controls operating within transactions cycles. These transactions cycles included the sales–accounts receivable–cash receipts cycle, purchases–inventory–creditors–cash payments cycle, payroll–cash payments cycle and other purchases–cash payments cycle.

Standard *internal control questionnaires* were developed for each of the business cycles, with the result that the chances of discovering fraud or potential fraud were significantly increased. This also had the advantage of generating a significant number of observations concerning conflicts in duties that could be passed on to management.

The problem with this approach in practice was that it tended to be highly structured with standard programs, allowing little judgment or original thought to be exercised by the auditor.

Financial risk analysis approach

The **financial risk analysis approach** to auditing has been used in practice since the 1980s. This approach involves:

- a systematic approach to planning where the auditor acquires an overall understanding of an entity's business;
- evaluation of internal control from a business perspective; and
- analytical procedures applied in all phases of the audit to see that the financial and operating trends and relationships make sense.

The auditor must give due consideration to the issues of *relative risk* and *materiality* in preparing the audit program and in adopting a risk analysis approach to determine the audit program for the operating cycles of a business. Only by designing the audit program to emphasise the material and high-risk components of the audit can a cost-effective audit that satisfies professional, contractual and legal standards be produced.

Business risk approach (audit risk approach)

In the late 1990s the financial risk analysis approach was modified to give greater consideration to the strategic or business risks facing the client. This approach is currently evolving in practice and is referred to in this book as the **business risk approach**. It is also commonly referred to as the 'audit risk approach.' The auditor must understand the business risks faced by the client in addition to understanding the risks that affect the traditional processing and recording of transactions.

Consideration of an entity's business risks requires that the auditor know the client's business strategy and how it plans to respond to, or control, changes in its business environment. Numerous rapid or momentous changes have significantly affected an industry or an entity within that industry. For example, the sale of books over the Internet by companies such as Amazon.com through a 'virtual' bookstore significantly affected the retail book industry. Traditional bookstores had to respond to this new form of competitor or lose sales and customers. Similarly, rapid and significant technological changes in telecommunications and in computers and peripheral equipment increase the business risks for entities that operate in those industries. A further example is that deregulation in the banking industry has significantly affected the risks for entities that operate in those industries.

This emphasis is contained in ASA 315 (ISA 315), where the auditor is required to gain an understanding of the entity and its environment, including its objectives and strategies and related business risks (ASA 315.39–.44/ISA 315.30–.34). This focus on the client's business risks leads to a more strategic and systematic approach to the audit. The auditor uses knowledge of the client's business and industry to develop a more efficient and effective audit. It is this business risk approach that is the audit approach that is outlined in more detail in Part 2 (Chapters 5 to 11).

Quick review

1. The UK *Companies Act* of 1845 included the first provision within legislation for audit.
2. The major objectives of audits prior to 1900 were to report on solvency and the detection of fraud and error.
3. From 1900 onwards, attesting to financial report credibility became a major objective.
4. Audit approaches used to attest to financial report credibility have evolved since the 1940s from a balance sheet approach, to a transactions cycle approach, to the current business risk approach.
5. Within the business risk approach, greater attention is currently given to strategic or business risks facing the client.

learning objective 8

THE AUDITOR–CLIENT–PUBLIC RELATIONSHIP

Today many different types of entities render reports on the administration of their resources. A comprehensive but not exhaustive list would include commercial and industrial companies, banks, railways, airlines, electric and gas utilities, insurance companies, hospitals and governmental bodies such as municipal councils and the state and federal governments.

In spite of the diverse activities of these entities, they all issue some type of report concerning their fulfilment of responsibilities to outside parties. Regulated entities issue reports to regulating authorities to serve as a basis for regulation. Creditors use financial reports for assessment of repayment ability before extending credit and as evidence of compliance with the loan agreement after issuance. There are many examples of such reports, and the audit function may be applied to all of them.

The auditor–client–public relationship is, however, complicated and delicate. The reports are the representations of management about its effectiveness in administration of resources to interested third parties. Entities represented by management are clients of auditors, but auditors generally report to the public. The client entity engages an auditor and pays the fee. Professions other than auditing confine their responsibilities almost solely to clients. However, independent auditors have for many years acknowledged responsibilities to several parties other than those who directly engage them and pay their fees.

As outlined earlier in this chapter in the section 'Demand for Assurance', management may exercise discretion in preparing financial reports and in using resources entrusted to it in operating the entity. An audit provides reasonable assurance that management's conduct in both activities has been appropriate. Thus, an audit has value because management's representations on its performance and stewardship are examined and reported on by an expert outside management's control.

However, in practice auditors are selected and paid by people affected by their work. In addition, an audit of a financial report requires a close working relationship with management. The auditor needs intimate knowledge of many of management's actions, decisions and judgments because of their significant effect on the financial report. An independent auditor is subject to conflicting pressures. The auditor depends on fees from clients and necessarily has a close relationship with clients. Thus, total independence is very difficult to achieve. Nevertheless, the auditor must often persuade a client to disclose unfavourable information in fulfilling the duties imposed by the audit function. As a result, independent auditors as a group have adopted ethical rules and professional standards to guide individual auditors in resolving the conflicts that inevitably arise, and to ensure the quality of the audit process and therefore the utility of the audit function. This is discussed in Chapter 3.

Quick review

1 Auditors have entities as clients but owners or other members of the public use their reports.
2 Being selected by and paid by the clients on whom they reported makes total independence difficult to achieve.

EXPECTATION GAP

9 learning objective

It is appropriate at this point to recognise that there are differences between the expectations of auditors and financial report users concerning the role and responsibilities of auditors. The existence and nature of this **expectation gap** was first indicated in a number of empirical studies and inquiries conducted in various countries during the 1970s and supported by further investigations in the 1980s and 1990s.

Liggio (1974, p. 27) first applied the term 'expectation gap' to auditing and defined it as the difference between levels of expected performance as envisaged by auditors and users of financial reports. Porter (1993, p. 50) argued that the definition was too narrow, as auditors may not accomplish expected performance. Therefore, she defined it as 'the gap between society's expectations of auditors and auditors' performance, as perceived by society'. As a result, two components of the expectation gap can be identified:

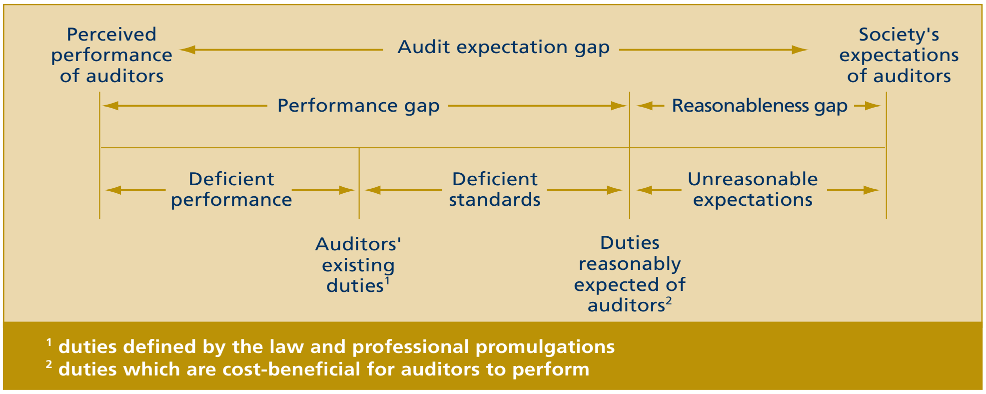
1 The 'reasonableness gap': a gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish.
2 The 'performance gap': a gap between what society can reasonably expect auditors to accomplish and what they are perceived to achieve. This may be further subdivided into:
   - 'deficient standards': a gap between the duties which can reasonably be expected of auditors and auditors' existing duties as defined by law and professional promulgations; and
   - 'deficient performance': a gap between the expected standard of performance of auditors' existing duties and auditors' perceived performance, as expected and perceived by society.

This structure of the audit expectation gap is shown in Figure 1.6 (overleaf).

The potential causes of the audit expectation gap are many and varied. Humphrey et al. (1992) point out that the gap has been attributed to a number of different causes:

- the probabilistic nature of auditing;
- the ignorance, naivety, misunderstanding and unreasonable expectations of non-auditors about the audit function;
- the evaluation of audit performance based upon hindsight not available to the auditor at the time the audit was completed;
- the evolutionary development of audit responsibilities, which create response time lags to changing expectations;
- corporate crises which lead to new expectations and accountability requirements, and periods of high standard-setting activities; or

FIGURE 1.6 **Structure of the gap between audit expectation and audit performance**



Source: Porter, 1993, p. 50.

- a self-interested profession which is a self-regulatory monopoly attempting to control the direction and outcome of the expectation gap debate to maintain the status quo, rather than risk their profitability.

While a consensus as to the cause of the audit expectation gap has not been achieved, its persistence has been acknowledged and bears testimony to the profession's inability or reluctance to narrow the gap. Humphrey et al. (1992) indicate that the accounting profession's responses to the gap may be categorised as either defensive or constructive. First, its defensive responses have included the profession emphasising the need to educate the public and reassure them about the exaggerated public outcries over isolated audit failures; codifying existing practices to legitimise them; and attempting to control the audit expectation gap debate and repeatedly propounding the views of the profession. Second, its constructive response has included emphasising an awareness and readiness to extend the scope of the audit. However, such extensions have been criticised for resulting in auditing being viewed as a package of services or a commodity for management's benefit.

The debate about the audit expectation gap consistently centres on a number of perennial issues. Four major expectation gap issues are:

1. the nature and meaning of audit report messages;
2. early warning by auditors of corporate failure;
3. the auditor's responsibility for the detection and reporting of fraud; and
4. the auditor's ability to communicate different levels of assurance.

The loss of faith in audited financial statements in the early part of this century has resulted in the auditing profession looking very closely at elements of the expectation gap again. For instance, the ICAA recently released a report entitled 'Financial Report Audit: Meeting the Market Expectations' (Trotman 2003). As outlined below and in later chapters, the auditing profession is looking at whether it can better communicate its intended message and address areas of concern, and reconsidering its responsibilities in relation to detecting and reporting fraud.

Audit report messages

Research studies have shown that many financial report users believe that an unqualified audit report indicates that the auditor is guaranteeing that the audited financial report is completely accurate. This view is quite different from that expressed by the auditing profession in ASA 200 (ISA 200), that is, that the auditor's opinion *helps establish the credibility* of the financial information.

Until approximately 10 years ago, the standard audit report consisted of a single paragraph, with very few details of the different parties' responsibilities, level of work performed or level of assurance that the auditor was intending to convey. In the early 1990s, the auditing profession attempted to overcome these problems through amendments to the contents of the auditor's standard report by adopting the expanded audit report. In Australia, Gay and Schelluch (1993) and Monroe and Woodliff (1994a) found that the wording of the expanded audit reports increased users' understanding of the audit process and the role and responsibilities of auditors and management. They found that the expanded audit report reduced the expectation gap but did not eliminate it and that there was still room for improvement in the wording of the audit report. The form and content of the auditor's report continues to be revised, and Exhibit 1.1 outlines the standard form of the unmodified auditor's report that is currently contained in ASA 700/ISA 700. A more detailed discussion of the standard auditor's report is provided in Chapter 13.

EXHIBIT 1.1

Independent audit report

INDEPENDENT AUDITOR'S REPORT

To the members of [name of entity]

We have audited the accompanying financial report of [name of entity], which comprises the balance sheet as at 30 June 20XX, and the income statement, statement of changes in equity and cash flow statement for the year ended on that date, a summary of significant accounting policies, other explanatory notes and the directors' declaration.

Directors' responsibility for the financial report

The directors of the [company/registered scheme/disclosing entity] are responsible for the preparation and fair presentation of the financial report in accordance with Australian Accounting Standards (including the Australian Accounting Interpretations) and the *Corporations Act 2001* (Cwlth). This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and fair presentation of the financial report that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's responsibility

Our responsibility is to express an opinion on the financial report based on our audit. We conducted our audit in accordance with Australian Auditing Standards. These Auditing Standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance whether the financial report is free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial report, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial report in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial report.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Continued . . .

Independence

In conducting our audit, we have complied with the independence requirements of the *Corporations Act 2001* (Cwlth). We confirm that the independence declaration required by the *Corporations Act 2001* (Cwlth), provided to the directors of [name of entity] on [date], would be in the same terms if provided to the directors as at the date of this auditor's report.

Auditor's opinion

In our opinion the financial report of [name of entity] is in accordance with the *Corporations Act 2001* (Cwlth), including:
(a) giving a true and fair view of the [company/registered scheme/disclosing entity]'s financial position as at 30 June 20XX and of its performance for the year ended on that date; and
(b) complying with Australian Accounting Standards (including the Australian Accounting Interpretations) and the *Corporations Regulations 2001.*

Source: AUASB, Auditing and Assurance Standard ASA 700 *The Auditor's Report on a General Purpose Financial Report.* Example 1: Unmodified auditor's report prepared under the *Corporations Act 2001* (Cwlth) – Single corporate entity, 2006.

Corporate failures

According to a survey by the Institute of Chartered Accountants in England and Wales, the general public expects external auditors to provide them with an early warning of corporate failures. While an entity's financial report is normally prepared based on the assumption that it is a going concern, this does not necessarily mean that the entity will continue in existence. The dilemma faced by the auditors is the requirement to state any unresolved doubts about the auditee's future versus the risk that any such comments may generate a self-fulfilling prophecy by undermining the confidence of the entity's owners and creditors. Nevertheless, if facts and circumstances raise doubts about the viability of the entity, those doubts must be dispelled or disclosed. Porter (1991) argues that too often this duty is not performed. Trotman (2003) points out that the profession could do more in this area, including auditors reporting on key non-financial indicators that can evidence corporate failure and providing commentary on entities' financial health.

Earnings management and fraud

Another area where there appears to be a large 'expectation gap' is in regard to the auditor's duty to detect and report earnings management and fraud. The general public appears to have a high expectation that auditors will detect or prevent all fraud whereas the auditing profession has generally not regarded fraud detection as a primary audit objective.

A survey of shareholders in Australia by Beck (1973) indicated that 93 per cent believed that an audit provided an assurance that company officials had committed no frauds. This result was supported by a US survey by Arthur Andersen for the Cohen Commission Report, in 1974, which revealed that 66 per cent of the investing public considered that detection of fraud was the most important function of an external audit (Gwilliam, 1987, p. 6). A study by Ernst and Whinney in Britain in 1985 similarly indicated that a significant proportion of investors consider either that the auditor has an obligation to detect all fraud or that the auditor's obligations should be extended to this level (Gwilliam, 1987, p. 6). Surveys by Porter (1993) in New Zealand and Monroe and Woodliff (1994b) and Gay et al. (1997) in Australia of auditors, auditees, the financial community and the general public present findings similar to these earlier surveys.

In his now famous 'Numbers Game' speech in 1998, Arthur Levitt, then Chairman of the Securities and Exchange Commission (SEC) in the United States, charged that many companies were involved in inappropriate earnings management and fraud. He also accused auditors of directly or indirectly assisting management by not challenging management's actions. Mr Levitt cited cases where a company's stock price dropped dramatically because the company missed the financial analysts' earnings forecasts by a penny or two a share, or failed to meet revenue forecasts. His speech led the SEC to instigate a number of important events and actions.

As a result of these concerns and the recent corporate collapses, the profession has been more willing to take on an increased responsibility for identifying fraud. Recently released auditing standards indicate that the auditor accepts a greater responsibility for actively searching for material frauds. Because of the nature and sophistication of these frauds, the auditors still disclaim their responsibility, or the expectation, of finding all material frauds. A more detailed discussion of the auditor's responsibility for fraud detection is contained in Chapter 4.

Ability to communicate different levels of assurance

As outlined earlier, the assurance framework (AUS 108/'International Framework for Assurance Engagements') allows either a reasonable level of assurance to be issued (audit) or a limited level of assurance to be issued (review). An important question as we move to an environment where reports will attempt to ascribe different levels of assurance is whether the user receives the level of assurance that is intended by the assurance provider. Using subjects from different backgrounds, Gay et al. (1998) provided some insight into whether users of review and audit reports understand the messages conveyed, and whether they are able to distinguish between the two levels of assurance. They found that users of financial information had different perceptions of the degree of reliability of financial information and the levels of assurance provided by review and audit reports. Results indicated that users found financial information to be less reliable compared to auditors. While all groups recognised that an audit report with a positive assurance opinion provided greater assurance than a review report with a statement of negative assurance, auditors had significantly stronger beliefs as to the extent of assurance being provided than did user and preparer groups. The findings suggested that such reports, once observed for financial report audits, were used in the form of a 'clean bill-of-health' stamp rather than giving information to the reader about the work performed.

Roebuck et al. (2000) researched whether users responded to changes in some of the factors that determine the level of assurance by manipulating, first, the subject matter of the work undertaken (historical (internal control) versus prospective (prospective information)) and, second, the level of work undertaken (higher work level versus moderate work level). In examining the level of assurance conveyed by the assurance report, it was found that shareholders did perceive a higher level of work for historical compared with prospective information. However, they did not change their level of assurance on the report as a result of the description of the work performed by the assurance provider (for which standard wording suggested for assurance reports and already used for audit and review reports was used). This demonstrates that at this time the auditing and assurance profession has problems communicating the level of work performed and that other means of reporting the level of work should be considered in order to communicate this dimension of the assurance process accurately to report users. Whether or not recent changes in reporting requirements contained in the assurance framework have adequately addressed this issue is a research question that is as yet unanswered.

Quick review

1. Auditors have entities as clients but owners or other members of the public use their reports.
2. Auditors and financial report users have different perceptions of the role and responsibilities of auditors.
3. The expectation gap is the gap between society's expectations of auditors and auditors' performance, as perceived by society.
4. The expectation gap consists of a reasonableness gap and a performance gap.
5. The performance gap may be due to deficient standards or deficient performance.
6. Four major expectation gap issues are the nature and meaning of audit report messages, auditors giving early warning of corporate failure, the auditor's duty to detect and report fraud, and the communication of different levels of assurance.

learning objective 10

THE ROLE OF AUDITING STANDARDS

Throughout this book reference will be made to the **auditing standards** (ASAs/ISAs) issued by auditing and assurance standard-setting bodies in Australia and internationally. The Auditing and Assurance Standards Board (AUASB), which is discussed in Chapter 2, currently develops the auditing and assurance standards in Australia. These standards prescribe the basic principles and essential procedures that govern the professional conduct of an auditor. It is important to understand the role that the standards have in the conduct of the audit function and the regulation of the auditing profession.

It is the essence of a profession that it should have standards that govern the way in which an assurance service is provided, and outline what the assurance service provider is required to do. Codified standards make it clear to third parties that the profession does have standards that its members should achieve and against which performance can be measured. Standards also assist an individual auditor by providing a benchmark against which to assess individual performance. In this regard the auditing standard-setting bodies seek to improve the quality of auditing practice, and by updating their standards these bodies can inform individual auditors about changes in the audit function. Codified standards 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.

The auditing standards are applicable to all audits and have legislative backing as a result of the recent CLERP 9 changes to auditing requirements contained in the *Corporations Act 2001*. Failure to observe these standards may expose a member to investigation and disciplinary action from the Australian Securities and Investments Commission (ASIC), as discussed in Chapter 2. There is also a series of **Auditing Guidance Statements** (AGSs) which are approved and issued by the board but do not establish new principles and do not amend existing standards. The AGS series provides guidance on procedural matters or on entity- or industry-specific issues, or clarifies and explains principles in an ASA. The AGS statements are not mandatory professional requirements but have the status of authoritative guidance. From 1998, the AUASB also started issuing **Audit and Assurance Alerts**, to bring to the attention of members of the profession matters considered to be of significant and immediate concern.

Authority of auditing standards

As indicated above, the ASAs contain the basic principles and essential procedures to be complied with by auditors in the conduct of an audit, together with related guidance. For audits undertaken under the *Corporations Act 2001*, the auditing standards have legal authority by virtue of the amendments contained in CLERP 9. 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 410 'Conformity with Auditing and Assurance Standards', issued by the Australian Professional and Ethical Standards Board (APESB). APES 410 states that the basic principles and essential procedures in an ASA are mandatory and are to be complied with in the planning, conduct and reporting of an audit engagement. APES 410 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.

As part of the process of obtaining legal backing, on 1 May 2006 the AUASB released thirty-five revised auditing standards, together with the Foreword to AUASB Pronouncements and the AUASB Glossary. The new auditing standards are in conformity with International Standards on Auditing and apply to audits of financial reports that are conducted for reporting periods commencing on or after 1 July 2006. The numbering of the revised Australian Auditing Standards (ASA standards) has been brought into line with that used for International Standards on Auditing (ISAs). The contents and status of these standards are as follows:

- Within each ASA, an auditor's obligations are stated as mandatory requirements and are identified in bold type. The mandatory requirements consist of basic principles and essential procedures. The term 'shall' (for example, 'the auditor shall . . .') is used to indicate such a requirement.
- ASAs are also interspersed with explanatory guidance, which consists of suggested (or typical) audit procedures, practical examples and other explanatory details and procedures that are included for the purposes of understanding and fulfilling mandatory requirements. Explanatory guidance does not include all possible audit procedures that may be used in the application of mandatory requirements. The auditor may consider it necessary to perform procedures alternative to those contained within the explanatory guidance. This explanatory guidance does not create or extend mandatory requirements or the auditor's obligations under ASAs.
- The ASAs include an Authority Statement, the purposes of which are to link the issuance of each individual ASA to the mandating legislation, identify the paragraphs that comprise the ASA, set out the requirement to read the ASA in conjunction with the preamble and identify the mandatory requirements of the ASA.
- In what are expected to be rare and exceptional circumstances, where the auditor is unable to comply with an essential procedure contained in a relevant mandatory requirement, the auditor is required, if possible, to perform appropriate alternative audit procedures, and to document in the working papers:
  (i) the circumstances surrounding their inability to comply;
  (ii) the reasons for their inability to comply; and
  (iii) justification of how alternative audit procedures achieve the objective(s) of the mandatory requirement.

When the auditor is unable to perform appropriate alternative audit procedures, they are required to consider the implications for the auditor's report (ASA 100/'Preface to the International Standards on Quality Control, Auditing, Review, Other Assurance and Related Services' contains similar guidance at the international level).

Quick review

1. The Auditing and Assurance Standards Board of Australia currently develops auditing standards in Australia, based on international auditing standards.
2. These standards prescribe the basic principles and essential procedures that govern the professional conduct of the auditor.
3. Auditing standards are mandatory for audits conducted under the *Corporations Act* and have legal backing.
4. The basic principles and essential procedures are identified in the audit standards by 'black lettering', and it is these black letter requirements which are mandatory.
5. There should be no departures from basic principles, and essential procedures should be undertaken in all except the rare circumstances where it is determined that the audit objective can be achieved more effectively with alternative procedures.

learning objective 11

AUDITS UNDER THE CORPORATIONS ACT 2001

Within the context of the general auditing process previously established, this section will outline the financial report audit function under Australian corporations legislation. As a prelude to these provisions, it is important to understand the rationale of corporations legislation in relation to the preparation and audit of financial reports. The underlying logic of the financial reports and audit divisions of the *Corporations Act 2001* can be found in the separation of ownership and control inherent in the corporate form of business entity. Within these sections of the legislation, management (directors) is required to present to the owners (shareholders) financial information concerning the activities of the company during the relevant financial period, accompanied by an audit report. The provisions of the *Corporations Act 2001* vest with the owners the powers dealing with the appointment and removal of auditors.

As a result, Part 2M.3 of the *Corporations Act 2001* establishes an accountability process whereby management is responsible for the preparation and presentation of appropriate financial reports, with those financial reports to be accompanied by a report of an independent auditor appointed by the shareholders. Section 307A of the *Corporations Act* gives legal backing to the auditing standards as it requires auditors to conduct audits and reviews of financial reports prepared under Part 2M.3 of the Act in accordance with auditing standards. The provisions of the *Corporations Act 2001* dealing with the appointment and removal of an auditor are found in Part 2M.4, ss 324–31, and are discussed in Chapter 3.

The responsibilities of directors

When discussing the audit provisions of companies legislation, it is important to note the responsibilities given to the directors of a company for the preparation and presentation of the financial report. Sections 292–306 require the directors to prepare annually a financial report (which includes an income statement, balance sheet, statement of changes in equity, cash flow statement, directors' declaration and other related notes and reports) and any other information or explanation as is necessary to give a true and fair view and, unless exempted under s. 301(2), to ensure that the financial report is audited. Section 296(1) also requires the directors to ensure that the financial report is prepared in accordance with the accounting standards. The accounting standards referred to are those that have been approved by the Australian Accounting Standards Board (AASB). The principal objective of the AASB is to improve the quality of financial reporting by reporting entities under the *Corporations Act 2001*. In meeting this objective, it develops and promulgates accounting standards and statements of accounting concepts. The accounting standards issued by the AASB are legally enforceable under the Law. However, under ss 295(3)(c) and 297 if a company's financial report, when prepared in accordance with accounting standards, would not otherwise give a true and fair view, the directors are required to add such information and explanations as will give a true and fair view.

Section 295A requires the chief executive officer and chief financial officer to attach to the company's financial report a declaration that indicates whether or not, in their opinion, the financial report and notes to the financial report give a true and fair view. Section 295(4)(c) also requires the directors to state whether there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due and payable. These representations by the directors are subject to audit. In addition to the preparation of the annual financial report, a company that is a disclosing entity must lodge a half-year financial report with the Australian Securities and Investments Commission (ASIC), accompanied by an audit or review report.

The auditor's responsibilities

The powers and duties of auditors to report on the annual financial report prepared by the directors are found under s. 308 of the Act. The auditor's basic obligation is to report to the members of the company on the financial report presented by the directors at the annual general meeting, and on the accounting and other records relating to that financial report. The specific responsibility of the auditor is to report an opinion as to whether the financial report is in accordance with the law, including compliance with accounting standards (s. 296), and provides a true and fair view (s. 297). These reporting responsibilities are discussed in more detail in Chapter 13.

Quick review

1. The *Corporations Act 2001* establishes an accountability process whereby directors are responsible for the preparation and presentation of appropriate financial reports, with an independent auditor appointed by the shareholders reporting on these financial reports.
2. The *Corporations Act 2001* requirements deal with the appointment and removal of auditors and their reporting responsibilities.

OTHER APPLICATIONS OF THE ASSURANCE FUNCTION

12 learning objective

The evidence-gathering methods of auditing can be applied for diverse purposes and are not confined to an expression of opinion on financial reports. An audit may also result in one or both of the following:

1. recommendations to improve the efficiency and effectiveness of operations; and/or
2. a positive influence on the behaviour of people whose activities are audited.

Audit recommendations normally cite some deficiencies in the activities audited and suggest possible improvements in performance. Recommendations may contain both an explanation of the causes of problems and the solution to those problems, or they may merely identify problems and suggest investigation. For example, auditors typically make recommendations to their clients on internal control and insurance coverage. Recommendations on internal control normally suggest improvements in procedures to correct weaknesses, but recommendations on insurance coverage are normally confined to identifying inadequate coverage.

Auditing textbooks normally list the effect on employees audited as one of the many benefits of auditing. Only recently, however, has research been conducted to support what auditors assumed to be true from their own experience. In laboratory simulations of the audit process it was found that people whose activities were audited conformed to established procedures more readily when told that their work would be audited than did another group who had not been previously audited. This performance prevailed even though more efficient alternatives were available. Thus, an audit has a beneficial effect on control activities.

The evidence-gathering methods of auditing are employed in activities other than auditing financial reports, for example in compliance audits and performance audits. These activities can be undertaken as separate engagements or as part of a comprehensive audit, and by external auditors, government auditors or as part of an internal audit function.

Compliance audits

Compliance audits are an examination of financial information for the purpose of reporting on the legality and control of operations and the probity of those responsible for the administration of funds provided by external parties, including the expression of an opinion on an entity's compliance with statute, regulations or other directives that govern the activities of the entity. In Australia, compliance auditing is particularly relevant in government.

In our society the largest organisation of all is the federal government. Government is truly a big business. The conventions of the Constitution and parliamentary practice in Australia, supported by statute, require accountability by government departments for receipts and expenditure. These departments, as well as statutory authorities, are also responsible for the administration of complex regulations and are themselves subject to regulations.

The responsibility for the audit of federal government operations rests with the Australian Auditor-General and state government operations with an appointed State Auditor-General. Essentially, the Auditor-General is required to report to Parliament on compliance by the government departments with the appropriate financial and legal regulations. The role of the Auditor-General also involves functioning in effect as the internal auditing department of the government.

The compliance auditing function also extends to the auditing of sections of some government departments that are concerned with the compliance of private sector entities and individuals with government regulations. For example, Australian Taxation Office inspectors are in essence auditors concerned with compliance of the community at large with government policy.

Performance audits

Performance auditing is often referred to as 'management auditing', 'value for money', 'operational auditing', 'efficiency auditing' and 'program results auditing'. It is more often associated with auditing in the public sector, although it is, in various forms, becoming more popular in other areas and is an integral part of many internal audit functions.

Performance auditing is a more comprehensive activity designed to analyse organisation structure, internal systems, work flow and managerial performance. It is usually associated with issues of efficiency, effectiveness and economy. In short, performance auditing is intended to provide a measure of an organisation's achievement of its goals and objectives.

The products of performance audit can range from reports recommending improvements in efficiency and effectiveness of current operations to general suggestions about the organisation's use of resources to provide the greatest long-range benefit to the entity. Performance audit reports may contain recommendations for restructuring of departments or divisions, recommendations for training and replacement of personnel, or results of cost–value analyses of internal controls of an entity. The performance audit has a broad scope and may encompass all major functions of an entity. This type of audit is dealt with further in Chapter 16.

Comprehensive audits

The discussion of the audit function to date has covered the following audit types that may be undertaken as discrete tasks or on an interactive basis:

- financial report audit
- compliance audit
- performance audit.

Collectively, these audits can be integrated and described as a **comprehensive audit**. This term is used to describe a broad-scope audit mandate comprising a combination of elements of the above three types of audits. In Australia, this approach is currently more prevalent in public sector auditing, where auditors undertake an examination for the purpose of expressing an opinion on financial reports, reporting on the legality and control of operations (including an opinion on an entity's compliance with statute, regulations and directives), and reporting on the economy, efficiency and effectiveness with which the entity has achieved its objectives.

Internal audits

Internal audit is not a separate type of audit, as are financial report, compliance, performance or comprehensive audits, but it is, in effect, an audit undertaken by a body of audit professionals who are internal to or employees of the audited entity. Over the last 50 years internal auditing has evolved from a simple clerical function into a highly professional activity. The Institute of Internal Auditors, formed in the US in 1941, is today an international association concerned with the development of the internal auditing profession. Like the external auditing profession, the Institute of Internal Auditors has instituted a code of ethics and standards for the professional practice of internal auditing. An Australian Institute of Internal Auditors was formed in 1986 with an affiliation to the international body.

The role of an internal auditor within an entity varies. Internal audits are performed by employees of organisations functioning in a staff capacity and reporting to a high-level officer in the organisation. The scope of internal auditing is evolving. Seen traditionally as an appraisal activity within an organisation for the review of accounting, financial and other operations as a basis for service to management, many internal auditors have today found that they can be of increased value to an organisation by participating in the business risk analysis of the organisation. The role of the internal auditor is discussed further in Chapter 15.

Forensic audits

Forensic auditors are employed by companies, government agencies, accounting firms, and consulting and investigative services firms. They are trained in detecting, investigating and deterring fraud and white-collar crime. Some examples of situations where 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 money-laundering activities by reconstructing cash transactions.
- Investigating and documenting embezzlement, and negotiating insurance settlements.

Quick review

1. Benefits from the audit process include recommendations to improve the efficiency and effectiveness of operations, and provision of an incentive for people to perform prescribed internal control activities more carefully.
2. The evidence-gathering methods of auditing are employed in activities other than auditing financial reports, including:
   - *compliance auditing*—the examination of financial information for the purpose of reporting on the legality and control of operations;
   - *performance auditing*—the analysis of organisation structure, internal systems, work flow and management performance;
   - *comprehensive auditing*—which includes the aspects of financial report, compliance and performance auditing;
   - *internal auditing*—an appraisal activity within an organisation for the review of financial and business risks and other operations as a basis for service to management; and
   - *forensic auditing*—an investigative/assurance activity aimed at detecting, investigating and deterring fraud.

Summary

This chapter has attempted to give the reader a feel for the recent crisis of confidence in the financial systems and the ways in which the auditing profession and standard-setters have responded to this crisis over the period 2003 to 2005. It has also tried to place the audit in a broader assurance framework. While this text deals with the concept of audit generally, with emphasis on the financial audit process in the private sector, much of the material in relation to audit principles, concepts and methods is applicable to the other types of assurance services and entities. For example, guidance on auditing in the public sector would reflect differences in matters of emphasis and practice rather than in basic principles and concepts. This reflects the view that users of audit reports are entitled to a uniform quality of assurance when audit objectives are the same. The same standards should apply regardless of the nature of the entity being audited, with users of the audit report not being well served by the application of alternative standards to the same type of audit.

Key terms

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Assignments

MaxMARK

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REVIEW QUESTIONS

1.1 The following questions deal with the relationship between audit and assurance.

(a) The relationship between audit and assurances services is best described by which of the following:

- **A** the relationship will depend on the terms of the contract
- **B** the audit function is a subset of assurance services
- **C** assurance services are a subset of the audit function
- **D** the audit function and assurance services are the same

(b) The highest level of assurance is provided by:

- **A** compiling financial reports
- **B** agreed-upon procedures
- **C** review
- **D** audit

(c) Which of the following would be suitable criteria for an assurance engagement?

- **A** An indicative list of corporate governance practices prescribed by ASIC for providing assurance on corporate governance practices.
- **B** An organisation's internal documents prescribing what constitutes satisfactory internal control, for providing assurance on internal controls.
- **C** Both of A and B above.
- **D** Neither of A and B above.

1.2 The following questions deal with the nature of the audit function. Select the *best* response.

(a) Users of financial reports demand independent audits because:

- **A** management relies on the auditor to improve the internal control
- **B** users expect auditors to correct management errors
- **C** management may not be objective in reporting
- **D** users demand assurance that fraud does not exist

(b) Which of the following best describes why an independent auditor is asked to express an opinion on a financial report?

- **A** To relieve management of the responsibility for the financial report.
- **B** To provide increased assurance to users as to the fairness of the financial report.
- **C** To guarantee that there are no misstatements in the financial report.
- **D** To satisfy legislative requirements.

(c) The independent auditor adds credibility to the client's financial report by:

- **A** testifying under oath about client financial information
- **B** attaching an auditor's opinion to the client's financial report
- **C** maintaining a clear-cut distinction between management's representations and the auditor's representations

D stating in the auditor's communication of internal-control-related matters that the audit was made in accordance with Australian auditing standards

(d) Financial report auditing can best be described as:

A a regulatory function that prevents the issuance of improper financial information

B a professional activity that measures and communicates financial and business data

C a discipline that attests to the results of accounting and other functional operations and data

D a branch of accounting

1.3 **(a)** What is the general character of the work conducted in performing a forensic audit?

A Identifying the causes of an entity's financial difficulties.

B Offering an opinion on the reliability of the specific assertions made by management.

C Detecting or deterring fraudulent activity related to the financial report.

D Providing assurance that the financial report is not materially misstated.

(b) Independent auditors are referred to as 'independent' because:

A their offices are not at the entity's place of business

B they are not employees of the entity being audited

C they are paid by parties outside of the audited entity

D they report to users outside of the audited entity

(c) The definition of auditing refers to auditing as a 'systematic process of objectively obtaining and evaluating evidence regarding assertions …' What is meant by 'systematic process'?

A All assertions are equally important for all audits.

B There should be a well-planned approach for conducting the audit.

C All audits involve evaluating evidence in the same manner.

D All audits involve obtaining the same evidence.

(d) Which of the following *best* describes why an independent auditor is asked to express an opinion on the fair presentation of financial statements?

A It is a customary courtesy that all shareholders of a company receive an independent report on management's stewardship in managing the affairs of the business.

B The opinion of an independent party is needed because a company may *not* be objective with respect to its own financial report.

C It is management's responsibility to seek available independent aid in the appraisal of the financial information shown in its financial report.

D It is difficult to prepare financial statements that fairly present a company's financial position and changes in cash flows without the expertise of an independent auditor.

The assurance framework

1 learning objective

1.4 Discuss the five elements of an assurance report for the audit of a financial report.

1.5 **Basic** The AUASB (IAASB) has recently issued two new overarching standards. These are AUS 108 ('International Framework for Assurance Engagements') and AUS 110 (ISAE 3000).

Required

To what extent do these standards apply to:

(a) a financial report audit; and

(b) an assurance engagement on environmental and sustainability information.

1.6 **Basic** The following are essential elements of an assurance engagement and are discussed in this chapter:

(a) a three-party relationship;

(b) an appropriate subject matter; and

(c) suitable criteria.

Required

Outline how these elements relate to a financial report audit.

learning objective 2

Structure of assurance standards and pronouncements

1.7 Explain what is meant by 'assurance' and distinguish between the various levels of assurance provided by an auditor, as described by AUS 106.

learning objective 3

Define auditing and other levels of assurance

1.8 What is the objective of an independent audit?

1.9 Why do assurance providers report their findings as an expression of opinion rather than as a statement of fact?

learning objective 4

Fundamental principles underlying an audit

1.10 Identify the fundamental principles of auditing and trace these through to the relevant auditing standards. Are all the fundamental principles supported by auditing standards?

learning objective 6

Demand for assurance

1.11 Why are independent audits necessary?

1.12 To what types of activities other than audits of financial reports are the evidence-gathering methods applied?

1.13 Discuss why there is a demand for assurance. What evidence suggests that assurance would be demanded even if it was not required by government regulation?

learning objective 7

History of the audit function

1.14 What has been the major change in audit emphasis and methodology since the nineteenth century?

learning objective 8

Relationship between auditor, client and public

1.15 Does society as a whole benefit from the services of independent auditors, or are the benefits restricted to individual third parties?

learning objective 9

Expectation gap

1.16 What is meant by the term 'expectation gap'? Provide some examples of the expectation gap.

1.17 What action has the auditing profession taken to reduce the expectation gap?

learning objective 10

Role of auditing standards

1.18 Are auditing standards mandatory? Explain.

learning objective 12

Performance, comprehensive, internal and forensic auditing

1.19 Give one example each of compliance, operational and forensic audits.

1.20 The following are major issues confronting the profession: expanding assurance and other services, introduction of new audit methodologies and globalisation. Are these issues all related to the concept of independence? Justify your answer.

DISCUSSION PROBLEMS AND CASE STUDIES

primary learning objective 1

Understand the assurance framework

1.21 **Moderate** For the last two years Maree Williams has been working as a trainee accountant with a local practice that specialises in auditing. During that time she has been involved in financial report audits, compliance audits and performance audits and feels she has a good understanding of auditing. As part of her traineeship, she is required to undertake a university degree and has just commenced her study of auditing and assurance services. During the first lecture the lecturer asks the class to indicate three types of engagements an assurance provider could undertake. Maree answers: 'financial report, compliance and performance audits'. The lecturer replies that these are not types of engagements but different applications of the audit function. Further, each application she has identified can be undertaken in conjunction with any of the three types of engagements. Maree is very confused and has asked you for an explanation.

Required

(a) Identify and describe the three types of engagements an auditor can undertake by reference to the assurance framework.

(b) Discuss the relationship between the applications identified by Maree and the engagements identified in AUS 106.

3 primary learning objective

Define auditing and other levels of assurance

1.22 Moderate 'The evidence-gathering methods of auditing can be applied for diverse purposes and are not confined to an expression of opinion on financial reports.'

Required

Provide an example of one (1) application of the audit function other than the audit of general purpose financial reports.

For the application identified indicate:

(a) whether this service meets the AAA definition of auditing provided in your text;

(b) the level of assurance usually provided by the auditor when performing this service;

(c) whether the engagement involves direct reporting or an attest engagement; and

(d) the type of auditor that usually provides this service.

1.23 Complex A1 Computers Ltd ('A1') is a major client of your firm. A1 has recently acquired B2 Modems Pty Ltd ('B2'). The price for the acquisition has been agreed at $5 million, providing A1 is satisfied with the financial records of B2. To allow A1 to assess these records, B2 have agreed to allow the auditors of A1 access to their books and records.

B2 is a small proprietary company and as such has not prepared statutory financial reports or undergone an audit since incorporation in 20X2 (three years ago).

A1 have approached your firm and asked that you assist. Specifically they have requested:

(a) a review of all transactions occurring from the date negotiations commenced until the settlement date to ensure all transactions were in the normal course of operations;

(b) a review of the management accounts for the years 20X3 and 20X4; and

(c) a review of the financial report prepared at the acquisition date.

In order to clarify your responsibilities, you have asked A1 to indicate the level of assurance they require for each item. The CEO has indicated that the most recent financial report is very important as is the review of transactions but he is willing to have less work done on the previous year's management accounts.

Required

Using AUS 106, identify the type of engagement that will most likely be undertaken for each of the tasks. Provide reasons for your decisions.

6 primary learning objective

Demand for assurance

1.24 Basic Auditors have been engaged to assure the propriety of the balloting to determine outstanding motion picture and television programs, actors, directors and technicians. Explain why auditors have been chosen for these tasks.

1.25 Moderate List as many reasons as you can for each of the following types of entities to have an annual audit.

(a) church

(b) municipal government

(c) trade union

(d) national hobby organisation

(e) professional accounting organisation

What benefits would such entities receive from an independent audit?

primary learning objective 7

History of audit function

1.26 **Moderate** Your text identifies three of the early approaches to auditing, namely the balance sheet, transactions cycle and financial risk analysis approach.

Required

(a) Provide a brief description of each approach.

(b) Define the term 'transactions cycle' and provide two examples of common transactions cycles, together with the account balances arising from the identified cycles.

(c) If an auditor adopts a risk-based approach to auditing, does this mean they do not consider the balance sheet or transactions cycles?

1.27 **Moderate**

> *The audit product has not changed fundamentally. Yeah, there are some bells and whistles but it has not changed fundamentally in a Century.*
>
> (Elliott, R. (1998) 'Audit Symposium Panel Discussion on Assurance Services', *Auditing: A Journal of Practice and Theory*, Vol. 17 Supplement, 1–9)

Required

Discuss the extent to which you agree or disagree with this statement. Your answer should consider the four main approaches to auditing employed during the twentieth century.

primary learning objective 8

Relationship between auditor, client and public

1.28 **Complex** Shelly Ling has recently been employed by a small accounting practice and is working on her first audit. During Shelly's testing she has found a number of large errors that she has brought to the attention of the audit manager. Shelly believes some of the errors are so large that a qualified audit opinion will be necessary. Towards the end of the audit Shelly is told that the audit manager has scheduled a meeting with the client in order to discuss audit adjustments and the type of audit opinion that is likely to be given.

After the meeting Shelly is told an unqualified audit opinion will be issued. Shelly is quite shocked as she thought that the auditor reported the results of the audit directly to shareholders. Instead she has found that results are discussed with management before communication to external users.

Required

Assume Shelly has come to you, the senior auditor, and expressed her dismay at the audit process.

(a) Explain to Shelly why the auditor would normally meet with the client prior to releasing the audit report.

(b) Identify and describe the mechanisms in place to ensure auditors fulfil their duties to shareholders.

primary learning objective 9

Expectation gap

1.29 **Basic** Discuss the following observation recently made by a businessman: 'Published financial reports should be designed to enable the efficiency and skill of management to be evaluated'.

1.30 **Basic** One of the common expectations of users of financial reports is that the audit report provides absolute assurance that there are no material misstatements in the financial report. Do you believe this is a reasonable expectation? Provide reasons for your decision.

1.31 **Moderate** The following statement is representative of attitudes and opinions sometimes encountered by auditors in their professional practices:

> *An audit is essentially negative and contributes to neither the gross national product nor the general wellbeing of society. Auditors do not create; they merely check what someone else has done.*

Evaluate this statement and indicate:

(a) areas of agreement with the statement, if any;

(b) areas of misconception, incompleteness or fallacious reasoning included in the statement, if any.

Describe the authority weighting of the black and grey lettering in the auditing standards. Discuss the potential concerns with these levels of authority and the proposals for dealing with these concerns.

Role of auditing standards

10 primary learning objective

1.32 Basic Describe the contents of the Australian Auditing Standards (ASAs). Must the auditor perform all essential (bold-type) procedures called for by a relevant requirement in an applicable ASA? Support your answer.

Performance, comprehensive, internal and forensic auditing

12 primary learning objective

1.33 Moderate The managing director of your company (a multidivision company) has been discussing the company's internal operations with several colleagues in the business community. He has discovered that most of them have an internal audit staff. The activities of the staff at other companies include financial audits, compliance audits and sometimes performance audits.

Required

Describe for him the meaning of the terms (a) financial auditing, (b) compliance auditing and (c) performance auditing as they would relate to the internal audit function.

1.34 Moderate G. Johnson, a local real estate agent, is a member of the Board of Directors of Kelly Ltd. At a recent board meeting, called to discuss the financial plan for 2000, Mr Johnson discovered two planned expenditures for auditing. In the management department's budget he found an internal audit activity and in the accountant's budget he found an estimate for the 2000 annual audit by an external audit firm.

Mr Johnson could not understand the need for two different expenditures for auditing. Since the external audit fee for the annual audit was less than the cost of the internal audit activity, he proposed eliminating the internal audit function.

Required

Explain to Mr Johnson the different purposes served by the two audit activities.