

# Demand for audit and assurance services

## LEARNING OBJECTIVES

After studying this chapter you should be able to:

- 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.
- 13 Describe the impact of e-commerce on public accountants.

## AUDITING STANDARDS

Referred to in this chapter

ASA 101	Preamble to Australian Auditing Standards
ASA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards
ASA 220	Quality Control for an Audit of a Financial Report and Other Historical Financial Information
ASA 300	Planning an Audit of a Financial Report
ASA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
ASA 320	Materiality in Planning and Performing an Audit
ASA 500	Audit Evidence
ASA 700	Forming an Opinion and Reporting on a Financial Report

ASA 705	Modifications to the Opinion in the Independent Auditor's Report
ASQC 1	Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements

## PROFESSIONAL STATEMENTS

Referred to in this chapter

APES 320 Quality Control for Firms

### Good auditing includes good client service

**'It's been a good week,' thought Melissa Wilson, as she drove out of the parking area of Solberg Paints on Friday afternoon.** Just a year earlier, she had graduated from university and had since commenced her CPA studies. Still, Melissa didn't think her transition to professional life had been all that smooth, and she was surprised at how much there still was to learn. However, she had made great progress on the Solberg engagement.

John Harris was the audit senior on the Solberg Paints audit, and he had a reputation as a patient supervisor and mentor. Melissa wasn't disappointed. At the start of the engagement, John told her, 'Don't be afraid to ask questions. If you see anything that seems unusual, let's discuss it. And most importantly, if you have any ideas that will help the client, bring them up. The client expects us to deliver more than an audit report.'

'I'd say I delivered,' thought Melissa. She had found a weakness in the company's computer user profiles that may have exposed Solberg to accounts payable fraud. But her biggest contribution almost didn't happen. Melissa read as much as she could about security in the Systems, Applications and Products in Data Processing (SAP) system used by the company. She was afraid to bring it up, thinking that she couldn't possibly know anything that the client didn't already know, but John encouraged her to discuss it with the client. The result was that the client wanted to meet further with Melissa's firm to better understand how they could improve their fraud prevention measures.

Friday was the last day of fieldwork on the audit, and the partner, Roger Marlow, was at the client's office to complete his review of the audit files. Melissa was surprised to hear him say to her, 'What are you doing on the 15th? We're going to meet with the client to discuss our audit findings. You've made a real contribution on this audit, and I'd like you to be there.' Melissa tried not to show her excitement too much, but she couldn't hide the smile on her face. 'Yes, it's been a good week.'

*Each chapter's opening vignette illustrates important auditing principles based on realistic situations. Some of these stories are based on public information about the audits of real companies, whereas others are fictitious. Any resemblance in the latter stories to those of real firms, companies or individuals is unintended and purely coincidental.*



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As the opening story illustrates, public accountants provide assurances on financial statements and also help businesses to be more successful. As businesses become more complex and need more reliable information, public accountants play a vital role, both in providing assurance on information other than financial reports and in providing business advisory and tax services. For example, businesses and consumers who use information technology and electronic communication networks, such as the Internet, to conduct business and make decisions need independent assurances about the reliability and security of that electronic information. Auditors are valued for their technical knowledge and independence in providing assurances, as well as for their competence and experience in assisting companies to improve operations. Auditors often make and help implement recommendations that improve profitability by enhancing or reducing costs, including the reduction of errors and fraud, and by improving operational controls.

## Assurance services

**Assurance services** are independent professional services that improve the quality of information for decision makers. Individuals who are responsible for making business decisions seek assurance services to help improve the reliability and relevance of the information they base their decisions on. Assurance services are valued because the assurance provider is independent and perceived as being unbiased with respect to the information examined.

Assurance services can be performed by public accountants or by a variety of other professionals. Assurances provided by firms other than public accountants include television ratings and radio ratings, and several non-profit organisations, such as Choice, which test a wide variety of products and report their evaluations of the quality in 'consumer reports'. The information provided in these reports is intended to help consumers make intelligent decisions about the products they buy, and many consumers consider this information more reliable than any that is provided by the product manufacturers because it comes from an independent source.

The need for assurance isn't new. Public accountants have provided many assurance services for years, particularly assurances about historical financial statement information. Public accounting firms also perform assurance services for lotteries and contests, to confirm that winners were determined fairly and in accordance with contest rules. More recently, public accountants have been expanding the range of assurance services they perform to include engagements that provide assurance about other types of information, such as company financial forecasts and website controls. The demand for assurance services continues to grow as the demand for forward-looking information increases and as more real-time information becomes available online.

### Attestation services

One category of assurance services that public accountants provide is attestation services. An **attestation service** is a type of assurance service in which the public accounting firm issues a written communication that expresses a conclusion about the reliability of a written assertion of another party. There are three categories of attestation services: audit of historical financial statements, review of historical financial statements, and other attestation services.

#### Audit of historical financial statements

An **audit of historical financial statements** is 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

### OBJECTIVE 1

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** a type of assurance service in which the public accounting firm issues a written communication that expresses a conclusion about the reliability of a written assertion 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

with accounting standards. Audits are the predominant form of assurance performed by public accounting firms.

In financial statements, the client makes various assertions about their financial condition and results of operations. External users who rely on those financial statements to make business decisions use the auditor's report as an indication of the statements' reliability. They value the auditor's assurance because the auditor is independent of the client and has knowledge of financial statement reporting matters.

Publicly traded companies in Australia are required to have audits under the *Corporations Act 2001*. Auditor reports can be found in any public company's annual financial report, and most companies' audited financial statements can be accessed over the Internet by visiting the company's website. Even without legislative requirements, many public companies would voluntarily contract for audits to provide assurance to investors and to facilitate access to capital. Many privately held companies also have annual financial statement audits to obtain financing from banks and other financial institutions. Government and not-for-profit entities often have audits to meet the requirements of lenders or funding sources.

### Review of historical financial statements

A **review of historical financial statements** is another type of attestation service performed by public accountants. Many entities want to provide assurance on their financial statements, without incurring the cost of an audit. Whereas an audit provides a high level of assurance, a review service requires less evidence and provides a moderate amount of assurance on the financial statements. A review is often adequate to meet users' needs and can be provided by the public accounting firm at a much lower fee than an audit. Public companies are required by the *Corporations Act* to have their half-year financial statements either audited or reviewed by the entity's auditor.

### Other attestation services

Public accountants provide a range of other attestation services. Many of these services are a natural extension of the audit of historical financial statements, as users seek independent assurances about other types of information. However, to qualify as an attestation service, the engagement must involve written assertions on some accountability matter. For example, banks often require debtors to engage public accountants to provide assurance about the debtor's compliance with certain financial covenant provisions stated in the loan agreement. Public accountants can also attest to the information in an entity's forecast financial statements, which are often used to obtain financing.

### Other assurance services

Most of the other assurance services that public accountants provide don't meet the formal definition of attestation services. They are similar to attestation services in that the public accountant must be independent and must provide assurance about information used by decision makers, but differ in that the public accountant may not be required to issue a written report, and the assurance doesn't have to be about the reliability of another party's written assertion about compliance with specified criteria. Rather, in these other assurance services engagements, the assurance is about the reliability and relevance of information, which may or may not have been asserted by another party. The common feature of all assurance services, including audits and attestation services, is the focus on improving the quality of information used by decision makers.

Public accountants have many opportunities to perform other assurance services engagements. The demand for assurance on other types of information is expected to grow substantially with the changing risks faced by businesses and increases in the number of available information sources. However, one important difference between attestation services and other assurance services is the potential competition that public accounting firms face when performing other assurance

#### 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

services—audits and many types of attestation services are limited by regulation to licensed public accountants, but the market for other forms of assurance is open to other competitors. For example, assisting companies to prepare customer surveys and evaluate the reliability and relevance of survey data is one potential assurance service that public accountants can provide. However, in the market for those services, public accountants face competition from market research firms. One competitive advantage that public accounting firms have in the market for assurance services is their reputation for competence and independence.

## ‘Now for the winning numbers . . .’

You probably recognise these words from the drawing of Lotto or Powerball. What you may not recognise is what these well-known events have to do with assurance services. Each drawing is observed by public accountants (government auditors) to assure viewers that the drawings are conducted fairly.

Auditing in the real world

### Assurance services on information technology

One of the main factors affecting the demand for other assurance services is the growth of the Internet and electronic commerce. Concerns over privacy and security of information on the Internet have slowed the potential growth of e-commerce. Also, the volume of real-time information available online is shifting the need for assurance from historical information at a point in time, such as financial statements, to assurances about the reliability of processes generating information in a real-time format. For example, many business functions, such as ordering and making payments, are conducted directly between computers using electronic data interchange (EDI). As transactions and information are shared online and in real time, there is even greater demand for assurances about computer controls and security surrounding information transacted electronically. Public accountants can help provide assurance about these functions. Two examples of assurance services related to information technology are assurances over website controls and assurances about information system reliability.

- 1** *WebTrust services.* To respond to the growing need for assurance resulting from the explosion of business transacted over the Internet, the American Institute of Certified Public Accountants (AICPA) created the public accountant *WebTrust* assurance service. Public accounting firms that are licensed to perform this service provide assurance to website users through the electronic *WebTrust* seal affixed to the website. This seal assures the user that the website owner has met established criteria related to business practices, transaction integrity and information processes. *WebTrust* is an attestation service, and the *WebTrust* seal is a symbolic representation of the public accountant’s report on management’s assertions about its disclosure of e-commerce practices. A growing number of public accounting firms in Australia are providing *WebTrust* assurance services.
- 2** *SysTrust services.* The AICPA and the Canadian Institute of Chartered Accountants (CICA) jointly created the *SysTrust* service to provide assurance on information system reliability. *SysTrust* is an attest-type engagement to evaluate and test system reliability in areas such as security and data integrity. Whereas the *WebTrust* assurance service is primarily designed to provide assurance to third-party users of a website, *SysTrust* services might be performed by CPAs to provide assurance to management, the board of directors or third parties about the reliability of information systems used to generate real-time information.

The AICPA and CICA have developed five principles related to online privacy, security, processing integrity, availability and confidentiality to be used in performing services such as *WebTrust* and

## Principles for *WebTrust* and *SysTrust* services

TABLE 1.1

TRUST PRINCIPLE	DESCRIPTION OF ASSURANCE
Online privacy	Provides assurance that the system protects the privacy of personal information provided by individuals, such as credit card numbers
Security	Provides assurance that access to the system and data is restricted to authorised individuals
Processing integrity	Provides assurance that transactions are processed completely and accurately
Availability	Provides assurance that systems and data will be available to users when they need them
Confidentiality	Provides assurance that information designated as confidential is protected
Certification authorities ( <i>WebTrust</i> only)	Provides assurance on the adequacy and effectiveness of controls used by certification authorities with responsibility for verifying electronic transactions

*SysTrust*. Table 1.1 includes a description of the assurance provided for each principle. The table also includes a description of assurance for certification authorities, which applies only to the *WebTrust* service.

### Assurance services on other types of information

The AICPA Special Committee on Assurance Services has identified a number of other services designed to enhance the relevance of information. Examples of these services include defining business performance measures, defining and developing measures of quality for services to the elderly (*ElderCare Plus*), developing other healthcare performance measures and developing comprehensive profiles of risk. The following is a description of the first two of these services:

- 1 *Business performance measurement services*. Investors, creditors, and boards of directors and managers often need more comprehensive information to evaluate an entity's performance than historical financial statements provide. These comprehensive performance measures are often called a *balanced scorecard*. Using a balanced scorecard, the board of directors and managers defines an entity's strategic objectives and goals, such as increased customer satisfaction, unit sales and revenue growth, and increased shareholder value. To assess the entity's success in achieving these goals, the board of directors and managers implements performance measurement systems. Public accountants can provide assurance about whether financial and non-financial information being reported from the entity's performance measurement system is reliable and whether the performance measures being used are accurately leading the entity towards meeting its strategic goals and objectives.
- 2 *ElderCare Plus*. As the population ages, more and more elderly people require either assistance to live in their own homes or institutional care. These individuals and their family members are increasingly concerned about the quality of care and related services. This emerging trend offers public accountants an opportunity to provide assurances to these elderly individuals and their families that care is being provided at an acceptable level. Such services might include periodic reporting to family members about the degree to which caregivers are complying with the contracted level of care or supervising the investments and accounting for the elderly individual's estate. Due to the varying types of care services provided, *ElderCare Plus* is an example of an assurance service that may require the expertise of other professionals. In these engagements, the public accountant serves as the coordinator and assurer of the quality of services provided to the elderly individual.

There are practically no limits to the types of assurances that public accountants can provide. Examples of other assurance service opportunities for public accountants are shown in Table 1.2.



## Other assurance services examples

TABLE 1.2

OTHER ASSURANCE SERVICES	THESE SERVICES INVOLVE
Controls over and risks related to investments, including policies related to derivatives	Assessing the processes surrounding a company's investment activities to identify risks and to determine the effectiveness of those processes in meeting the company's investment objectives
Mystery shopping	Performing anonymous shopping to assess sales personnel interactions with customers and procedures performed by sales personnel
Assessment of risks of accumulation, distribution and storage of digital information	Assessing physical and online security risks and related controls surrounding data and other information stored electronically, including the adequacy of backup and off-site storage
Fraud and illegal acts risk assessment	Developing fraud risk profiles and assessing the adequacy of company systems and policies in preventing and detecting fraud and illegal acts
Compliance with trading policies and procedures	Examining transactions between trading partners to ensure that the handling of the transactions complies with the terms of the trading agreement or contract, including the identification of risks surrounding the trade arrangement
Compliance with entertainment royalty agreements	Assessing whether royalties paid to artists, authors, and others are in accordance with royalty agreement provisions
ISO 9000 certifications	Certifying a company's compliance with ISO 9000 quality control standards, which help ensure company products are of high quality
Annual environmental audit	Assessing whether company policies effectively ensure the company's compliance with environmental standards and laws

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## Non-assurance services provided by public accountants

Public accounting firms perform a number of other services that generally fall outside the scope of assurance services. Three specific examples of non-assurance services that public accountants often provide include accounting and bookkeeping services, tax services and management consulting services.

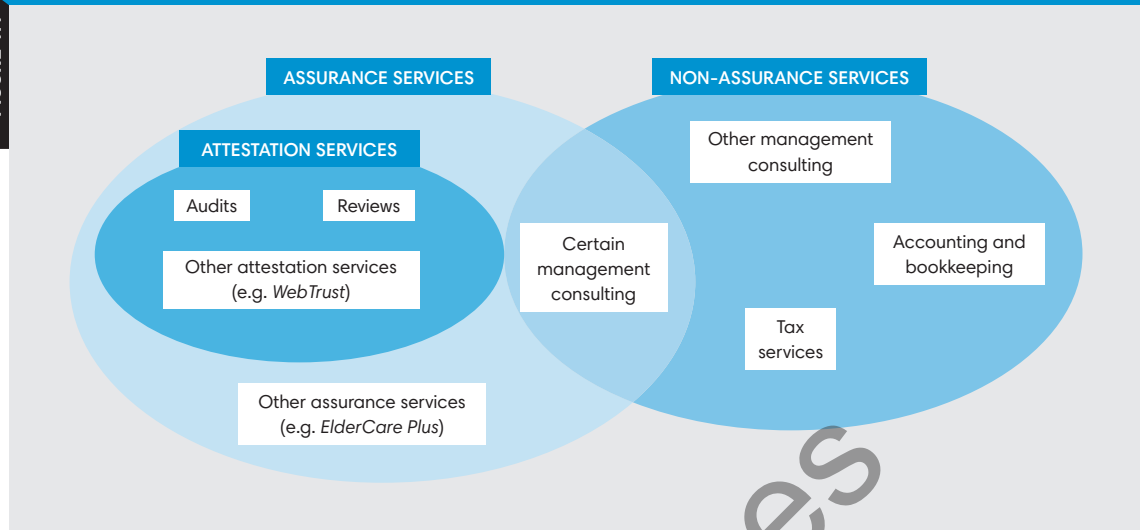
Some overlap exists between management consulting and assurance services. The primary purpose of a management consulting engagement is to generate a recommendation to management, whereas the primary purpose of an assurance services engagement is to improve the quality of information. Although the quality of information is often an important criterion in a consulting engagement, this goal is normally not the primary purpose. For example, a public accountant may be engaged to design and install a new information technology system for an entity as a consulting engagement. The purpose of that engagement is to install the new system; the goal of improved information is a byproduct of that engagement. Consulting engagements and assurance services occasionally overlap when improving the quality of information for decision makers is a primary goal.

Public accounting firm revenues from management consulting services have increased significantly in recent years. Many large public accounting firms have departments that exclusively perform management consulting services. Management consulting services are often called management advisory services (MAS).

Figure 1.1 reflects the relationship between assurance and non-assurance services. Audits, reviews and other attestation services are all examples of attestation services that fall under the scope of assurance services. Some of the new assurance services identified by the AICPA, such as *WebTrust*, are also attestation services. In contrast, most management consulting services, accounting and bookkeeping services, and tax services fall outside the scope of assurance services, although there is some common area of overlap between consulting and assurance services.

## Relationships among assurance services, attestation services and non-assurance services

FIGURE 1.1



## Economic demand for auditing

### OBJECTIVE 2

Explain the importance of auditing in reducing information risk.

This book focuses on the audit of historical financial statements by public accounting firms. Because of the need for reliance on the financial statements by external users, there is a well-defined set of standards for auditing historical financial statements. Also, the ability to issue opinions on financial statements is restricted to registered auditors. Many of the skills and concepts necessary to perform an audit of historical financial statements are useful when performing other assurance services.

To illustrate the need for auditing, consider the decision of a bank manager in making a loan to a business. This decision will be based on factors such as previous financial relationships with the business and the financial condition of the business as reflected by its financial statements. If the bank makes the loan, it will charge a rate of interest determined primarily by three factors:

- 1 **Risk-free interest rate.** This is approximately the rate the bank could earn by investing in government bonds for the same length of time as the business loan.
- 2 **Business risk for the customer.** This risk reflects the possibility that the business won't be able to repay its loan because of economic or business conditions such as a recession, poor management decisions or unexpected competition in the industry.
- 3 **Information risk. Information risk** reflects the possibility that the information on which the business risk decision was made was inaccurate. A likely cause of information risk is the possibility of inaccurate financial statements.

**information risk**  
the risk that information on which a business decision is based is inaccurate

Auditing has no effect on either the risk-free interest rate or business risk, but it can have a significant effect on information risk. If the bank manager is satisfied that there is minimal information risk because a borrower's financial statements have been audited, the risk is substantially reduced and the overall interest rate to the borrower can be reduced. The reduction of information risk can have a significant effect on the borrower's ability to obtain capital at a reasonable cost. For example, assume a large company has a total interest-bearing debt of approximately \$10 million. If the interest rate on that debt is reduced by only 1%, the annual saving in interest is \$100 000.



 OBJECTIVE 3

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

## Causes of information risk

As society becomes more complex, decision makers are more likely to receive unreliable information. There are several reasons for this: remoteness of information, biases and motives of the provider, voluminous data and the existence of complex exchange transactions.

### Remoteness of information

In today's world it is virtually impossible for decision makers to have much first-hand knowledge about the organisation they do business with so they must rely on information provided by others; however, the likelihood of this third-party information being intentionally or unintentionally misstated increases.

### Biases and motives of the provider

If information is provided by someone whose goals are inconsistent with those of the decision maker, the information may be biased in favour of the provider. The reason could be an honest optimism about future events or an intentional emphasis designed to influence users in a certain manner. In either case, the result is misstated information. For example, in a lending decision where the borrower provides financial statements to the lender, the borrower is considerably likely to bias the statements to increase their chance of obtaining a loan. The misstatement could be in the form of outright incorrect dollar amounts or inadequate or incomplete disclosures of information.

### Voluminous data

As organisations become larger, so does the volume of their exchange transactions. This increases the likelihood that improperly recorded information will be included in the records—perhaps buried in a large amount of other information. For example, if a large government agency overpays a vendor's invoice by \$200, there is a fairly good chance that it won't be uncovered unless the agency has instituted reasonably complex procedures to find this type of misstatement. If many minor misstatements remain undiscovered, the combined total could be significant.

### Complex exchange transactions

In the past few decades, exchange transactions between organisations have become increasingly complex and therefore more difficult to record properly. For example, the correct accounting treatment of the acquisition of one entity by another poses relatively difficult and important accounting problems. Other examples include properly combining and disclosing the results of operations of subsidiaries in different industries and properly disclosing derivative financial instruments.

## Reducing information risk

Business managers and financial statement users may conclude that the best way to deal with information risk is simply to have it remain reasonably high. A small company may find it less expensive to pay higher interest costs than to increase the costs of reducing information risk. For larger businesses, it is usually practical to incur costs to reduce information risk. There are three main ways to reduce information risk, as described below.

### User verifies information

The user may go to the business premises to examine records and obtain information about the reliability of the statements. Normally, this is impractical because of costs, plus it would be economically inefficient for all users to verify the information individually. Nevertheless, some users perform their own verification. For example, the Australian Taxation Office (ATO) performs considerable verification of businesses and individuals to determine whether filed tax returns reflect the actual tax due to the Federal Government. Similarly, if a business intends to purchase another business, it is common for the purchaser to use a special audit team to independently verify and evaluate key information of the prospective business.

## User shares information risk with management

Considerable legal precedent indicates that management is responsible for providing reliable information to users. If users rely on inaccurate financial statements and as a result incur a financial loss, they have a basis for a legal action against management. A difficulty with sharing information risk with management is that users may not be able to collect on losses. If a company is unable to repay a loan because of insolvency, management is unlikely to have sufficient funds to repay users.

## Audited financial statements are provided

The most common way for users to obtain reliable information is to have an independent audit performed. The audited information is then used in the decision-making process on the assumption that it is reasonably complete, accurate and unbiased.

## Audits of newspaper circulation

The Audited Media Association of Australia (AMAA) media audits provide assurance, insight and advantage to consumer, business-to-business, and specialty and community media owners and media buyers.

The AMAA is an independent, not-for-profit self-regulating organisation governed by a tripartite Board with input from member committees. The AMAA delivers the Audit Bureau of Circulations (ABC) Paid Media Audit and the Audit Bureau of Circulations (CAB) Total Distribution Audit metrics along with verified website traffic, email newsletter distribution and exhibition, event and conference attendance. The Board and Committees, through members' consultation, set auditing rules and organisational policies and are comprised of representatives from advertisers, advertising agencies and publishers. Members of the AMAA include over 1100 media organisations from the Asia Pacific region. The AMAA is based in Sydney, Australia, and is part of an international group, the International Federation of Audit Bureaus of Certifications (IFABC). The media audit services it provides range from print and digital versions from major metropolitan newspapers and consumer publications to free and controlled magazines, newspapers, website traffic, exhibition and conference organisers, providers of email newsletters and digital publications.

### What does audited media mean for you?

If you are an advertiser, audited media means your agency can deliver media products for your selection with confidence, knowing the sales or distribution of print and digital products has been tested through a rigorous census-based audit process. For digital media and exhibitions, you can rely on information verified by the AMAA to deliver verified proof of audience.

Source: © Audited Media Association of Australia. Extract from ABC Paid Media Audit. Reproduced by permission of Audited Media Association of Australia.

Typically, management engages the auditor to provide assurances to users that the financial statements are reliable. If the financial statements are ultimately determined to be incorrect, the auditor can be sued by both the users and management. Auditors obviously have considerable legal responsibility for their work.

## OBJECTIVE 4

Describe auditing.

### auditing

the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria

## Nature of auditing

So far, we have discussed the importance of audits of financial statements and their relation to other attestation and assurance services offered by public accounting firms. We now examine **auditing** more specifically using the following definition:

*Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be performed by a competent, independent person.*

This definition of the auditing process is considerably broader than the definition of an audit of historical financial statements and encompasses many attestation and assurance service activities. The definition also includes several key words and phrases. For ease of understanding, the terms are discussed in a different order from how they occur in the description above.

## Information and established criteria

To do an audit, there must be information in a verifiable form and some standards (criteria) the auditor can evaluate the information against. Information can and does take many forms. Auditors routinely perform audits of quantifiable information, including companies' financial statements and individuals' income tax returns. Auditors also perform audits of more subjective information, such as the effectiveness of computer systems and the efficiency of manufacturing operations.

The criteria for evaluating information also vary depending on the information being audited. For example, in the audit of historical financial statements by public accounting firms the criteria are usually accounting standards. To illustrate, this means that in the audit of Woolworths' financial statements, the public accounting firm determines whether the financial statements have been prepared in accordance with accounting standards. For the audit of tax returns by the ATO, the criteria are found in the *Income Tax Assessment Act 1997*. In the ATO's audit of Woolworths' corporate tax return, the tax auditor would use the *Income Tax Assessment Act* as the criteria for correctness, not accounting standards.

For more subjective information, such as auditing the effectiveness of computer operations, it is more difficult to establish criteria. Typically, auditors and the entities being audited agree on the criteria well before the audit starts. For a computer application, for example, the criteria might include the absence of input or output errors.

## Accumulating and evaluating evidence

**Evidence** is any information used by the auditor to determine whether the information being audited is stated in accordance with the established criteria. Evidence takes many different forms, including oral testimony of the client, written communication with outsiders and observations by the auditor. It is important to obtain a sufficient quality and volume of evidence to satisfy the purpose of the audit. Determining the types and amount of evidence necessary and evaluating whether the information corresponds to established criteria is a critical part of every audit. It is the primary subject of this book.

**evidence**  
any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria

## Competent, independent person

The auditor must be qualified to understand the applicable criteria and must be competent to know the types and amount of evidence required to reach the proper conclusion after the evidence has been examined. The auditor must also have an independent mental attitude. The competence of the individual performing the audit is of little value if he or she is biased in the accumulating and evaluating of evidence.

Auditors reporting on company financial statements are often called **independent auditors**. Even though auditors of published financial statements are paid a fee by a company, they are normally sufficiently independent to conduct audits that can be relied on by users. Although absolute independence is impossible, auditors strive to maintain a high level of independence to keep the confidence of users who rely on their reports. Although internal auditors work for the company, they usually report directly to senior management to help maintain independence from the operating units they are auditing.

**independent auditors**  
public accountants or accounting firms that perform audits of commercial and non-commercial financial entities

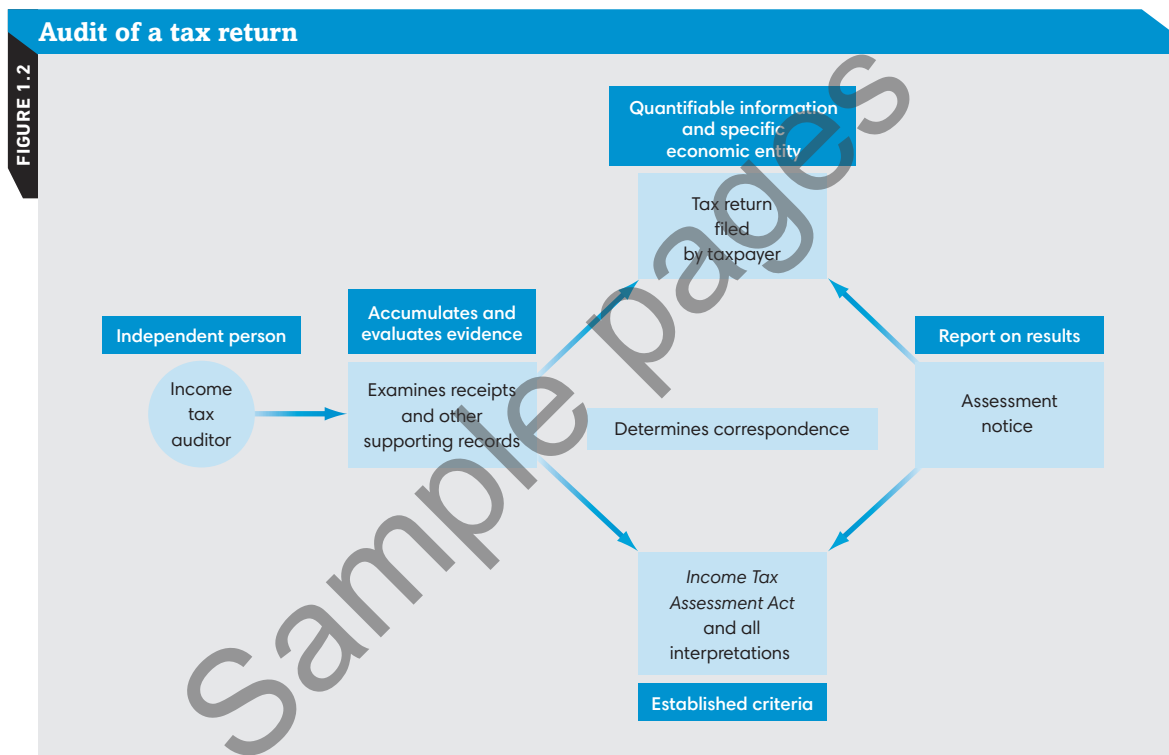
## Reporting

The final stage in the auditing process is preparing the **audit report**, which is the communication of the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of

**audit report**  
the communication of audit findings to users

correspondence between information and established criteria. Reports also differ in form and can vary from the highly technical type usually associated with financial statement audits to a simple oral report in the case of a performance audit of a small department's effectiveness. We explore how to write an audit report in more detail in Chapter 18.

Figure 1.2 summarises the important ideas in the description of auditing by illustrating a tax auditor's audit of an individual's tax return. The objective is to determine whether the tax return was prepared in a manner consistent with the requirements of the *Income Tax Assessment Act*. To accomplish this, the auditor examines supporting records provided by the taxpayer and from other sources, such as the taxpayer's employer. After completing the audit, the tax auditor will issue a report to the taxpayer assessing additional taxes, advising that a refund is due or stating that there is no change in the status of the tax return.



## Distinction between auditing and accounting

### OBJECTIVE 5

Distinguish between auditing and accounting.

#### accounting

recording, classifying and summarising of economic events in a logical manner for the purpose of providing financial information for decision making

Many financial statement users and members of the general public confuse auditing with accounting. Confusion arises because auditing is usually concerned with accounting information, and many auditors have considerable expertise in accounting matters; confusion increases when the title 'public accountant' is given to many individuals who perform audits.

**Accounting** is recording, classifying and summarising of economic events in a logical manner for the purpose of providing financial information for decision making. The function of accounting is to provide certain types of quantitative information that management and others can use to make decisions. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity's economic events are properly recorded on a timely basis and at a reasonable cost.

When auditing accounting data, the main concern is determining whether recorded information properly reflects the economic events that occurred during the accounting period. Because accounting rules are the criteria for evaluating whether the accounting information is properly recorded, any auditor involved with these data must also thoroughly understand those rules. In the context of the audit of financial statements, the rules are accounting standards. Throughout this book, we assume that you have already studied accounting standards.

In addition to understanding accounting, the auditor must possess expertise in accumulating and interpreting audit evidence. This expertise distinguishes auditors from accountants. Determining the proper audit procedures, deciding the number and types of items to test and evaluating the results are problems unique to the auditor.

## Types of audits

### OBJECTIVE 6

Differentiate the three main types of audits.

Public accountants perform three primary types of audits: financial statement audits, performance audits and compliance audits. The last two services are often called audit activities, even though they are most similar to assurance and attestation services. We now examine each type of audit in more detail.

### Financial statement audits

Auditors conduct **financial statement audits** to determine whether the overall financial statements (the information being verified) are stated in accordance with specified criteria. Normally, the criteria are accounting standards, although it is also common to conduct audits of financial statements prepared using the cash basis or some other basis of accounting appropriate for the organisation. The financial statements most often included are the balance sheet, income statement and cash flow statement including accompanying footnotes.

In determining whether financial statements are fairly stated in accordance with accounting standards, the auditor performs appropriate tests to determine whether the statements contain material errors or other misstatements. An integrated approach to auditing considers both the risk of errors and operating controls intended to prevent errors. Increasingly, this integrated approach incorporates a strategic perspective of the business entity.

As businesses increase in complexity, it is no longer sufficient for auditors to focus narrowly on accounting transactions. In a **strategic systems audit** approach, the auditor must have a thorough understanding of the entity and its environment. This holistic, top-level understanding includes knowledge of the client's industry and its regulatory and operating environment, including external relationships with, for example, suppliers, customers and creditors. The auditor also considers the client's business strategies and processes and measurement indicators for critical success factors related to those strategies. This analysis helps the auditor identify risks associated with the client's strategies that may affect whether the financial statements are fairly stated. Many of the skills necessary for the strategic systems audit approach are similar to those needed to provide other types of assurance services that can add value to the audit function.

#### financial statement audit

an audit conducted to determine whether the overall financial statements of an entity are stated in accordance with specified criteria (usually accounting standards)

#### strategic systems audit

audit approach based on understanding the client's business strategies and processes and external relations and factors that affect those strategies

### Performance audits

A **performance audit** (also referred to as an **operational audit**) is a review of any part of an organisation's operating procedures and methods for the purpose of evaluating efficiency and effectiveness. An example of a performance audit is evaluating the efficiency and accuracy of processing payroll transactions in a newly installed computer system. Another example, where most accountants would feel less qualified, is evaluating the efficiency, accuracy and customer satisfaction in processing

#### performance audit or operational audit

a review of any part of an organisation's operating procedures and methods for the purpose of evaluating efficiency and effectiveness

the distribution of letters and packages by Australia Post. When a performance audit is complete, management normally expects recommendations for improving operations.

Because of the many different areas in which operational effectiveness can be evaluated, it is impossible to characterise the conduct of a typical performance audit. In one organisation, the auditor might evaluate the relevance and sufficiency of the information used by management in making decisions to acquire new non-current assets, whereas in a different organisation the auditor might evaluate the efficiency of the information flow in processing sales. In performance auditing, the reviews are not limited to accounting. They can include the evaluation of organisation structure, computer operations, production methods, marketing and any other area in which the auditor is qualified.

Conducting a performance audit and reporting results are less easily defined than for either of the other two types of audits. Efficiency and effectiveness of operations are far more difficult to evaluate objectively than compliance or the presentation of financial statements in accordance with accounting standards, and establishing criteria for evaluating information in a performance audit is extremely subjective. In this sense, performance auditing is more like management consulting than what is generally regarded as auditing. Performance auditing has increased in importance in the past decade. It is discussed in greater depth in Chapter 19.

## Compliance audits

### compliance audit

(1) a review of an organisation's financial records performed to determine whether the organisation is following specific procedures, rules or regulations set by some higher authority; (2) an audit performed to determine whether an entity that receives financial assistance from the Federal Government has complied with specific laws and regulations

The purpose of a **compliance audit** is to determine whether the client is following specific procedures, rules or regulations set by some higher authority. A compliance audit for a private business could include determining whether accounting personnel are following the procedures prescribed by the company financial controller, reviewing wage rates for compliance with minimum wage laws, or examining contractual agreements with bankers and other lenders to be sure the company is complying with legal requirements. In the audit of governmental units, such as school districts, there is considerable compliance auditing because of the extensive regulation by higher government authorities. In virtually every private and not-for-profit organisation, there are prescribed policies, contractual agreements and legal requirements that may call for compliance auditing.

Results of compliance audits are typically reported to someone within the organisational unit being audited, rather than to a broad spectrum of users. Management, as opposed to outside users, is the primary group concerned with the extent of compliance with certain prescribed procedures and regulations. Therefore, a significant portion of work of this type is done by auditors employed by the organisational units themselves. There are exceptions, however. When an organisation wants to determine whether individuals or organisations are complying with its requirements, the auditor is employed by the organisation issuing the requirements. For example, when auditing taxpayers for compliance with tax laws, the auditor is employed by the government to audit the taxpayers' tax returns. Compliance audits for federally funded grant programs are widely performed by public accountants.

Table 1.3 summarises and provides an example of each of the three types of audits, and applies three of the key parts of the definition of auditing to each type.

## Types of auditors

### OBJECTIVE 7

Identify the primary types of auditors.

Several types of auditors practise today. The most common are public accounting firms, officers serving the Auditor-General, tax auditors and internal auditors.

## Public accounting firms

Public accounting firms are responsible for auditing the published historical financial statements of all publicly traded companies, most other reasonably large companies, and many smaller companies and



Examples of three types of audits

TABLE 1.3

TYPE OF AUDIT	EXAMPLE	INFORMATION	ESTABLISHED CRITERIA	AVAILABLE EVIDENCE
Financial statement audit	Annual audit of Woolworths' financial statements	Woolworths' financial statements	Accounting standards	Documents, records and outside sources of evidence
Performance audit	Evaluate whether the computerised payroll processing for subsidiary H is operating efficiently and effectively	Number of payroll records processed in a month, costs of the department and number of errors made	Company standards for efficiency and effectiveness in payroll department	Error reports, payroll records and payroll processing costs
Compliance audit	Determine whether bank requirements for loan continuation have been met	Company records	Loan agreement provisions	Financial statements and calculations by the auditor

non-commercial organisations. Because audited financial statements are widely used in the Australian economy, as well as businesspersons' and other users' familiarity with these statements, it is common to use the terms 'auditor' and 'public accounting firm' synonymously, even though several different types of auditors exist. Public accounting firms are often called *external auditors* or *independent auditors* to distinguish them from internal auditors.

The term **public accountant** is used throughout this book to refer to people who have obtained registration as company auditors in accordance with the provisions of the *Corporations Act*. To become a registered company auditor, a person must apply to the Australian Securities and Investments Commission (ASIC) and provide evidence of either membership of Chartered Accountants Australia and New Zealand (CAANZ), CPA Australia or another prescribed body, or of tertiary qualifications in accountancy (including auditing) and commercial law or other equivalent qualifications. ASIC must be satisfied also that the applicant has had sufficient practical experience in auditing and is a capable, fit and proper person to be registered as an auditor.

**public accountant** person who has obtained registration as a company auditor in accordance with the provisions of the *Corporations Act 2001*

## Officers serving the Auditor-General

The Federal Government and the various State governments have offices of the Auditors-General. These agencies, which are headed by the Auditors-General, report to and are responsible solely to the Federal or State Parliament. The primary responsibility of the audit staff is to perform the audit function for government. They are referred to as **officers serving the Auditor-General**.

Many of the audit responsibilities of public sector auditors are the same as those of a public accounting firm. Much of the financial information prepared by various government agencies is audited by the Auditor-General before it is submitted to Parliament. As the authority for expenditures and receipts of governmental agencies is defined by law, there is considerable emphasis on compliance in these audits.

An increasing portion of the audit efforts of public sector auditors has been devoted to evaluating the *efficiency* and *effectiveness* of various programs. An example is the evaluation of the computer operations of a particular governmental unit. Auditors can review and evaluate any aspect of the computer system, but they are likely to emphasise the adequacy of the equipment, the efficiency of the operations, the adequacy and usefulness of the output and similar matters, with the objective of identifying means of providing the same services at a lower cost.

Because of the immense size of many Federal and State agencies and the similarity of their operations, the offices of the Auditors-General have made significant advances in recent years in developing better methods of auditing through the widespread use of more sophisticated statistical sampling and computer auditing techniques.

**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

As a result of their great responsibility for auditing the expenditures of the Federal and State governments, their use of advanced auditing concepts and their efforts in performance auditing, public sector auditors are highly regarded in the auditing profession.

## Tax auditors

The ATO, under the direction of the Commissioner of Taxation, is responsible for enforcing the *Federal tax laws* as they have been defined by Parliament and interpreted by the courts. A major responsibility of the ATO is to audit the returns of taxpayers to determine whether they have complied with the tax laws. The auditors who perform these examinations are referred to as **tax auditors**. These audits can be regarded as solely compliance audits.

It might seem that the audit of returns for compliance with the Federal tax laws would be a simple and straightforward matter, but nothing could be further from the truth. The tax laws are highly complicated, and there are hundreds of volumes of interpretations. The tax returns being audited vary from the simple returns of individuals who work for only one employer and take the standard tax deductions to the highly complex returns of multinational companies. Common taxation problems involve individual taxpayers, probate taxes, corporate taxes, fringe benefits taxes and so forth, so an auditor involved in any of these areas must have considerable knowledge to conduct an audit.

### tax auditors

auditors who work for the Australian Taxation Office (ATO) and conduct examinations of taxpayers' returns

## Internal auditors

**Internal auditors** are employed by individual companies to audit for management much as the Auditor-General does for Parliament. The internal audit group in some large firms can include more than 30 people and typically reports directly to the managing director, another senior executive officer or even the audit committee of the board of directors.

Internal auditors' responsibilities vary considerably, depending on the employer. Some internal audit staffs consist of only one or two employees, who may spend most of their time doing routine compliance auditing. Other internal audit staffs consist of numerous employees with diverse responsibilities, including many outside the accounting area. Many internal auditors are involved in performance auditing or have expertise in evaluating computer systems.

To operate effectively, internal auditors must be independent of the line functions in an organisation, but they cannot be independent of the entity as long as an employer–employee relationship exists. Internal auditors provide management with valuable information for making decisions concerning the effective operation of its business. Users from outside the entity are unlikely to want to rely on information verified solely by internal auditors because of their lack of independence. This lack of independence is the main difference between internal auditors and public accounting firms.

### internal auditors

auditors employed by a company to audit for the company's board of directors and management

## Behind the numbers

The thought of marrying the words forensic and accounting may seem like an odd coupling; after all, forensics is all about science, isn't it? Or is forensic accounting simply the latest in the seemingly never-ending series of catch-phrases devised to cash in on recent global events? On the contrary, forensic accounting is real, in demand, and likely to reshape accounting as we know it.

Given the volume of significant corporations such as HIH and OneTel that have made dramatic and expensive exits from the corporate landscape, now more than ever we need to understand how and why these collapses occurred, and, more importantly, how to learn from them.

Forensic accounting deals with the analysis of such corporate breakdowns in an effort to avoid repeating some of the less enviable moments in Australian corporate history. Through the marriage of principles from accounting, law, statistics and IT, the discipline focuses on prevention, fact finding, diagnosis and review.

Source: J. Entwistle, 'Behind the Numbers', *ANU News*, ANU, Summer 2009.

 OBJECTIVE 8

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

## Public accounting firms

Several thousand public accounting firms currently operate in Australia. The size of public accounting firms ranges from one person to several thousand staff and partners. Four size categories can be used to describe public accounting firms: (1) Big Four international firms, (2) national firms, (3) large local and regional firms, and (4) small local firms.

### Big Four international firms

The four largest public accounting firms in Australia are referred to as the *Big Four*. Each has offices in every major Australian city and in many cities throughout the world. The smallest of these firms has international revenues exceeding \$20 billion and national revenues exceeding \$1 billion. The total number of partners and staff of the largest firm exceeds 150 000 internationally and 5000 in Australia. These four firms audit nearly all of the largest companies both in Australia and worldwide, and many of the smaller companies as well.

Prior to 1989 there were eight large public accounting firms, commonly referred to as the Big Eight. In 1989, two mergers of two firms each resulted in the Big Six. In 1998 Price Waterhouse and Coopers & Lybrand merged to form PricewaterhouseCoopers, resulting in the Big Five. There was no single reason for these mergers although a major factor was the need for international public accounting firms to serve all major international cities due to the increasing globalisation of businesses. For example, if a German company has offices in Australia, Brazil, Japan and the United States, the public accounting firm doing its audit needs auditors in each of those countries.

The ranks of the Big Five lost a further member following the demise of the Andersen firm after it was indicted and found guilty of obstruction of justice in the *Enron* case. This proud firm at one time was the largest public accounting firm, in large part due to its successful consulting practice. The firm had enjoyed a reputation for upholding the highest ethical standards but became involved in several alleged audit failures in addition to Enron. Andersen Consulting separated from Andersen in 2000, and is now known as Accenture.

### National firms

Several other public accounting firms in Australia are referred to as national firms because they have offices in most major cities. These firms perform the same services as Big Four firms and compete directly with them for clients. In addition, each is affiliated with firms in other countries and therefore has an international capability.

### Large local and regional firms

Relatively few public accounting firms have more than 50 professional staff. Some have only one office and serve clients primarily within commuting distance. Others have several offices in a State or region and service a larger radius of clients. These firms compete for clients with other public accounting firms, including international and national firms. Many of them have become affiliated with associations of public accounting firms in order to share resources for such things as technical information and continuing education.

### Small local firms

The large majority of public accounting firms have fewer than a dozen professionals in their single-office firm. They perform audits and related services primarily for smaller businesses and not-for-profit entities, although some do have one or two clients with public ownership.

## Activities of public accounting firms

Public accounting firms provide audit services and have expanded their scope of services to provide additional attestation and assurance services. Additional services that public accounting firms

commonly provide include accounting and bookkeeping services, tax services and management consulting services. Public accounting firms continue to develop new products and services, including specialities in financial planning and business valuation.

### Accounting and bookkeeping services

Many small clients with limited accounting staff rely on public accounting firms to prepare their financial statements. Some small clients lack the personnel or expertise to prepare even their own journals and ledgers. Thus, public accounting firms perform a variety of accounting and bookkeeping services (termed *write-up* work) to meet the needs of these clients. In many cases where the financial statements are to be given to a third party, a review or even an audit is also performed. Where neither of these is done, the public accountant firm writes a type of report to accompany the financial statements, called a *compilation* report, which provides no assurance to third parties.

### Tax services

Public accounting firms prepare corporate and individual tax returns for both audit clients and non-audit clients. In addition, tax planning and other aspects of tax services are provided by most public accounting firms. Tax services are now performed by almost every public accounting firm and, for many small firms, such services are far more important to their practice than auditing.

### Management consulting services

Most public accounting firms provide certain services that enable their clients to operate their businesses more effectively. These range from simple suggestions for improving the client's accounting system to aids in marketing strategies, computer installations and actuarial benefit consulting. Many large firms now have divisions involved exclusively in management advisory services, with little interaction with the audit or tax staff.

## Structure of public accounting firms

Because of their responsibility for the audit of financial statements, professionals working for public accounting firms must have a high level of *independence* and *competence*. Independence permits auditors to remain unbiased in drawing conclusions about the financial statements. Competence permits auditors to conduct the audit efficiently and effectively. Confidence in an auditor's independence and competence enables users to rely on the statements. However, the large number of public accounting firms in Australia makes it impossible for users to evaluate the independence and competence of individual firms. Consequently, an organisational structure for public accounting firms has emerged that encourages, but certainly doesn't guarantee, these qualities.

The organisational form used by public accounting firms is that of a *sole proprietorship*, *partnership* or an *incorporated company*. Under the *Corporations Act*, firms acting as auditors may form incorporated companies provided they obtain appropriate and adequate professional indemnity insurance. Only very small firms are organised as a sole proprietorship. In a typical firm organised as a partnership, several public accountants join together to practise as partners, offering auditing and other services to interested parties. The partners normally hire professional staff to assist them in their work. These assistants are, or aspire to become, public accountants.

The existence of a separate entity to perform audits encourages independence by avoiding an employee–employer relationship between public accounting firms and their clients. A separate entity also enables a public accounting firm to become sufficiently large to prevent any one client from representing a significant portion of a partner's total income and thereby endangering the firm's independence. Competence is encouraged by having a large number of professionals with related interests associated in one firm, which facilitates a professional attitude and makes continuing professional education more meaningful.

Thus, the organisational hierarchy in a typical public accounting firm includes partners, managers, supervisors, seniors or in-charge auditors and assistants, with a new employee usually starting as an assistant and spending two or three years in each classification before achieving partner status. The titles of the positions vary from firm to firm, but the structure is basically the same in all firms. When we refer in this book to the *auditor*, we mean the particular person performing some aspect of an audit. It is common to have one or more auditors from each level on larger engagements.

## OBJECTIVE 9

Describe the key functions performed by the professional accounting bodies.

## Professional accounting bodies

National professional organisations, such as CAANZ and CPA Australia, exert the most important influence on public accountants. These organisations set professional requirements for members, conduct research and publish materials on many different subjects related to accounting, auditing, management consulting services and taxes.

Membership of CAANZ is restricted to chartered accountants and currently exceeds 60 000. Approximately 38% of members are engaged in public practice. Many members formerly worked for a public accounting firm but are currently in government, industry and education.

Currently, there are more than 140 000 members of CPA Australia. However, only about 18% of members are involved in public accounting as principals or employees.

CAANZ and CPA Australia have three main functions: (1) establishing standards and rules, (2) research and publications, and (3) continuing education.

### Establishing standards and rules

Each professional organisation is empowered to set standards (guidelines) and rules that their members must follow. Standards and rules are set in two main areas:

- 1 *Professional standards.* Until 2004, CAANZ and CPA Australia jointly funded the Australian Accounting Research Foundation (AARF), which was responsible for issuing accounting and auditing standards in Australia. These standards were prepared by the Australian Accounting Standards Board (AASB) and the Auditing and Assurance Standards Board (AUASB) of the AARF, respectively. Since 2004, the AASB and the AUASB have been reconstituted as independent statutory bodies responsible for issuing standards, under the direction of the Financial Reporting Council (FRC). Australian Auditing Standards (ASAs) are discussed in the next section. CAANZ and CPA Australia jointly issue Auditing Guidance Statements and Miscellaneous Professional Statements.
- 2 *Professional conduct.* Until 2006, CAANZ and CPA Australia jointly issued rules of conduct that members were required to meet. From 1 July 2006, both these bodies adopted APES 110 *Code of Ethics for Professional Accountants*, which is mandatory for members and carries the force of law for audits conducted in accordance with the *Corporations Act*. This Code is the subject of Chapter 3.

### Research and publications

CAANZ and CPA Australia support research by their own research staff, by the AARF and through grants to others. Some of the major periodicals and other publications in accounting and auditing that are issued are listed below:

- 1 **Periodic journals**
  - › *Acuity* (CAANZ)
  - › *InTheBlack* (CPA Australia)
  - › *The Australian Accounting Review* (CPA Australia)

## 2 Other publications

- › Auditing Guidance Statements
- › Miscellaneous Professional Statements
- › Handbooks (including Member Handbooks)
- › Weekly bulletins (CAANZ)
- › Technical updates (CAANZ)
- › Newsletters (CPA Australia)

## Continuing education

The extensive and ever-changing body of knowledge in accounting, auditing, management services and taxes means public accountants need to study continuously to stay current. CAANZ and CPA Australia provide their members with a considerable number of seminars and educational aids on a wide variety of subject matters. An example is a two-day seminar, 'Auditing Superannuation Funds'.

### OBJECTIVE 10

Use auditing standards as a basis for further study.

ASA 200

ASA 300

ASA 315

ASA 500

ASA 700

ASA 705

#### auditing standards

establish mandatory requirements and provide explanatory guidance to auditors in fulfilling their professional responsibilities in the audit of financial reports

## Australian Auditing Standards

**Auditing standards** establish mandatory requirements and provide explanatory guidance to auditors in fulfilling their professional responsibilities in the audit of financial reports. On 1 July 2004, the *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9) came into effect. CLERP 9 led to amendments to the *Corporations Act*, which resulted in the reconstitution of the AUASB as a statutory body under the direction of the FRC and gave auditing standards the 'force of law' under the Act. Section 307A of the Act requires auditors to conduct audits and reviews of the financial reports prepared under Part 2M.3 of the Act, in accordance with auditing standards.

The AUASB issues Australian Auditing Standards (ASAs) and standards on review engagements, assurance engagements and related services. There are seven categories of auditing standards, which are summarised in Table 1.4.

New auditing standards are issued whenever an auditing problem arises of sufficient importance to warrant an official interpretation by the AUASB.

### Summary of Australian Auditing Standards

TABLE 1.4

<b>ASQC 1</b>	<b>QUALITY CONTROL</b>
ASQC 1	Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements
<b>ASA 100–199</b>	<b>INTRODUCTORY MATTERS</b>
ASA 101	Preamble to Australian Auditing Standards
ASA 102	Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements
<b>ASA 200–299</b>	<b>GENERAL PRINCIPLES AND RESPONSIBILITIES</b>
ASA 200	Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards
ASA 210	Agreeing the Terms of Audit Engagements
ASA 220	Quality Control for an Audit of a Financial Report and Other Historical Financial Information
ASA 230	Audit Documentation
ASA 240	The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report
ASA 250	Consideration of Laws and Regulations in an Audit of a Financial Report
ASA 260	Communication with Those Charged with Governance
ASA 265	Communicating Deficiencies in Internal Control to Those Charged with Governance and Management



### Summary of Australian Auditing Standards (cont.)

TABLE 1.4

<b>ASA 300–499</b>	<b>RISK ASSESSMENT AND RESPONSE TO ASSESSED RISKS</b>
ASA 300	Planning an Audit of a Financial Report
ASA 315	Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment
ASA 320	Materiality in Planning and Performing an Audit
ASA 330	The Auditor's Responses to Assessed Risks
ASA 402	Audit Considerations Relating to an Entity Using a Service Organisation
ASA 450	Evaluation of Misstatements Identified during the Audit
<b>ASA 500–599</b>	<b>AUDITING EVIDENCE</b>
ASA 500	Audit Evidence
ASA 501	Audit Evidence—Specific Considerations for Inventory and Segment Information
ASA 502	Audit Evidence—Specific Considerations for Litigation and Claims
ASA 505	External Confirmations
ASA 510	Initial Audit Engagements—Opening Balances
ASA 520	Analytical Procedures
ASA 530	Audit Sampling
ASA 540	Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures
ASA 550	Related Parties
ASA 560	Subsequent Events
ASA 570	Going Concern
ASA 580	Written Representations
<b>ASA 600–699</b>	<b>USING THE WORK OF OTHERS</b>
ASA 600	Special Considerations—Audits of a Group Financial Report (Including the Work of Component Auditors)
ASA 610	Using the Work of Internal Auditors
ASA 620	Using the Work of an Auditor's Expert
<b>ASA 700–799</b>	<b>AUDIT CONCLUSIONS AND REPORTING</b>
ASA 700	Forming an Opinion and Reporting on a Financial Report
ASA 705	Modifications to the Opinion in the Independent Auditor's Report
ASA 706	Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report
ASA 710	Comparative Information—Corresponding Figures and Comparative Financial Reports
ASA 720	The Auditor's Responsibilities Relating to Other Information in Documents Containing an Audited Financial Report
<b>ASA 800–899</b>	<b>SPECIALISED AREAS</b>
ASA 800	Special Considerations—Audits of Financial Reports Prepared in Accordance with Special Purpose Frameworks
ASA 805	Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement
ASA 810	Engagements to Report on Summary Financial Statements
ASRE 2410	Review of a Financial Report Performed by the Independent Auditor of the Entity

The ASAs provide less direction to auditors than might be assumed. There are almost no specific audit procedures required by the standards, and there are no specific requirements for auditors' decisions, such as determining sample size, selecting sample items from the population for testing, or evaluating results. Many practitioners believe the standards should provide more clearly defined guidelines for determining the extent of evidence to be accumulated. Such specificity would eliminate some difficult audit decisions and provide a line of defence for a public accounting firm charged with conducting an inadequate audit. However, highly specific requirements could turn auditing into mechanistic evidence gathering, devoid of

professional judgment. From the point of view of both the profession and the users of auditing services, there is probably greater harm in defining standards too specifically rather than too broadly.

Auditing standards should be looked on by practitioners as *minimum standards* of performance, rather than as maximum standards or ideals. Any professional auditor who seeks means of reducing the scope of the audit by relying only on the standards, rather than evaluating the substance of the situation, fails to satisfy the spirit of the standards. At the same time, in exceptional circumstances, the auditor may be unable to comply with a prescribed procedure contained within a relevant mandatory requirement. In such cases, the auditor is required, if possible, to perform alternative procedures and provide full documentation in audit working papers. If performing alternative procedures is not feasible, the auditor is required to consider the impact of this limitation of scope on the audit opinion. Similarly, if the issue in question is immaterial in amount, it is also unnecessary to follow the standard. It is important to note, however, that the burden of justifying departures from the standards falls on the practitioner.

When auditors desire more specific guidelines, they must turn to less authoritative sources. These include textbooks, journals and technical publications. Materials published by the professional bodies, mentioned earlier in the chapter, such as *Acuity* and industry audit guides, are particularly useful in furnishing assistance on specific questions. In the remainder of this section, we provide an overview of the main categories of the ASAs. Throughout the rest of the book, we further study the standards and make frequent reference to the ASAs.

## Introductory matters

ASA 101 defines the AUASB's intentions on how auditing standards should be understood, interpreted and applied, and should be read in conjunction with Australian Auditing Standards operative on or after 1 January 2010. ASA 101 requires auditors to apply the mandatory components of Australian Auditing Standards when conducting an audit or review in accordance with those standards. Auditing standards apply to audits of financial reports prepared in accordance with the *Corporations Act*, as well as to audits of financial reports prepared for other purposes.

Mandatory requirements are specified in the ASAs. These are basic principles and required procedures. Explanatory guidance is provided to clarify the scope and application of the mandatory requirements and may provide practical examples to assist understanding.

Each ASA contains an authority statement that links the standard to the mandating legislation.

## General principles and responsibilities

The auditing standards that deal with auditors' responsibilities specify requirements on issues such as the objectives of an audit, terms of engagement, quality control, audit documentation, consideration of fraud and communication with management.

ASA 200 deals with the objective and general principles governing an audit of a financial report. According to ASA 200, 'the objective of an audit of a financial report is to enable the auditor to express an opinion as to whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework'.\* The majority of this book deals with audits of general-purpose financial reports, prepared in accordance with Australian accounting standards. ASA 200 requires an audit to be conducted in accordance with auditing standards and requires the auditor to obtain *reasonable assurance* as to whether the financial report is free from material misstatement.

## Risk assessment and response to assessed risks

ASA 300 requires auditors to plan their audit work so that they perform the audit effectively. Planning involves 'establishing an overall audit strategy for the engagement and developing an audit plan, in

\* © Commonwealth of Australia

order to reduce audit risk to an acceptably low level'.\* Audit procedures must be selected so that auditors accumulate appropriate audit evidence to support the expression of the audit opinion. Planning also helps keep audit costs reasonable. Audit planning is discussed in detail in Chapter 6.

One of the most widely accepted concepts in the theory and practice of auditing is the ability of the client's internal control structure to generate reliable financial information. If the auditor is convinced that the client has an excellent structure, one that includes controls for providing reliable data and for safeguarding assets and records, then they require significantly less audit evidence than they would for an inadequate structure. In some instances, the controls can be so inadequate as to preclude conducting an effective audit. Auditors are required by ASA 315 to obtain an understanding of the entity and its environment, including its internal control, sufficient to identify and assess the risks of material misstatements, and to design and perform audit procedures. Internal controls are examined in Chapter 8.

## Auditing evidence

According to ASA 500, the auditor shall accumulate *sufficient appropriate audit evidence* necessary to express the audit opinion. The decision as to how much evidence to accumulate for a given set of circumstances requires professional judgment. A major portion of this book is concerned with the study of evidence accumulation and the circumstances affecting the amount needed.

## Audit conclusions and reporting

ASA 700 defines the scope and structure of the audit report on a general-purpose financial report. It specifies the obligation of auditors to report on whether the financial report is presented fairly, in all material respects, in accordance with an applicable financial reporting framework and, when appropriate, with other relevant statutory or other requirements. In Australia, the applicable financial reporting framework is Australian accounting standards. The audit report shall contain a clear written expression of opinion on the financial report taken as a whole. When an unmodified opinion is not expressed, the audit report shall state in a clear and informative manner the reasons therefore and, unless incapable of being measured reliably, a quantification thereof (ASA 705). ASA 700 and ASA 705 are discussed in Chapter 18.

# International auditing standards

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. Currently, representatives from different countries are working together on standards-setting projects to coordinate new international auditing standards.

International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). IFAC is the worldwide organisation for the accountancy profession, with 167 member organisations in 127 countries, representing more than 2.5 million accountants throughout the world. The IAASB works to improve the uniformity of auditing practices and related services throughout the world by issuing pronouncements on a variety of audit and attest functions, and promoting their acceptance worldwide. Within each country, their own regulations generally govern audit practices. These regulations may be either government statutes or statements issued by regulatory or professional bodies. ISAs don't override a country's regulations governing the audit of financial or other information. The ASAs issued by the AUASB generally conform to the related ISAs, although there are some exceptions (which are described in each ASA). If an auditor in Australia is auditing historical financial reports also in accordance with ISAs, the auditor must meet any ISA requirements that extend beyond Australian Auditing Standards.

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## Quality control

### OBJECTIVE 11

Identify quality control standards and practices within the accounting profession.

ASQC 1

ASA 220

#### quality controls

the procedures used by the public accounting firm to provide reasonable assurance that the firm complies with auditing standards, relevant ethical requirements and applicable legal and regulatory requirements, and that reports issued by the firm are appropriate

#### peer review

the review, by public accountants, of a public accounting firm's compliance with its quality control system

For a public accounting firm, quality control comprises the methods used to make sure that the firm meets its professional responsibilities to clients. These methods include the organisational structure of the public accounting firm and the procedures the firm sets up. For example, a public accounting firm might have an organisational structure that assures the technical review of every engagement by a partner who has expertise in the client's industry.

Quality control is closely related to, but distinct from, auditing standards. A system of quality control is required for each public accounting firm by ASQC 1 to provide reasonable assurance that the firm complies with auditing standards, relevant ethical requirements and applicable legal and regulatory requirements, and that reports issued by the firm are appropriate. **Quality controls** are the procedures used by the public accounting firm to help it meet these requirements consistently on every engagement. Quality controls are therefore established for the entire public accounting firm, whereas auditing standards are applicable to individual engagements.

ASA 220 requires the audit engagement team to implement quality control procedures applicable to the individual audit engagement.

### Elements of quality control

There are no specific quality control procedures for public accounting firms. Procedures should depend on such things as the size of the firm, the number of practice offices and the nature of the practice. For example, the quality control procedures of a 150-office international firm with many complex multinational clients would differ considerably from those of a five-person firm specialising in small audits in one or two industries.

ASA 220 states six mandatory elements of a system of quality control for audit engagements. These are listed in Table 1.5, with a brief description of the requirement for each element and an example of a quality control procedure a firm might use to help satisfy the requirement. In addition, APES 320 *Quality Control for Firms* provides more detailed guidance to firms.

### Peer review or quality review

**Peer review** is the review, by public accountants, of a public accounting firm's compliance with its quality control system. The purpose of peer review is to determine and report whether the public accounting firm being reviewed has developed adequate policies and procedures for the elements of quality control and follows them in practice.

Peer reviews and quality reviews can be beneficial to the profession and individual firms. By helping firms meet quality control standards, the profession gains from improved practitioner performance and higher quality audits. A firm having a peer review or quality review can also gain if it improves the firm's practice and thereby enhances its reputation and effectiveness and reduces the likelihood of legal actions. Of course, these reviews are costly. There is always a trade-off between cost and benefit.

CAANZ has implemented a Quality Review Program whereby all practices would be reviewed over time for compliance with quality control requirements. The program is intended to be educational, not disciplinary. The Quality Review Program is designed to ensure that practices understand their professional responsibilities. The objectives of the program are to help members in practice improve the quality of their work, enhance service to clients and increase returns via risk reduction and better practice policies and administration.

## Elements of quality control

TABLE 1.5

ELEMENT	SUMMARY OF REQUIREMENTS	EXAMPLE OF A PROCEDURE
Leadership responsibilities	The engagement partner shall take overall responsibility for quality on the engagement.	The engagement partner should instruct the engagement team of the importance of compliance with auditing standards and the firm's quality control policies and procedures.
Ethical requirements	The engagement partner shall consider whether the engagement team has complied with ethical requirements.	Each partner and employee must answer an 'independence questionnaire' annually, dealing with such things as share ownership and membership on boards of directors.
Client acceptance and continuance	The engagement partner shall ensure that appropriate client acceptance and continuance procedures have been followed.	A client evaluation form, dealing with such matters as predecessor auditor comments and evaluation of management, must be prepared for every new client before acceptance.
Human resources—assignment of engagement teams	The engagement partner shall ensure that the engagement team has appropriate capabilities, competence and time to perform the audit.	In assigning personnel to engagements, the staff partner should consider the client's industry, and experience, training and expertise of staff.
Engagement performance	The engagement partner shall be responsible for the direction, supervision and performance of the engagement team, and for the audit report issued.	Review and approval of audit programs by the engagement partner is required before detailed testing takes place.
Monitoring	The firm should monitor the relevance, adequacy and effectiveness of, and compliance with, its system of quality control.	The quality control partner must test compliance with the firm's quality control policies and procedures at least annually.

All practices are reviewed every five years, with practices conducting audits of publicly listed companies being reviewed every three years. The reviewee practice is required to complete a questionnaire indicating how quality control standards are being met prior to the reviewer's visit.

Interviews may be conducted with selected personnel at various levels to evaluate their understanding of compliance with the practice's quality control policies and procedures. A report is issued to the reviewee practice on completion of the review, indicating an opinion on whether or not the practice has met the standards and any deficiencies identified, with recommended action. It is expected that the reviewee practice will agree to a plan to remedy such deficiencies and that the practice will be revisited after a suitable period to assess progress. In extreme cases, disciplinary proceedings may be appropriate and cancellation of the practice's Certificate of Public Practice may be warranted. Members are required to complete an annual compliance certificate when renewing their practice certificates.

CPA Australia operates a similar Quality Review Program. This program is designed primarily as an educational service that offers long-term benefits to members, clients and the community. All members with a public practice certificate are reviewed in all areas of professional practice over a five-year cycle. To maximise the expected benefits to the reviewee, fellow members with proper accreditation conduct these reviews. Reviewees may choose their reviewer from a list provided by CPA Australia, and reviewers will sign confidentiality agreements. As with CAANZ's program, the reviewer will prepare a report. The reviewee is expected to remedy deficiencies identified, and matters are referred to the disciplinary committee only in extreme cases. Members must certify compliance with quality control standards on an annual basis. Refusal by a member to undertake a review results in the withdrawal of the member's public practice certificate.

The primary purposes of these initiatives by CAANZ and CPA Australia are to demonstrate that the professional bodies are committed to the concept of excellence through self-regulated quality control, to demonstrate to the community that quality control standards are being adhered to by practitioners, and to provide feedback and guidance to practitioners on measures that will enhance the quality of service provided to clients.

## Corporations Act 2001

### OBJECTIVE 12

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

Like other legislation affecting corporate behaviour, the main purpose of the *Corporations Act 2001* is to help ensure that corporations serve the public interest. This is accomplished by establishing appropriate corporate governance mechanisms to promote appropriate decision making by participants and managerial accountability to shareholders.

The sections of the *Corporations Act* that affect accounting and auditing are intended to ensure that adequate information is provided to shareholders to use in assessing the performance of management and the corporation overall. The *Corporations Act* requires corporations to file detailed annual reports with ASIC so that ASIC can monitor and enforce the statutory requirements. Directors must provide audited financial reports to shareholders so that they can better determine their participation in the company.

In addition to reporting requirements, the Act also deals with matters such as qualifications, appointment, removal, powers and duties of auditors. From 2004 the Act provides for the issuance of auditing standards by the Auditing and Assurance Standards Board. The Act requires the auditor to report to the shareholders on the financial reports that the directors must provide. The auditor's report is appended to the published financial report. The auditor's report includes the auditor's opinion as to whether the financial report is in accordance with the *Corporations Act*, including giving a true and fair view of the financial position and performance of the company, complying with accounting standards and the Corporations Regulations.

The accounting standards the accounts must comply with (s. 296) are those issued by the Australian Accounting Standards Board, which was established under the *Corporations Act*.

## Impact of e-commerce on public accountants

### OBJECTIVE 13

Describe the impact of e-commerce on public accountants.

#### e-commerce

the use of information technology and electronic communication networks to exchange information and conduct transactions in electronic form

Almost all businesses rely on information technology to assist in accounting for business transactions. Advances in information technologies and the expansion of the Internet continue to introduce new ways for conducting business electronically, often referred to as **e-commerce**. As these developments continue, businesses will expand their reliance on those technologies.

To help public accountants understand emerging technology issues, the AICPA Top Technology Task Force annually releases its top 10 list of technology issues, applications and emerging technologies destined to have a significant impact on business in the year ahead.

Information security has been one of the top issues for the past five years. Mobile computing is destined to significantly change how public accountants engage with their clients and other professionals and how transactions will be initiated. The AICPA top technologies for 2014 are as set out in Table 1.6.

The rapid development of new methods of conducting business and processing information affects all aspects of assurance services. Public accountants who perform audits or provide other assurance services about information generated with these emerging technologies need a basic knowledge and understanding of information technology and e-commerce. Although public accountants don't need to be experts on the detailed complexities of these systems, they need to understand how key



## AICPA top 10 technologies for 2014

TABLE 1.6

## 2014 TOP TECHNOLOGY INITIATIVES FOR BUSINESS &amp; INDUSTRY

1.	Securing the IT environment
2.	Managing and retaining data
3.	Managing IT risks and compliance
4.	Ensuring privacy
5.	Enabling decision support and analytics
6.	Managing system implementations
7.	Preventing and responding to computer fraud
8.	Governing and managing IT investment and spending
9.	Leveraging emerging technologies
10.	Managing vendors and service providers

Source: Based on American Institute of Certified Public Accountants, Top Technology Initiatives Resource Index 2014, [www.aicpa.org](http://www.aicpa.org).

technologies are transforming all aspects of business and affecting the services public accountants provide. Public accountants also need to understand how information technology in hardware, software, communications and the Internet can be used to provide assurance services. Knowledge about e-commerce technologies is necessary to identify and respond to risks in information generated by these emerging technologies.

Like all industries, public accounting firms are using the Internet to market their services. Firms of all sizes use the Internet to highlight such things as office locations or affiliations, service lines and industry specialisations, and to provide reference tools and materials to existing and potential clients. Firm websites feature news on and insights into business issues, such as updates on changes in tax laws and interactive forms to determine which type of retirement account to choose. Firm websites also feature online software tools and databases to subscribers who pay a fee. For example, Ernst & Young sells its *Accounting and Auditing Tool Kit* to subscribers through its Ernst & Young *Online* website. PricewaterhouseCoopers, LLP, through an alliance with Watchfire, offers a privacy management software tool, *WatchfireWebCPO*, which provides protection to online information.

Public accounting firms also use the Internet to connect their global professional staff. Firm personnel from around the world can contribute services to a client on a timely basis without having to be physically present at the client's location. Electronic communication among firm personnel is especially advantageous for firms that serve multinational clients with operations around the globe. For example, personnel in New York, Tokyo and London who have expertise in local regulations and business cultures can serve local clients and branches of international clients with operations in those cities, and can also communicate with engagement team personnel serving those clients in other locations.

Public accounting firms are also taking advantage of online resources and databases that can be accessed through the Internet. These resources are useful to public accountants for staying current on emerging business and standards-setting issues. Databases provide extensive industry-specific information and coverage of companies which public accountants use on a subscription basis to stay current on industry developments and to obtain industry data that is useful for auditing and consulting.

## Summary

**This chapter discusses audit and assurance services and describes the relationships among audits, attestation services and assurance services.** The market for assurance services will likely grow with increases in technology and information. Audits are valuable because they reduce information risk, which lowers the cost of obtaining capital. This chapter defines auditing, and describes different types of audits and auditors. It also discusses the nature of the public accounting profession and the activities of public

accounting firms. Because public accounting firms play an important social role, the professional accounting bodies and other organisations provide mechanisms to increase the likelihood of appropriate audit quality and professional conduct. These mechanisms are summarised in Figure 1.3. The potential for legal liability has also a significant influence on auditor conduct and is discussed in Chapter 2. The Code of Ethics for Professional Accountants provides a standard of conduct for practitioners and is discussed in Chapter 3.

### Ways in which the profession and society encourage public accountants to conduct themselves at a high level

FIGURE 1.3



## Questions and problems

### REVIEW QUESTIONS

- |             |   |
|-------------|---|
| OBJECTIVE 1 | 1.1 Explain the relationships among audit services, attestation services and assurance services, and give examples of each.   |
| OBJECTIVE 2 | 1.2 Discuss the main factors in today's society that have made the need for independent audits much greater than it was 50 years ago.                                       |
| OBJECTIVE 2 | 1.3 Distinguish among the following three risks: risk-free interest rate, business risk and information risk. Which one(s) does the auditor reduce by performing an audit?  |
| OBJECTIVE 3 | 1.4 Identify the main causes of information risk, and name the three main ways in which information risk can be reduced. What are the advantages and disadvantages of each? |

- 1.5 Explain what is meant by 'determining the degree of correspondence between information and established criteria'. What are the information and established criteria for the audit of Jones Co. Ltd's tax return by a tax auditor? What are they for the audit of Jones Co. Ltd's financial statements by a public accounting firm? OBJECTIVE 4
- 1.6 Describe the nature of the evidence the tax auditor will use in the audit of Jones Co. Ltd's tax return. OBJECTIVES 4, 7
- 1.7 In the conduct of audits of financial statements, it would be a serious breach if the auditor didn't thoroughly understand accounting. However, many competent accountants don't have an understanding of the auditing process. What causes this difference? OBJECTIVE 5
- 1.8 What are the differences and similarities between audits of financial statements, compliance audits and performance audits? OBJECTIVE 6
- 1.9 List five examples of specific performance audits that could be conducted by an internal auditor in a manufacturing company. OBJECTIVES 6, 7
- 1.10 What are the main differences in the scope of the audit responsibilities for public accountants, officers serving the Auditor-General, tax auditors and internal auditors? OBJECTIVE 7
- 1.11 What main characteristics of the organisation and conduct of public accounting firms permit them to fulfil their social function competently and independently? OBJECTIVES 8, 11
- 1.12 What roles are played by the professional accounting bodies for their members? OBJECTIVE 9
- 1.13 Distinguish between Australian Auditing Standards and Australian accounting standards, and give two examples of each. OBJECTIVE 10
- 1.14 'An audit conducted in accordance with auditing standards provides *reasonable assurance* as to whether the financial report taken as a whole is free from material misstatement.' What is meant by 'reasonable assurance'? OBJECTIVE 10
- 1.15 Australian Auditing Standards have been criticised from different sources for failing to provide useful guidelines for conducting an audit. The critics believe the standards should be more specific to enable practitioners to improve the quality of their performance. In their view, the standards, as now stated, provide little more than an excuse to conduct inadequate audits. Evaluate this criticism of Australian Auditing Standards. OBJECTIVE 10
- 1.16 What is meant by the term 'quality control' as it relates to a public accounting firm? OBJECTIVE 11
- 1.17 The following is an example of a public accounting firm's quality control procedure requirement: 'Any person being considered for employment by the firm must have completed a basic auditing course and have been interviewed and approved by an audit partner of the firm before he or she can be hired for the audit staff.' Which element of quality control does this procedure affect and what is the purpose of the requirement? OBJECTIVE 11
- 1.18 State what is meant by the term 'mandatory peer review'. What are the implications for the profession? OBJECTIVE 11
- 1.19 Describe the role of the *Corporations Act 2001* and discuss its relationship with and influence on the practice of auditing. OBJECTIVE 12
- 1.20 Explain why public accountants need to be knowledgeable about e-commerce technologies. OBJECTIVE 13

## **MULTIPLE CHOICE QUESTIONS**

- 1.21 The following questions deal with audits by public accounting firms. Choose the *best* response. OBJECTIVES 1, 2, 4
- a Which of the following statements best describes why an independent auditor is asked to express an opinion on the fair presentation of financial statements?
- (1) It is difficult to prepare financial statements that fairly present a company's financial position, operations and cash flows without the expertise of an independent auditor.
- (2) It is management's responsibility to seek available independent aid in the appraisal of the financial information shown in its financial statements.

- (3) The opinion of an independent party is needed because a company may not be objective with respect to its own financial statements.
- (4) It is a customary courtesy that all shareholders of a company receive an independent report on management's stewardship of the affairs of the business.
- b Independent auditing can best be described as:
  - (1) a branch of accounting
  - (2) a discipline that attests to the results of accounting and other functional operations and data
  - (3) a professional activity that measures and communicates financial and business data
  - (4) a regulatory function that prevents the issuance of improper financial information.
- c Which of the following professional services would be considered an attestation engagement?
  - (1) a consulting service engagement to provide information technology processing advice to a client
  - (2) an engagement to report on statutory requirements
  - (3) an income tax engagement to prepare Federal and State tax returns
  - (4) the compilation of financial statements from a client's financial records.
- d In performing an attestation engagement, a public accountant typically:
  - (1) supplies litigation support services
  - (2) assesses control risk at a low level
  - (3) expresses a conclusion about an assertion
  - (4) provides management consulting advice.

(AICPA adapted)

OBJECTIVES 6, 7

1.22 The following questions deal with types of audits and auditors. Choose the *best* response.

- a Performance audits are generally conducted by internal auditors and governmental audit agencies, but may be performed by public accountants. A primary purpose of a performance audit is to provide:
  - (1) a means of assurance that internal accounting controls are functioning as planned
  - (2) a measure of management performance in meeting organisational goals
  - (3) the results of internal examinations of financial and accounting matters to a company's senior management
  - (4) aid to the independent auditor who is conducting the audit of the financial statements.
- b In comparison with the external auditor, an internal auditor is more likely to be concerned with:
  - (1) internal administrative control
  - (2) cost accounting procedures
  - (3) performance auditing
  - (4) internal control.
- c Which of the following best describes the performance audit?
  - (1) It requires the constant review by internal auditors of the administrative controls as they relate to the operations of the company.
  - (2) It concentrates on implementing financial and accounting control in a newly organised company.
  - (3) It attempts and is designed to verify the fair presentation of a company's results of operations.
  - (4) It concentrates on seeking aspects of operations in which waste could be reduced by the introduction of controls.
- d Compliance auditing often extends beyond audits leading to the expression of opinions on the fairness of financial presentation, and includes audits of effectiveness as well as:
  - (1) accuracy
  - (2) evaluation
  - (3) adherence to specific rules or procedures
  - (4) internal control.

(AICPA adapted)

- 1.23 The following questions deal with quality controls. Choose the *best* response.
- a Inquiring of third parties as to any information regarding a prospective client and its management which may have a bearing on evaluating the prospective client is a procedure relevant to the quality control objective of:
    - (1) leadership responsibilities
    - (2) assignment of engagement teams
    - (3) client acceptance and continuance
    - (4) engagement performance.
  - b Review and testing of compliance with the firm's general quality control policies and procedures is concerned with the quality control objective of:
    - (1) assignment of engagement teams
    - (2) monitoring
    - (3) client acceptance and continuance
    - (4) engagement performance.
  - c Utilisation of standardised forms, checklists and questionnaires to assist in the performance of audits is a procedure relevant to the quality control objective of:
    - (1) ethical requirements
    - (2) engagement performance
    - (3) assignment of engagement teams
    - (4) monitoring.
  - d Having each partner and employee complete annually a questionnaire concerning ownership of shares and membership on boards of directors is a procedure relevant to the quality control objective of:
    - (1) client acceptance and continuance
    - (2) ethical requirements
    - (3) assignment of engagement teams
    - (4) engagement performance.

(AICPA adapted)

## DISCUSSION QUESTIONS AND PROBLEMS

- 1.24 The list below indicates various audit, attestation and assurance engagements involving auditors.
- 1 An auditor's report on whether the financial statements are fairly presented in accordance with accounting standards.
  - 2 An electronic seal indicating that an electronic seller observes certain practices.
  - 3 A report indicating whether a governmental entity has complied with certain government regulations.
  - 4 A report on the examination of a financial forecast.
  - 5 An evaluation of risk for investment securities.
  - 6 A review report that provides moderate assurance about whether financial statements are fairly stated in accordance with accounting standards.
  - 7 A report on compliance with a royalty agreement.
  - 8 An evaluation of the effectiveness of key measures used to assess an entity's success in achieving specific targets linked to an entity's strategic plan and vision.

OBJECTIVE 1

### REQUIRED

- a Explain, or use a diagram to indicate, the relationships among audit services, attestation services and assurance services.
- b For each of the services listed above, indicate the type of service from the list that follows:
  - (1) an audit of historical financial statements
  - (2) an attestation service other than an audit service
  - (3) an assurance service that is not an attestation service.

## OBJECTIVE 2

- 1.25 Vial-tek Ltd has an existing loan in the amount of \$1.5 million with an annual interest rate of 9.5%. The company provides an internal company-prepared financial statement to the bank under the loan agreement. Two competing banks have offered to replace Vial-tek's existing loan agreement with a new one. National Australia Bank has offered to lend Vial-tek \$1.5 million at a rate of 8.5% but would require Vial-tek to provide financial statements that have been reviewed by a public accounting firm. Westpac has offered to lend Vial-tek \$1.5 million at a rate of 7.5% but would require Vial-tek to provide financial statements that have been audited by a public accounting firm. The financial controller of Vial-tek approaches a public accounting firm and is given an estimated cost of \$12 000 to perform a review, and \$20 000 to perform an audit.

**REQUIRED**

- a Explain why the interest rate for the loan that requires a review report is lower than for the loan that doesn't require a review. Explain why the interest rate for the loan that requires an audit report is lower than the interest rate for the other two loans.
- b Calculate Vial-tek's annual costs under each loan agreement, including interest and costs for the public accounting firm's services. Indicate whether Vial-tek should keep its existing loan, accept the offer from National Australia Bank or accept the offer from Westpac.
- c Assume the National Australia Bank has offered a loan at a rate of 8.0% with a review, and the cost of the audit has increased to \$25 000 due to economic conditions. Indicate whether Vial-tek should keep its existing loan, accept the offer from National Australia Bank or accept the offer from Westpac.
- d Discuss why Vial-tek may desire to have an audit performed, ignoring the potential reduction in interest costs.

OBJECTIVES 1,  
2, 3

- 1.26 Consumers Union is a not-for-profit organisation that provides information and counsel on consumer goods and services. A major part of its function is the testing of different brands of consumer products that are purchased on the open market and then reporting the results of the tests in *Consumer Reports*, a monthly publication. Examples of the types of products it tests are motor vehicles, residential air-conditioners, canned tuna and jeans.

**REQUIRED**

- a In what ways are the services provided by Consumers Union similar to assurance services provided by public accounting firms?
- b Compare the concept of information risk introduced in this chapter with the information risk problem faced by a buyer of a motor vehicle.
- c Compare the four causes of information risk faced by users of financial statements as discussed in this chapter with those faced by a buyer of a motor vehicle.
- d Compare the three ways that users of financial statements can reduce information risk with the ways available to a buyer of a motor vehicle.

## OBJECTIVE 4

- 1.27 Fred Owens is the loan officer of the Commonwealth Bank in Newcastle. The bank has a loan of \$260 000 outstanding to Regional Delivery Service Pty Ltd, a company specialising in delivering products of all types on behalf of smaller companies. The bank's collateral on the loan consists of 35 small delivery trucks with an average original cost of \$17 000.

Owens is concerned about the collectability of the outstanding loan and whether the trucks still exist. He therefore engages Susan Virms, public accountant, to count the trucks, using registration information held by Owens. She is engaged because she is very experienced in auditing used motor vehicle and truck dealerships and has extensive specialised knowledge about used trucks. Owens requests that Virms issue a report stating the following:

- 1 which of the 35 trucks are parked in Regional's parking lot on the night of 30 June 20X1
- 2 whether all of the trucks are owned by Regional Delivery Service



- 3 the condition of each truck, using the guidelines of poor, good and excellent
- 4 the fair market value of each truck, using the current 'blue book' for trucks, which states the approximate wholesale prices of all used truck models, and also using the poor, good and excellent condition guidelines.

**REQUIRED**

- a State how the preceding narrative applies to each of the following parts of the definition of auditing:
    - (1) information
    - (2) established criteria
    - (3) accumulating and evaluating evidence
    - (4) competent, independent person
    - (5) reporting results.
  - b Identify the greatest difficulties Virms is likely to have doing this audit.
- 1.28 Five university students with majors in accounting are discussing alternative career plans. The first student plans to become a tax auditor because his primary interest is taxation. He believes the background in tax auditing will provide him with better exposure to income taxes than any other available career choice. The second student has decided to go to work for a public accounting firm for at least five years, possibly as a permanent career. She believes the variety of experience in auditing and related fields offers a better alternative than any other available choice. The third student has decided on a career in internal auditing with a large industrial company because of the many different aspects of the organisation with which internal auditors become involved. The fourth student plans to become an auditor for the State Auditor-General because she believes that this career will provide excellent experience in computer risk-assessment techniques. The fifth student plans to pursue some aspect of auditing as a career but hasn't decided on the type of organisation to enter. He is especially interested in an opportunity to continue to grow professionally, but having meaningful and interesting employment is also an important consideration.

OBJECTIVE 7

**REQUIRED**

- a What are the main advantages and disadvantages of each of the four types of auditing careers?
  - b What other types of auditing careers are available to those who are qualified?
- 1.29 In the normal course of performing their responsibilities, auditors often conduct audits or reviews of the following:
- 1 Federal income tax returns of an officer of the company to determine whether he or she has included all taxable income in the return.
  - 2 Disbursements of a branch of the Federal Government for a special research project to determine whether it would have been feasible to accomplish the same research results at a lower cost to taxpayers.
  - 3 Computer operations of a company to evaluate whether the computer centre is being operated as efficiently as possible.
  - 4 Annual statements for the use of management.
  - 5 Operations of the ATO to determine whether the tax auditors are using their time efficiently conducting audits.
  - 6 Statements for bankers and other creditors when the entity is too small to have an audit staff.
  - 7 Financial statements of an agency of the Federal Government to ensure that the statements present fairly the financial position and performance of the agency during a period of time.
  - 8 Federal income tax returns of a company to determine whether the tax laws have been followed.
  - 9 Financial statements for use by shareholders when there is an internal audit staff.
  - 10 A debenture trust deed to ensure that a company is following all the requirements of the contract.
  - 11 The computer operations of a large company to evaluate whether the internal controls are likely to prevent errors in accounting and operating data.

OBJECTIVES 6, 7

- 12 Disbursements of an agency of the Federal Government for a special research project to determine whether the expenditures were consistent with the legislation that authorised the project.

**REQUIRED**

- a For these 12 examples, state the most likely type of auditor (public accountant, officer serving the Auditor-General, tax auditor, internal auditor) to perform each.
- b In each example, state the type of audit (financial statement audit, performance audit, compliance audit).

OBJECTIVES 6, 7

- 1.30 A large conglomerate is considering acquiring a medium-sized manufacturing company in a closely related industry. A major consideration by the management of the conglomerate in deciding whether to pursue the merger is the operational efficiency of the company. Management has decided to obtain a detailed report based on an intensive investigation of the operational efficiency of the sales department, production department, and research and development department.

**REQUIRED**

- a Whom should the conglomerate engage to conduct the performance audit?
- b What major problems are the auditors likely to encounter in conducting the investigation and writing the report?

OBJECTIVE 11

- 1.31 The following comments summarise the beliefs of some practitioners about quality control and peer review.

*Quality control and peer review are quasi-governmental methods of regulating the profession. There are two effects of such regulation. First, it gives a competitive advantage to national public accounting firms because they already need formal structures to administer their complex organisations. Quality control requirements don't significantly affect their structure. Smaller firms now need a more costly organisational structure, which has proven unnecessary because of existing partner involvement on engagements. The main advantage smaller public accounting firms have traditionally had is a simple and efficient organisational structure, now that advantage has been eliminated because of quality control requirements. Second, quality control and peer review are not needed to regulate the profession. The first five elements of quality control have always existed, at least informally, for quality firms. Three things already provide sufficient assurance that informal quality control elements are followed without peer review. They are competitive pressures to do quality work, legal liability for inadequate performance and the requirement that public accounting firms follow Australian Auditing Standards.*

**REQUIRED**

- a State the pros and cons of these comments.
- b Evaluate whether quality control requirements and peer reviews are worth their cost.

OBJECTIVE 11

- 1.32 For each of the following procedures, taken from the quality control manual of a medium-sized regional public accounting firm, identify the applicable element of quality control from Table 1.5.
- a Appropriate accounting and auditing research requires adequate technical reference library facilities. Each practice office must maintain minimal facilities, including industry audit guides, to help assure an awareness of problems unique to specific industries. In addition, a more extensive library is maintained in the office of the director of accounting and auditing.
- b Each audit engagement of the firm is directed by a partner and, in most instances, a manager of the firm. On every engagement, an attempt is made to maintain continuity of at least a portion of the personnel.
- c When prospective employees are interviewed by campus recruiters and are deemed to possess the potential for employment, they will be further screened by a practice office interview pursuant to the firm's procedure for practice office visitation. Practice office partners make the final hiring decisions pursuant to the guidelines established by the director of personnel.

- d At all stages of any engagement, an effort is made to involve professional staff at appropriate levels in the accounting and auditing decisions. Various approvals of the partner, manager or senior accountant are obtained throughout the audit.
  - e No employee will have any direct or indirect financial interest, association or relationship (for example, a close relative serving a client in a decision-making capacity), not otherwise disclosed, that might be adverse to the firm's best interest.
  - f Each office of the firm shall be visited on at least an annual basis by quality review persons selected by the director of accounting and auditing. Procedures to be undertaken by the reviewers are provided in the office review program.
  - g Existing clients of the firm are reviewed on a continuing basis by the engagement partner. Termination may result if circumstances indicate there is reason to question the integrity of management or the firm's independence, or if accounting and auditing differences of opinion cannot be reconciled. Doubts concerning whether the client–auditor relationship should be continued must be promptly discussed with the director of accounting and auditing.
  - h Individual partners submit the nominations of those persons they wish to be considered for partner. To become a partner, an individual must have exhibited a high degree of technical competence, must possess integrity, motivation and judgment, and must have a desire to help the firm progress through the efficient despatch of the job responsibilities to which he or she is assigned.
  - i Through the firm's continuing employee evaluation and counselling program, and through the quality control review procedures as established by the firm, educational needs are reviewed and formal staff training programs modified to accommodate changing needs. At the conclusion of practice office reviews, apparent accounting and auditing deficiencies are summarised and reported to the firm's director of personnel.
- 1.33 Ray, the owner of a small company, asked Harris, a public accountant, to conduct an audit of the company's records. Ray told Harris that an audit was to be completed in time to submit audited financial statements to a bank as part of a loan application. Harris immediately accepted the engagement and agreed to provide an auditor's report within three weeks. Ray agreed to pay Harris a fixed fee, plus a bonus if the loan was granted.

OBJECTIVE 10

Harris hired two accounting students to conduct the audit and spent several hours telling them exactly what to do. Harris told the students not to spend time reviewing the controls but instead to concentrate on proving the mathematical accuracy of the ledger accounts and summarising the data in the accounting records that support Ray's financial statements. The students followed Harris's instructions and after two weeks gave Harris the financial statements, which didn't include footnotes. Harris reviewed the statements and prepared an unmodified auditor's report. The report didn't refer to Australian accounting standards, nor to the year-to-year application of such principles.

**REQUIRED**

Briefly describe how the action(s) of Harris resulted in a failure to comply with Australian Auditing Standards.

Organise your answer as follows:

AUDITING STANDARDS	HARRIS'S ACTIONS RESULTING IN FAILURE TO COMPLY

- 1.34 A small, but expanding, speciality home-products retailer recently implemented an Internet portal that allows customers to order merchandise online. In the first few months of operation, its Internet site attracted a large number of visitors; however, very few placed orders online. The retailer conducted several focus-group sessions with potential shoppers to identify reasons why shoppers were visiting the website without placing orders. Shoppers in the focus groups made these comments:

OBJECTIVES 1–13

- 1 'I'm nervous about doing business with this retailer because it is relatively unknown in the marketplace. How do I know the product descriptions on the website are accurate, and that the stated return policies are followed?'
- 2 'I'm reluctant to provide my credit card information online. How do I know the transmission of my personal credit card information to the retailer's website is protected?'
- 3 'Retailers are notorious for selling information about customers to others. The last thing I want to do is enter personal information online, such as my name, address, telephone number and email address. I am afraid this retailer will sell that information to third parties and then I'll be bombarded with a bunch of junk email messages!'
- 4 'Websites go down all the time due to system failures. How do I know the retailer's website will be operating when I need it?'

**REQUIRED**

- a Discuss whether this situation provides an opportunity for public accountants to address these customer concerns.
- b For each customer comment, identify the appropriate *WebTrust* principle that a *WebTrust* licensed public accountant could apply to the retailer to address the concerns noted. Choose from the following:
  - *WebTrust* Online Privacy
  - *WebTrust* Security
  - *WebTrust* Processing Integrity
  - *WebTrust* Availability
  - *WebTrust* Confidentiality
  - *WebTrust* Certification Authorities.



## Online issue

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**OBJECTIVE 11**

Visit the websites of Chartered Accountants Australia and New Zealand and CPA Australia. Search for 'quality review' and compile a report on each body's Quality Review Program, including published findings of the programs.