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Auditing, Assurance Services & Ethics in Australia

An Integrated Approach

Arens / Best / Shailer / Fiedler / Elder / Beasley

Pearson Australia

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Objectives

The tenth edition of *Auditing, Assurance Services and Ethics in Australia: An Integrated Approach* is based on the fifteenth US edition of *Auditing and Assurance Services: An Integrated Approach*. It contains numerous changes and revisions, but the principal objectives and emphasis remain unchanged from the previous edition. It represents a conscious effort to focus on the Australian auditing environment in terms of the current practices and standards issued by the Auditing and Assurance Standards Board (AUASB).

The book is an introduction to auditing for students who have not had significant experience in the field and is intended for either a full-year or one-semester course at the undergraduate or graduate level. The book is also appropriate for introductory professional development courses for public accounting firms, internal auditors and government auditors.

The primary emphasis in this textbook is on the auditor's decision-making process. We believe that the most fundamental concepts in auditing relate to determining the nature and amount of evidence the auditor should accumulate after considering the unique circumstances of each engagement. If students of auditing understand the objectives to be accomplished in a given audit area, the circumstances of the engagement and the decisions to be made, they should be able to determine the appropriate evidence to gather and how to evaluate the evidence obtained.

Thus, as the title of the book reflects, our purpose is to integrate the most important concepts of auditing with certain practical aspects in a logical manner to assist students in understanding audit decision making and evidence accumulation. For example, internal control is integrated into each of the chapters dealing with a particular functional area and is related to tests of transactions. Tests of transactions are, in turn, related to the tests of details of financial statement balances of the accounts for the area; and audit sampling is applied to the accumulation of audit evidence rather than treated as a separate topic. Technology, e-commerce and fraud issues are also integrated throughout the chapters.

Features of the tenth edition

Auditing regulations

The tenth edition incorporates recently issued auditing standards (ASAs, ASREs and ASAEs), Accounting Professional and Ethical Statements (APESs), the Framework for Assurance Engagements, the Explanatory Guide to AUASB Standards Applicable to Review Engagements, and guidance statements (AGSs and GSs). It includes up-to-date referencing of relevant legislation (including the *Corporations Act 2001*) and common law.

Chapter 9 on fraud auditing and expanded fraud coverage

This chapter on fraud auditing examines the auditor's responsibility for assessing the risk of fraud and detecting material misstatements due to fraud. The chapter includes coverage of corporate governance and other factors that reduce fraud risk. Specific fraud risk areas and procedures to detect fraud are also discussed. Additional references to fraud risks have been integrated into other chapters. The results from the KPMG *A Survey of Fraud, Bribery and Corruption in Australia & New Zealand 2012* are incorporated within the chapter.

Increased emphasis on audit quality

There is an emphasis on audit quality, in the context of the role of auditing in corporate governance. The major changes in relevant regulation, including the changes to the *Corporations Act 2001*, are integrated into relevant chapters.

Running case—Rouge Clothing annual report

Extracts from the annual report for the running case of the fictitious Rouge Clothing Company are included as a full-colour insert at the back of the textbook. Financial statements and other information included in the annual report are used in examples throughout the book to illustrate chapter concepts. When Rouge Clothing is referred to in the text, a shopping bag icon is shown in the margin.

Running case—Pinnacle Manufacturing integrated case study

The Pinnacle Manufacturing integrated case represents a larger, multi-division company, and appears in six parts in Chapters 6, 7, 8, 14 and 15. Each part of the case is included at the end of the chapter to which the part relates. The parts of the case are connected so that students will gain a better understanding of how the parts of the audit are interrelated and integrated by the audit process.

Online issues

Each chapter includes Internet-based cases that require students to research relevant auditing issues online.

ACL Education edition student software supplement

Students are exposed to ACL audit software in the opening vignettes for Chapters 9 and 10. Chapter 10 illustrates the application of audit software using an ACL demonstration showing screenshots.

ACL provides a wide range of opportunities for incorporating computer-assisted audit techniques (CAATs) in the auditing curriculum. Instructors may use this supplement in conjunction with Chapter 10, *The Impact of Information Technology on the Audit Process*, which introduces the study of CAATs. The objectives of this supplement are twofold:

- 1 developing students' understanding of CAATs—audit software exercises explore how CAATs can assist the auditor in testing audit objectives
- 2 developing students' proficiency in global, market-leading audit software—the marketability of accounting graduates seeking audit-related employment is significantly enhanced through exposure to ACL.

ACL is generalised audit software used by auditors to extract and analyse data on client's computerised systems. Generalised audit software is discussed on pages 352–358 of the textbook.

ACL is a personal-computer implementation of the English-like Audit Command Language. It has been designed primarily as a powerful auditing tool for easy access to and analysis of data. ACL has a number of key features.

ACL is installed on the auditor's personal computer and provides universal access to client data. The client's data tables are downloaded to the auditor's computer and defined to the system so that data analysis is feasible.

Commands are issued through selections from menus and submenus. Error messages notify the user if the required data for a command have not been entered correctly. Context—sensitive help is available, along with a full Windows-style help system. Commands can also be executed interactively through the command log window. ACL permits both sequential and direct access to data tables. Sequential access involves a complete pass through the consecutive records in a data table and suits most applications; for example, locating all records meeting specified criteria. Direct access permits the location of the first record meeting a criterion or containing a specified key field value (e.g. product number).

ACL possesses powerful expression evaluation capabilities, thereby allowing the creation of computed fields—that is, those calculated from other fields, with formulae and functions. Commands may be batched and executed on request. Groups of commands may be executed concurrently to permit more efficient processing. All commands and results are automatically saved in the command log. This provides the auditor with the basis for review of work, a set of working papers and the potential development of future batch applications. ACL can also extract data to create working audit tables for further processing, and export data to other applications, such as *MS Word*. An in-depth study of its use is beyond the scope of most first auditing courses.

To access the educational ACL software go to <https://accounts.aclgrc.com/promo> and enter the promotional code in the front of the book. Further information about the ACL software can be located at <http://www.acl.com/about-us>.

Auditing and assurance implications of carbon trading

Chapter 19 has been revised for the Australian developments pertaining to carbon emissions reporting and assurance requirements.

Acknowledgments

We wish to thank the Auditing and Assurance Standards Board (AUASB) and the Australian Accounting Standards Board (AASB) for permission to quote their standards, statements and other pronouncements. Material from these Standards Boards is © Commonwealth of Australia. Every attempt has been made to ensure that the material used is current.

The authors and publisher would also like to thank ACL Services Ltd for permission to package the ACL student version with this textbook.

The dedicated contributions of many individuals helped make refinements and improvements in this edition. An impressive cast of reviewers provided many helpful suggestions and enthusiasm for the organisation and content of the book. The authors and publisher are grateful to each one of them. These include:

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B. A. Fiedler

Visual preface

For students

How do I use this book?

Learning objectives

These are listed at the beginning of each chapter and explain the key concepts that you should understand after studying the chapter. They are then signposted throughout the chapter, which steps you through each objective by listing the objective to which each section corresponds.

Professional statements referred to in this chapter

These provide you with a list of relevant auditing and accounting legislation that is explained throughout the chapter.

Audit responsibilities and objectives

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- 1 Explain the objective of conducting an audit of financial statements.
- 2 Distinguish management's responsibilities for preparing financial statements from the auditor's responsibilities for verifying those financial statements.
- 3 Explain the auditor's responsibility for discovering material misstatements.
- 4 Classify transactions and account balances into financial statement cycles, and identify benefits of a cycle approach to segmenting the audit.
- 5 Describe why the auditor obtains a combination of evidence by auditing classes of transactions, ending balances in accounts, and presentation and disclosure.
- 6 Distinguish among the three categories of management assertions about financial information.
- 7 Link the six general transaction-related audit objectives to management assertions for classes of transactions.
- 8 Link the eight general balance-related audit objectives to management assertions for account balances.
- 9 Link the four presentation and disclosure-related audit objectives to management assertions for presentation and disclosure.
- 10 Explain the relationship between audit objectives and the accumulation of audit evidence.

AUDITING STANDARDS

Referred to in this chapter

ISA 200	General Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards
ISA 300	Planning an Audit of a Financial Report
ISA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
ISA 500	Audit Evidence

Who's guarding the guards?

Can someone give credit to PwC or guarantee the investor?

While the regulators are grasping at shadowy hedge funds and deplorable renegade managers, the accountants remain as always unaccountable. What is the asset of an auditor if not to audit ABX, ABC, Gator, NPS, Cui Pacific, dog? 'bookends' all. Billions of dollars move, millions of dollars clipped in audit and arbitrary fees for the accounting practice, chiefly PwC and KPMG.

KPMG paid up \$2.5 million to make the ABX last year from the parent alone. For 'value' work it booked \$2.6 million for a total of \$5 million. PwC picked up \$1.1 million from the ABX's bond stock the year before. It was the stock and the mother, however, which picked up on the \$1.1 billion mostly in identifying short-term liabilities on long-term liabilities. And when such relief from suspension a few weeks ago, and was stamped, another \$200 million in debt was required to reflect a smaller capitalisation class. Not even a decrease in the account.

The first bond stock of the sub-prime debacle was of course RAMS—auditor PwC—but the form of the item was because Gator whose inconvertible account was perhaps only increased by one interest period. PwC's Baring noted \$1.7 million in debt last year alone, compensation by a total of \$1.7 million by 'ventures' last year of \$1.1 million in tax advice. That's \$4.7 million. But the \$4.7 million.

Gator itself, when during its account and which makes a regular habit of the methodology, main-frames, also used PwC. Audit \$400,000, 'ventures' \$400,000 each at \$7.2M.

Thus and the fact of the company's financial position. 'Can the PwC'—one thing. It qualified the account after the how-by by using 'material accounting misstatements on a going concern'. It's always 'true' and 'fair'. The qualifications however could provide the history. In Gator's case, an ever-growing interest rate and last on the scale from which shares were trading at \$7.2 million because \$1.

To balance the equation in favor of the big audit firms, they make sure not to give the work that gets done behind the scenes. Was it worth those millions in fees? Is the last it might be to give back this year.

Auditors have a responsibility to investors, not to the managers of capital who give the big firms and go along with the 'value' work. Clearly, the regulator has failed or prevented and are over relying that based on a very thin showing budget funds. One is to see more costly than prevention and if there is to be fundamental reform then governance and professional standards should be the other side of a bank of such finding finding opportunities between the system and its safeguards have failed.

Chapter opening vignette

Both real and fictitious companies and situations introduce you to the concepts covered in the chapter via a practical 'real-life' example.

Auditing FYI

Some chapters contain boxed features with additional information, examples and/or samples of audit documents to get you thinking.

Auditing FYI

Specific auditing standards functions of the FRC

The FRC functions include:

- (a) reporting the members of the AASB (other than the Chair)
- (b) reporting and monitoring the AASB's:
 - (i) activities
 - (ii) business plans
 - (iii) budgets
- (c) setting arrangements (including level, structure and composition of staff)
- (d) monitoring the AASB's broad strategic direction
- (e) giving the AASB direction, advice or feedback on matters of general policy and on the AASB's procedures
- (f) monitoring the development of international auditing standards and the auditing standards that apply to international financial centres
- (g) promoting the development of a single set of auditing standards for worldwide use with appropriate regard to international developments
- (h) promoting the continued adoption of international best practice auditing standards in the Australian public interest in the Australian economy
- (i) monitoring:
 - (1) the operation of auditing standards to assess their continued relevance and their effectiveness in achieving their objectives in respect of both the private and public sectors of the Australian economy
 - (2) the effectiveness of the consultative arrangements used by the AASB
 - (3) making contributions towards the work of the Australian auditing standard-setting processes
- (j) monitoring and periodically reviewing the level of funding, and the funding arrangements, for the AASB

Lack of professional scepticism in the HIH audit

Auditors play a vital role in the financial reporting process. This is particularly so with companies such as HIH because their financial position and performance is a matter of national economic significance. A properly conducted audit should show users of the company's financial report—including regulators, shareholders, public bodies, lenders and other investors—reliable information on which to base their decisions about the company's operations and value of its accounts with early notice of potential risks affecting the company's operations and value.

It is sometimes suggested that whenever a company fails its auditor must have been at fault. It is not necessarily so. There is a correct method of carrying out an audit. The work performed by the auditor must be carefully assessed, having regard to all the circumstances of the audit process. In the case of Auditors, those circumstances include the fact that in some circumstances and in relation to material matters they were misled.

During the course of the inquiry a subset number of specific accounting matters dealt with by Auditors in the course of the audit of 2005-06 were reviewed. The review identified a number of instances where Auditors did not obtain sufficient audit evidence to support their conclusions. In many instances it found that adjustments might have been made to the accounts to rectify matters that were the subject of enquiries.

One such instance was the manner in which Auditors relied on the valuations of HIH's consulting activity David Shaw. In the conduct of its audit, as noted, the largest single item on the balance sheet of a general insurer in the process is one used for payment of many claims. There is a high level of uncertainty. Auditors did not have any material reports, and nor did it assess such reports as part of its audit process. It therefore relied heavily on Shaw's work to confirm the credibility of the provisions for outstanding claims.

In these circumstances it was incumbent on Auditors to take steps to satisfy itself as to Shaw's competence, integrity and objectivity. It also needed to obtain an understanding of the assumptions and methods that Shaw used and to consider whether they were reasonable, based on Auditors' knowledge of the business and the results of other procedures performed. This is not to suggest that Shaw was not questionable. It is to say that Auditors were required to satisfy itself that Shaw's work was beyond reproach before relying on it as fairly.

Auditing in the real world

Excerpts from real auditing cases, standards, news items and reports appear in various chapters to show real-life examples of auditing in action.

Auditor's responsibilities for detecting material fraud

Auditing standards make no distinction between the auditor's responsibility for searching for errors and for fraud, whether from fraudulent financial reporting or misappropriation of assets. For both errors and fraud, the auditor must obtain reasonable assurance about whether the financial statements are free of material misstatements.

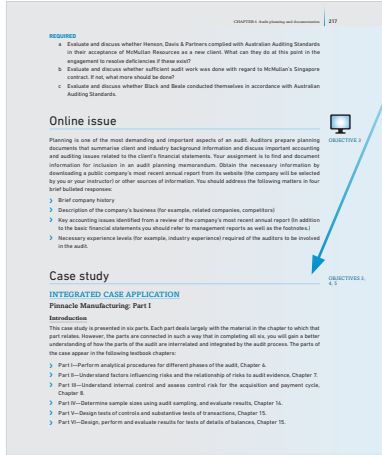
The standards also recognise that it is often more difficult to detect fraud than errors because misstatements, or the misstatements representing the fraud, emerge to conceal the fraud. The difficulty of detection doesn't change the auditor's responsibility to plan and perform the audit properly.

An important part of planning every audit is to assess the risk of errors and fraud. In making a risk assessment for fraud, it is useful to keep in mind that fraud typically includes two characteristics: (1) the auditor's risk assessment for fraud focuses on both of these characteristics, which are or differ:

- 1 **Person or persons in control of the Audit.** Often, this person is in control of direct financial points in the case of misappropriation of assets, or in indirect points in the case of fraudulent financial reporting.
- 2 **The gains in the second case may be, for example, an increase in the market value of company shares held by management.**

Running glossary in the margin

Bolded key terminology and concepts are explained as they occur in the text.



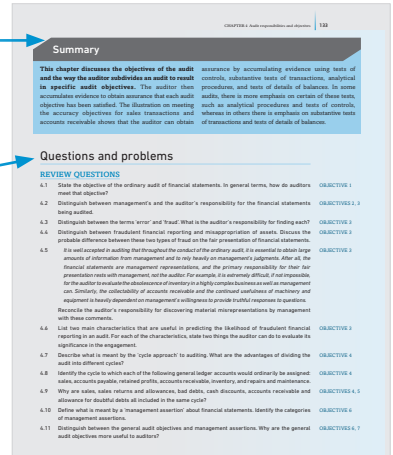
Integrated case study—Pinnacle Manufacturing

This running case appears in Chapters 6, 7, 8, 14 and 15. When all parts of the case are completed you will have a very sound understanding of each stage of the audit and how it relates to the whole process.



Chapter summary

All the material covered in each chapter is encapsulated in a few paragraphs; a great revision tool.



End-of-chapter questions and problems

Review questions, multiple choice questions, discussion questions and problems, case studies and Internet problems help reinforce your understanding of chapter content. All questions are keyed to the learning objective to which they correspond so you can pick and choose the areas you want to work on.

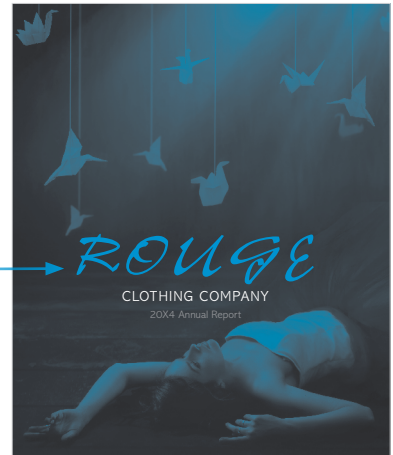


Appendices

Where appropriate, some chapters will have an appendix to extend and explicate chapter content.

Extra features

- Rouge Clothing—Extracts from the annual report for the running case of the fictitious Rouge Clothing Company are included as a four-colour insert at the end of the book. This case illustrates chapters concepts in a 'real-world' business context. When Rouge Clothing is referred to in the text, a shopping bag icon is shown in the margin.
- ACL software will help develop your proficiency in a global, market-leading audit software, and give you more marketability as an accounting graduate seeking audit-related employment.



What else can I use with this book?

For instructors

The following is available for download from the Pearson catalogue site. Contact your sales representative for passwords to access this material.

Solutions manual

The solutions manual provides educators with detailed, accuracy-verified solutions to all of the end-of-chapter problems in the book.

PowerPoint slides

A comprehensive set of PowerPoint slides can be used by educators for class presentations or by students for lecture preview or review. They include key figures and tables, as well as a summary of key concepts and examples from the text.

Test bank

The test bank provides a wealth of accuracy-verified testing material. Updated for the new edition, each chapter offers a wide variety of true/false, short-answer and multiple-choice questions, arranged by learning objective and tagged by AACSB standards.

ACL software

Educators may use this software in conjunction with Chapter 10 'The impact of information technology on the audit process', which introduces the study of CAATs.