Lecture 1 – The demand for Audit, the audit report

Part 1: Chapter 1 – The demand for Audit

Learning Objectives

1. Describe assurance services, and distinguish audit services from other assurance and non-assurance services provided by public accountants.
2. Explain the importance of auditing in reducing information risk
3. List the causes of information risk, and explain how this risk may be reduced.
4. Describe auditing.
5. Distinguish between auditing and accounting.
6. Differentiate the three main types of audits.
7. Identify the primary types of auditors.
8. Describe the nature of public accounting firms, what they do, and their structure.
9. Describe the key functions performed by the professional accounting bodies.
10. Use auditing standards as a basis for further study.
11. Identify quality control standards and practices within the accounting profession.
12. Summarise the role of the Corporations Act 2001 in accounting and auditing

LO1: Describe assurance services, and distinguish audit services from other assurance and non-assurance services provided by public accountants.

Assurance services
Independent professional services that improve the quality of information for decision makers

Attestation service
Type of assurance service in which the public accounting firm issues a written communication (audit report) that expresses a conclusion about the reliability of a written assertion/statement of another party

Audit of historical financial statements
A form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are in material conformity with accounting standards
Audit = reasonable

Review of historical financial statements
A form of attestation in a written report, issued by a public accounting firm, that provides less assurance than an audit as to whether the financial statements are in material conformity with accounting standards.
Review engagement = limited

Assurance Services
- Independent professional services that improve the quality of information for decision makers
  - Assurance provider is independent,
  - perceived as being unbiased with respect to the information being examined (objective assessment)
  - Make the best decisions for themselves (could be shareholders etc)
- Provides satisfaction as to reliability and relevance of provided information
- Can be performed by public accountants or a variety of other professionals
- Various levels (reasonable, limited) depending on nature and extent of procedures and evidence
- Growth continues given the demand for real-time and forward-looking information.
  - Assurance is mainly provided on historic information, for example financial statements
  - Although some growth in industry toward audit of forward projections

**Attestation Services**
- Type of assurance service in which the public accounting firm issues a written communication (audit report) that expresses a conclusion about the reliability of a written assertion/statement of another party
  - Audit of historical financial statements:
    - Auditor issues a written report with an opinion about whether the financial statements are in material conformity with accounting standards.
    - Are the statements a true representation of the economic activity of the business etc.
  - Review of historical financial statements:
    - Provides a moderate amount of assurance on the financial statements.
  - Other attestation services:
    - Must involve written assertions on an accountability matter.

**Other Assurance Services**
- Most do not meet the formal definition of attestation services.
- Assurance services on information technology:
  - WebTrust services
  - SysTrust services
- Assurance services on other types of information:
  - Business performance measurement services
  - ElderCare Plus

![Relationships among assurance services, attestation services and non-assurance services](image-url)
LO2: Explain the importance of auditing in reducing information risk

Economic Demand for Auditing
- Information risk:
  - The possibility that information on which a business risk decision was made was accurate.
  - *The risk that information collected may not be useful for decision making or for its other intended purpose(s). What assumptions exist in data collection etc.?*
- Auditing can have a significant effect on information risk.
  - *Information used for decision making – needs to be relevant and reliable.*
    - Quantities bought & sold, prices, discounts, manufacturing & marketing costs and processes.
    - *Informs shareholder decision making. Where information is inaccurate, ill-informed shareholder decisions can result in buy/sell/hold decisions that don’t reflect the true value of the firm.*
    - *Informs managerial decision making at multiple organisation levels*
    - Lending decisions → if the bank manager is satisfied there is minimal information risk because the borrower’s financial statements have been audited, the risk is substantially reduced and the overall interest rate to the borrower can be reduced. This can have a significant effect on a firm’s ability to obtain capital at a reasonable cost, etc.

LO3: List the causes of information risk, and explain how this risk may be reduced.

Causes of Information Risk
- **Remoteness** of information
  - Agency theory – Management and Shareholder relationship
  - Information asymmetry may facilitate decision making that is biased
    - Investors have little first hand info about firm
    - Likelihood of third party information being intentionally or unintentionally misstated increases
- **Biases and motives** of the provider
  - Information provided by someone who is goals are inconsistent with those of the decision maker – incorrect financial information, lack of disclosure etc.
  - Earnings management → personal gain of management / reputation of firm may be valued over shareholder earnings/
  - Within the context of information asymmetry, agency theory
- **Voluminous data**
  - Abundance of information, can be difficult to ascertain which information is most useful / relevant. What is driving cost/profit/value creation in the firm?
- **Complex exchange transactions.**
  - Borders and jurisdictions of information collection / reporting
  - Business structures – subsidiaries, joint ventures
  - Financial instruments e.g. derivatives, disclosure.

Reducing Information Risk
*How do we know that information is accurate & true for decision making?*
- **User verifies information**
  - Very difficult, and not reliable
- User shares information risk with management
  • Investors, as financers, share risk.
  • Management must communicate with investors, to ensure individuals purchase/hold shares and see value in company.
- Audited financial statements are provided
  • Reduce agency related risk by detecting any likelihood of manipulation of accounting information.

LO4: Describe auditing.
Any claim needs to be asserted against a standard or criteria to determine whether the claim is legitimate.

Nature of Auditing
- Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information (financial statements) and established criteria (AASB).

1. Information and established criteria (financial statements and AASBs):
   o Verifiable information and criteria

2. Accumulating and evaluating evidence:
   o Sufficient quality and volume
   o Designing methods to collect evidence, different methods across time

3. Auditing should be performed by a competent, independent person.
   o Qualified, competent and independent

4. Reporting:
   o Audit report - Communication of the auditor’s findings to users
   o Under the Corporations Act you must provide a written report as to the outcome of the audit.

LO5: Distinguish between auditing and accounting.

Differentiate between Auditing and Accounting
Accounting is the recording of the information, where auditing is the independent assessment of the recording process to determine whether records truly reflect the economic events that have been recorded.

<table>
<thead>
<tr>
<th>Accountants</th>
<th>Auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Record, classify and summarise economic events for the purpose of providing financial information used in decision-making.</td>
<td>Determine whether recorded information properly reflects the economic events that occurred during the accounting period.</td>
</tr>
</tbody>
</table>

LO6: Differentiate the three main types of audits.

Types of audits
1. Financial statement audit:
   o To determine whether the overall financial statements are stated in accordance with specified criteria (usually accounting standards).

2. Performance audit:
   o Evaluation of efficiency and effectiveness of organisation’s operating procedures and methods.
3. Compliance audit:
- To determine whether the client is following specific procedures, rules or regulations set by a higher authority.
- Companies might undergo a compliance audit to ensure specific requirements have been met, to minimise fines or political costs relating to non-compliance

**Examples of 3 types of audits**

<table>
<thead>
<tr>
<th>Type of audit</th>
<th>Example</th>
<th>Information</th>
<th>Established criteria</th>
<th>Available evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statement audit</td>
<td>Annual audit of Woolworths’ financial statements</td>
<td>Woolworths’ financial statements</td>
<td>Accounting standards</td>
<td>Documents, records, and outside sources of evidence</td>
</tr>
<tr>
<td>Performance audit</td>
<td>Evaluate whether the computerised payroll processing for subsidiary H is operating efficiently and effectively.</td>
<td>Number of payroll records processed in a month, costs of the department and number of errors made.</td>
<td>Company standards for efficiency and effectiveness in payroll department.</td>
<td>Error reports, payroll records and payroll processing costs</td>
</tr>
<tr>
<td>Compliance audit</td>
<td>Determine whether bank requirements for loan continuation have been met.</td>
<td>Company records</td>
<td>Loan agreement provisions</td>
<td>Financial statements and calculations by the auditor</td>
</tr>
</tbody>
</table>

**LO7: Identify the primary types of auditors.**

**Public Accountant**
- A person who has obtained registration as a company auditor in accordance with the provisions of the Corporations Act 2001.
- Responsible for auditing **historical financial statements of publicly traded companies**

**Officers serving the Auditor-General**
- An auditor serving a Federal or State Auditor-General; the Auditor-General reports to and is responsible solely to parliament.
- Responsible for performing the audit function for government

**Tax Auditors**
- Auditors who work for the Australian Tax Office (ATO).
- Conduct examinations of taxpayers’ returns to determine whether they have complied with tax law.

**Internal Auditors**
- Auditors employed by a company to audit for the company’s board of directors and management.
- Vary considerable depending of the type of firm and industry. Not all within the accounting area: compliance, performance audit.

**1. Public accounting firms:**
- Responsible for auditing **historical financial statements of publicly traded companies**
- Registered as company auditors under the *Corporations Act 2001.*
- E.g Deloitte, EY, KPMG, PWC

**2. Officers serving the Auditor-General (Government):**
- Responsible for performing the audit function for government
• Audit of financial information and evaluation of efficiency and effectiveness.

3. **Tax auditors (work specifically for the ATO):**
   • Audit tax returns to determine compliance with tax laws.

4. **Internal auditors:**
   • Responsibilities vary considerably depending on the employer.
   • Involved in compliance (minimise fines) auditing and performance auditing.

**LO8:** Describe the nature of public accounting firms, what they do, and their structure.

**Public Accounting Firms**
- Big Four international firms
- National firms
- Large local and regional firms
- Small local firms

**Activities of Public Accounting Firms**
1. Audit services (high volume, low margin)
2. Accounting and bookkeeping services (high volume, low margin)
3. Tax services (high volume, low margin)
4. Management consulting services (highmargin)

**Structure of Public Accounting Firms**
- Forms of public accounting firms:
  • Sole proprietorship
  • Partnership
  • Incorporated company
- Hierarchy in public accounting firms:
  • Partners, managers, supervisors, seniors and assistants.
  • Traditionally, public accounting forms operated in a hierarchical structure, but this is becoming less so. There are now far fewer employed at the very bottom level:
    - **Automated process** allow for digitized records which makes processes faster and require less junior staff.
    - More **outsourcing and offshore operations** means less junior level staff are required within the firm.

**LO9:** Describe the key functions performed by the professional accounting bodies.

**Professional Accounting Bodies**
- Chartered Accountants Australia and New Zealand
- CPA Australia

**Main functions**
1. **Establishing standards and rules** – professional standards and conduct
2. **Research and publications** – guidance statements, professional statements, Handbooks, bulletins, newsletters, technical updates.
3. **Continuing education** – seminars and educational aids to ensure educated professionals maintain their skills and are up to date with any changes in standards/processes/industry.
L10: Use auditing standards as a basis for further study.

**Australian Auditing Standards (ASAs)**
- The AUASB issues ASAs:
  - Auditing standards establish mandatory requirements and provide explanatory guidance to auditors in fulfilling their professional responsibilities in the audit of financial reports.
  - Uses language of law – Auditor ‘Must’ or ‘Shall’ → minimum legal requirements of audit process are set out in the ASAs.
- CLERP 9 led to amendments to the *Corporations Act 2001*:
  - Gave ASAs the ‘Force of Law’.
- ASAs represent minimum standards of performance for auditors.

**International Auditing Standards (ISAs)**
Due to the globalisation of business and capital markets, there is a strong interest and trend towards developing uniform accounting and auditing standards throughout the world. Many countries working together at present on standard setting projects to coordinate new international standards.

L11: Identify quality control standards and practices within the accounting profession.

Quality control processes should occur across firms and within firms as per ASA and corporations legislation.

**Quality control**
- Procedures used by the public accounting firms to help it consistently meet auditing standards.
- Elements of quality control:
  - Leadership responsibilities
  - Ethical requirements
  - Client acceptance and continuance
  - Human resources
  - Engagement performance
  - Monitoring

**Peer Review or Quality Reviews**
- Review of a public accounting firm’s compliance with its quality control system.
- CAANZ and CPA Australia operate Quality Review Programs:
  - Demonstrate a commitment by the professional bodies to the concept of excellence
  - Programs aim to be educational, not disciplinary
  - Ensure that practices understand their professional responsibilities.

**ASIC**
- own inspections programs
- fines for non-compliance.
- Big firms audited by ASIC yearly, smaller ones every few years per a rotation.

LO12: Summarise the role of the *Corporations Act 2001* in accounting and auditing

**The Corporations Act 2001**
- Main purpose is to help ensure corporations serve the public interest
- Accounting provisions:
Part 2: Chapter 18 – Audit Reporting

Learning Objectives

1. Describe the nature of and need for the auditor’s report.
2. Specify the conditions that justify issuing the standard unmodified audit report, and describe the report.
3. List the two conditions requiring a departure from an unmodified audit report.
4. Identify the three types of audit report that can be issued when an unmodified opinion isn’t justified.
5. Explain the circumstances in which an unmodified report with an emphasis of matter is appropriate.

LO1: Describe the nature of and need for the auditor’s report. 
ASA required the preparation of a written report, provides templates for reporting.

Categories of Audit Report

- Audit report based on an audit of financial reports prepared in accordance with Australian Accounting Standards.
- The profession recognises the need for uniformity in reporting.

LO2: Specify the conditions that justify issuing the standard unmodified audit report, and describe the report.

Standard unmodified report – the report an auditor issues when it is the auditor’s opinion that the financial report is prepared and presented fairly, in all material respects, in accordance with the applicable financial reporting framework (AASBs).

Standard Unmodified Audit Report

- ASA 700 requires auditor to gain reasonable assurance on:
  - Whether the financial report as a whole is free from material misstatement, due either to fraud or error.
  - Whether the financial report is prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework.
  - Whether the financial report achieves a fair presentation
  - Whether financial report is in accordance with the Corporations Act 2001.

Unmodified Audit Report Parts

- Uniformity in the form and content of the auditors’ report enhances the effectiveness of communication with readers of the reports (ASA700):
LO3: List the two conditions requiring a departure from an unmodified audit report.

Condition one – the financial report is materially misstated
Condition two - Inability to obtain sufficient appropriate audit evidence

LO4: Identify the three types of audit report that can be issued when an unmodified opinion isn’t justified.

Whenever any of the two conditions requiring a departure from an unmodified opinion exists, a report other than an unmodified report must be issued. Three main types of audit report are issued under these conditions:

1. An adverse opinion
2. Disclaimer of opinion
3. Qualified opinion

ASA705 – Explanatory Material

Types of modified opinions:

- The table below illustrates how the auditor’s judgement

<table>
<thead>
<tr>
<th>Nature of Matter Giving Rise to the Modification</th>
<th>Auditor’s Judgement about the Pervasiveness of the Effects or Possible Effects on the Financial Report</th>
</tr>
</thead>
<tbody>
<tr>
<td>Material but Not Pervasive</td>
<td>Material and Pervasive</td>
</tr>
<tr>
<td>The financial report is materially misstated (not truthful)</td>
<td>Qualified opinion</td>
</tr>
<tr>
<td>Inability to obtain sufficient appropriate audit evidence (not enough evidence)</td>
<td>Qualified opinion</td>
</tr>
</tbody>
</table>

Opinion given depends on the severity of the issue

If the issue is material but not pervasive → self contained, only a small section of the FS
If material and pervasive → there is an issue that will affect
LO5: Explain the circumstances in which an unmodified report with an emphasis of matter is appropriate.

Unmodified Audit Report with an Emphasis of Matter (ASA706)
- An unmodified audit report with an emphasis of matter is **appropriate for an audit with satisfactory results and a financial report that is fairly presented** but where the auditor is required to **provide additional information**.
  - Additional disclosures
  - Significant uncertainties and going concern
  - Inconsistent other information
  - Revised financial report

ASA 701 – Communicating Key Audit Matters in the Independent Auditor’s Report
- NEW standard, developed at International level
- For periods ending on or after 31 Dec 2016-07-28
- Why?
  - Increased transparency over auditor decision making (& increased accountability) → must now disclose process of decision making, where there was significant judgement or particular difficulty, e.g. handling interpretations of flexible ASAs and how and why they interpreted it as they did.
- Australian early adopters of new reporting (required after 31 Dec 16)
  - QBE Insurance, Cochlear, ASX Ltd

ASA 701 - requirements

**Determining Key Audit Matters**

9. The auditor shall determine, from the matters communicated with those charged with governance, those matters that required significant auditor attention in performing the audit. In making this determination, the auditor shall take into account the following:
   (Ref: Para. A9–A18)
   (a) Areas of higher assessed risk of material misstatement, or significant risks identified in accordance with ASA 315.  
   (Ref: Para. A19–A22)
   (b) Significant auditor judgements relating to areas in the financial report that involved significant management judgement, including accounting estimates that have been identified as having high estimation uncertainty. (Ref: Para. A23–A24)
   (c) The effect on the audit of significant events or transactions that occurred during the period. (Ref: Para. A25–A26)

10. The auditor shall determine which of the matters determined in accordance with paragraph 9 of this Auditing Standard were of most significance in the audit of the financial report of the current period and therefore are the key audit matters. (Ref: Para. A9–A11, A27–A30)