CHAPTER 1

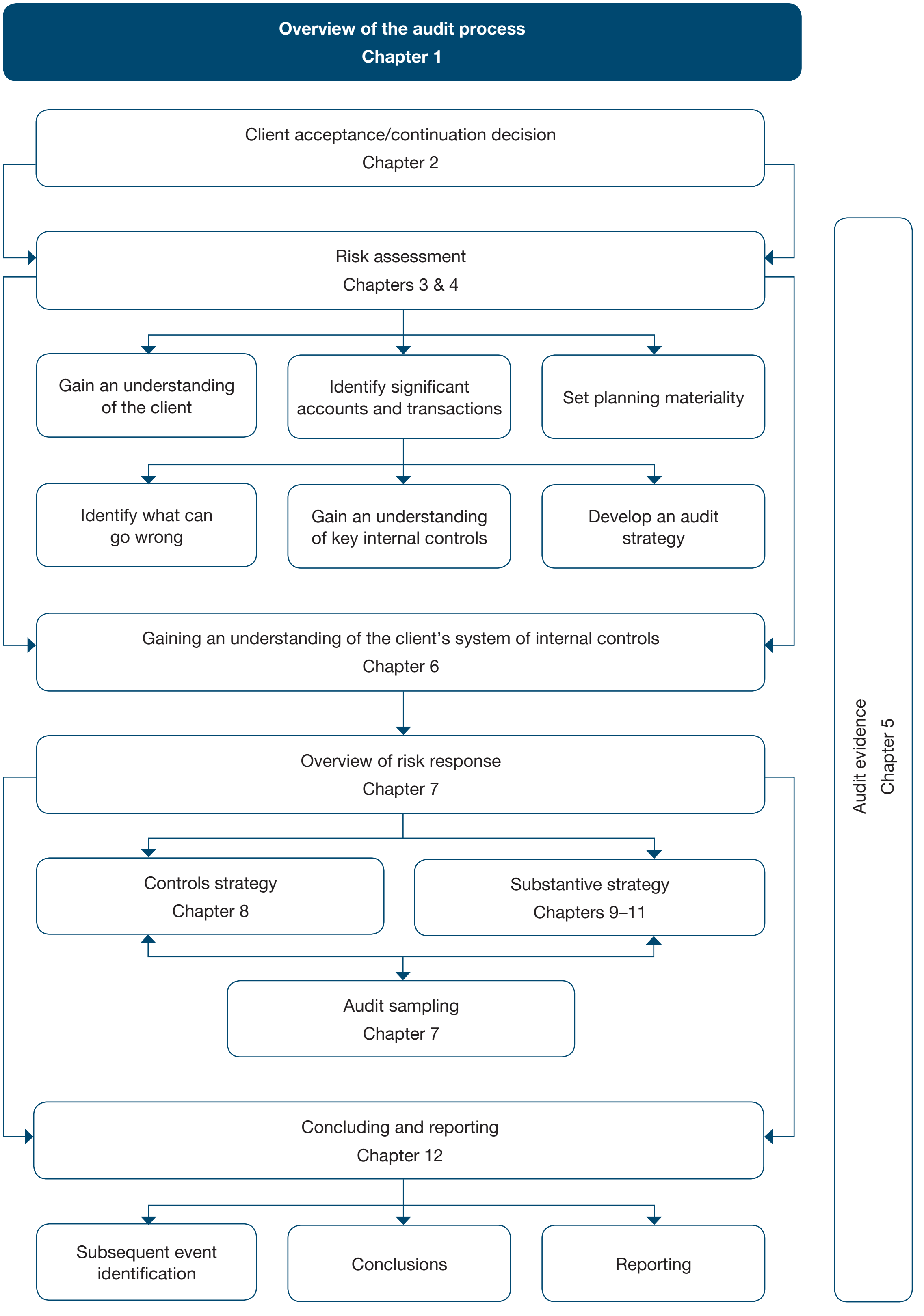
Introduction and overview of audit and assurance

LEARNING OBJECTIVES

After studying this chapter you should be able to:

1.1 describe an assurance engagement
1.2 discriminate between different types of assurance services
1.3 discriminate between different levels of assurance
1.4 categorise different audit opinions
1.5 discriminate between the different role of the preparer and the auditor, and discuss the different firms that provide assurance services
1.6 justify the demand for audit and assurance services
1.7 compare the different regulators and regulations surrounding the assurance process
1.8 categorise the audit expectation gap.

AUDITING AND ASSURANCE STANDARDS	
AUSTRALIAN	**INTERNATIONAL**
Framework for Assurance Engagements	*International Framework for Assurance Engagements*
APES 110 *Code of Ethics for Professional Accountants*	*Code of Ethics for Professional Accountants*
APES 210 *Conformity with Auditing and Assurance Standards*	
ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*	ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*
ASA 210 *Agreeing the Terms of Audit Engagements*	ISA 210 *Agreeing the Terms of Audit Engagements*
ASA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*	ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*
ASA 610 *Using the Work of Internal Auditors*	ISA 610 *Using the Work of Internal Auditors*
ASA 700 (Revised) *Forming an Opinion and Reporting on a Financial Report*	ISA 700 (Revised) *Forming an Opinion and Reporting on Financial Statements*
ASA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*	ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*
ASA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*	ISA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*
ASA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*	ISA 706 (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*
ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity*	ISRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity*
ASAE 3000 *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*	ISAE 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*
ASAE 3410 *Assurance Engagements on Greenhouse Gas Statements*	ISAE 3410 *Assurance Engagements on Greenhouse Gas Statements*
ASAE 3500 *Performance Engagements*	
ASQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements*	ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*
Regulatory Guide 230 Disclosing non-IFRS financial information	


Overview of the audit process
Chapter 1
Client acceptance/continuation decision
Chapter 2
Risk assessment
Chapters 3 & 4
Gain an understanding of the client
Identify significant accounts and transactions
Set planning materiality
Identify what can go wrong
Gain an understanding of key internal controls
Develop an audit strategy
Gaining an understanding of the client’s system of internal controls
Chapter 6
Overview of risk response
Chapter 7
Controls strategy
Chapter 8
Substantive strategy
Chapters 9–11
Audit sampling
Chapter 7
Concluding and reporting
Chapter 12
Subsequent event identification
Conclusions
Reporting
Audit evidence
Chapter 5

CLOUD 9

This text is designed to provide students with the opportunity to learn about auditing by using a practical, problem-based approach. Each chapter begins with some information about an audit client — Cloud 9 Pty Ltd (Cloud 9). The chapter then provides the underlying concepts and background information needed to deal with this client's situation and the problems facing its auditor. As students work through the chapters, they gradually build up their knowledge of auditing by studying how the contents of each chapter are applied to Cloud 9. The end-of-chapter exercises and problems also provide students with the opportunity to study other aspects of Cloud 9's audit, in addition to applying the knowledge gained in the chapter to other practical examples.

Cloud 9 Inc., a listed company in the United States (US), is looking to expand. McLellan's Shoes was seen as a potential target.

In 1980, Ron McLellan starts a business in Sydney manufacturing and retailing customised basketball shoes. Ron calls his business McLellan's Shoes. Ron borrows from the bank to start the business, using his house as security, and over the years he works very hard to establish a profitable niche in the highly competitive sport shoe market. Ron is able to repay the bank in 1993, just before the recession. As he watches interest rates soar above 20 per cent, he vows to never borrow again.

As the business grows, Ron's wife and three adult children start to work for him, with responsibility for administration, marketing and sales, production and distribution. By the early 1990s, Ron's business employs 20 people full time, most of whom work in production. There are also several casual employees and part-time staff in the retail outlet, particularly during busy periods.

In February 1995, Ron receives a call from Chip Masters, the senior vice-president of Cloud 9 Inc. Chip expresses an interest in buying McLellan's Shoes. Ron is getting tired, and his children are starting to fight amongst themselves about who is going to take over from their father. Ron has had enough, but he does not want Chip to know that. He asks if Chip is ready to talk about the price. Chip said he is, but first he needs to see the audited financial reports for McLellan's Shoes.

Ron asks for some time. He tells Chip that he needs to talk to his family and will get back to him. When Ron puts the phone down he immediately rings his friend from the golf club, Ernie Black, who is a chartered accountant. For years, Ernie has been quietly suggesting to Ron that his business affairs need attention. Ron is good at making deals and working hard, but he has never bothered with sophisticated financial arrangements. He is still running his business as a sole trader (not a company), and his wife does all the tax returns. Ron is in a panic — he wants to sell McLellan's Shoes, but what is he going to do about Chip's request for audited financial reports?

Audit process in focus

The purpose of this chapter is to provide an overview of audit and assurance services. While the focus of this text is the audit of financial reports, in this chapter we define assurance engagements and differentiate between different types of assurance engagements. The assurance engagements explained in this chapter include financial report audits, compliance audits, performance audits, comprehensive audits, internal audits and assurance of corporate social responsibility disclosures. We also provide an overview of the different levels of assurance that can be provided when conducting assurance procedures. The levels of assurance discussed in this chapter include reasonable, limited and no assurance engagements.

Next we provide a brief overview of the different audit reports that an auditor can issue after completing their audit. Auditors can issue either an unmodified or a modified audit report. Four modifications to an audit report are: the inclusion of an emphasis of matter paragraph, a qualified opinion, an adverse opinion or a disclaimer of opinion. These concepts are explained further in this chapter.

The roles of the financial report preparer and auditor are explained and contrasted. An overview is then provided of the different firms that provide assurance services. That section contains details of both accounting and consulting firms and the different services that they provide. The factors that explain why there is a demand for audit and assurance services are then described before an overview is provided of assurance regulators and their regulations. The audit expectation gap is explained in the last section of this chapter.

1.1 Auditing and assurance defined

LEARNING OBJECTIVE 1.1 Describe an assurance engagement.

CLOUD 9

Chip Masters has asked Ron McLellan for audited financial reports of McLellan's Shoes. Ron has never had an audit and is not sure what it involves. He has heard about tax audits, environmental audits, efficiency audits, as well as financial report audits. Are they all the same thing? Ernie explains to Ron that there are several services that people call 'audits' that are different to financial report audits. However, all these services, including financial report audits, can be defined as assurance engagements.

An **assurance engagement** (or service) is defined as 'an engagement in which an assurance practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria' (*Framework for Assurance Engagements*, para. 10; *International Framework for Assurance Engagements*, para. 7).

An assurance practitioner may be, for example, an auditor working in public practice providing assurance on financial reports of publicly listed companies or a consultant providing assurance about environmental disclosures. Intended users are the people for whom the assurance provider prepares their report (for example, the shareholders). The responsible party is the person or organisation (for example, a company) responsible for the preparation of the subject matter (for example, the financial reports). While the audit of a company's financial reports is the most common assurance engagement and the focus of much of this text, it is not the only type of assurance. The next section of this chapter provides a description of different types of assurance services.

BEFORE YOU GO ON

- What are two examples of assurance providers?
- What might an assurance provider express a conclusion about?
- What is a responsible party?

1.2 Different assurance services

LEARNING OBJECTIVE 1.2 Discriminate between different types of assurance services.

In this section we provide an overview of the different types of assurance services that an assurance practitioner can provide. The most common types of assurance engagements are financial report audits, compliance audits, performance audits, comprehensive audits, internal audits and assurance on corporate social responsibility (CSR) disclosures. Each will now be explained in turn.

1.2.1 Financial report audits

According to ASA 200 (ISA 200) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, the objective of a **financial report audit** is for the auditor to express an opinion about whether the financial report is prepared in all material respects in accordance with a financial reporting framework (ASA 200, para. 11; ISA 200, para. 11). Within an Australian context, this means that the financial report has been prepared in accordance with Australian Accounting Standards and interpretations and any relevant legislation such as the *Corporations Act 2001*. Where a fair presentation framework is applicable, which is generally the case for financial reports, the opinion required by the Australian Auditing Standards is on whether the financial report is presented fairly, in all material respects, or gives a true and fair view (ASA 200, para. A13; ISA 200, para. A13).

CLOUD 9

Ron is not running a company; he operates his customised basketball shoe business as a sole trader. He is aware that big companies have to be audited, but because he is not affected by the Corporations Act he does not believe that he has to have an audit. Ernie agrees that Ron does not have to follow the same rules, but also tells him that Australian Auditing Standards apply to an audit of a financial report for any purpose. This means that although all the attention is usually on companies, sole traders can have their financial reports audited too.

A financial report and a directors' report must be prepared annually by disclosing entities, public companies, large proprietary companies and registered schemes (s. 292 of the Corporations Act). Under sections 295(4)(c) and 295A of the Act, directors of the reporting entity must declare whether the reporting entity will be able to pay its debts as and when they become due, whether the financial records have been properly maintained, whether the financial report and notes comply with Australian Accounting Standards including interpretations, and whether the financial report and notes give a **true and fair view** (this concept is discussed in more detail in section 1.5 of this chapter). A true and fair view refers to the consistent and faithful application of accounting standards in accordance with the financial reporting framework when preparing the financial report (ASA 200, para. 13; ISA 200, para.13). Australian companies must prepare their financial report in compliance with accounting standards (s. 296 of the Corporations Act). If compliance with accounting standards does not give a true and fair view, a company should provide additional information in the notes to the financial report (s. 295(3)(c) of the Corporations Act). Regulatory Guide 230 (ASIC, 2011) provides information for company directors and financial report preparers regarding the disclosure of information other than in accordance with accounting standards. Section 301 of the Act requires that the financial report be audited. It is part of the auditor's responsibility to form an opinion on the truth and fairness of the financial report. In fulfilling their role, the auditor must be independent of the company they audit, exercise due professional care, and comply with Auditing and Assurance Standards (APES 210, para. 1.2).

CLOUD 9

Ron believes that his business has good, reliable financial records. Ron's wife helps him keep tight control of the cash and other assets, and together they prepare some simple reports on a regular basis. Ron believes he knows exactly what is happening in the business and monitors the business's cash flow and profit very closely. However, he has not prepared financial reports that comply with Australian Accounting Standards. Is this a problem? Ernie explains to Ron that some businesses must apply the accounting standards, even if they are not companies. It all depends on whether it is reasonable to expect the existence of users dependent on the reports for information that will be useful to them in making and evaluating decisions about the allocation of scarce resources (Statement of Accounting Concepts 1 (SAC1) *Definition of the Reporting Entity*, para. 40). Ron is a bit worried now — how does he know if he has these 'users'?

Limitations of an audit

A financial report audit is conducted to enhance the reliability and credibility of the information included in a financial report. Yet it is not a guarantee that the financial report is free from error or fraud.

The limitations of an audit stem from the nature of financial reporting, the nature of audit procedures and the need for the audit to be conducted within a reasonable period of time and at a reasonable cost (ASA 200, ISA 200).

The nature of financial reporting refers to the use of judgement when preparing financial reports due to the subjectivity required when arriving at accounting estimates. Judgement is also required when selecting and applying accounting methods.

The nature of audit procedures refers to the reliance on evidence provided by the client and its management. If an auditor does not have access to all the information relevant to the audit there is a limitation in the scope of their audit. If the auditor is unaware of this situation, they may arrive at an inappropriate conclusion based on incomplete facts. Evidence may be withheld or modified by perpetrators of fraud. It can be difficult for an auditor to determine whether a fraud has occurred and documents altered as those committing a fraud generally hide evidence. Sampling is used when testing transactions and account balances. If a sample is not representative of all items available for testing, an auditor may arrive at an invalid conclusion.

The timeliness and cost of a financial report audit refers to the pressure an auditor faces to complete their audit within a certain time frame at a reasonable cost. While it is important that an auditor does not omit procedures in an effort to meet time and cost constraints, they may be under some pressure to do so. This pressure will come from clients wanting to issue their financial reports by a certain date, from clients refusing to pay additional fees for additional audit effort, and from within the audit firm where there are pressures to complete all audits on a timely basis to avoid incurring costs that may not be recovered. By taking the time to plan the audit properly, an auditor can ensure that adequate time is spent where the risks of a significant error or fraud are greatest.

1.2.2 Compliance audits

A **compliance audit** involves gathering evidence to ascertain whether the person or entity under review has followed the rules, policies, procedures, laws and regulations with which they must conform. There are a number of examples of compliance audits. A tax audit is used to determine whether an individual or company has completed their tax return in accordance with the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*. Within an organisation, management may specify that certain processes be followed when completing a function. For example, a company may have policies and procedures for the hiring of new staff. In that case the organisation's internal auditors may be called upon to check whether employees are following the specified processes appropriately.

1.2.3 Performance audits

Performance audits are concerned with the economy, efficiency and effectiveness of an organisation's activities (ASAE 3500 *Performance Engagements*, para. 12). Economy refers to the cost of inputs, including wages and materials. Efficiency refers to the relationship between inputs and outputs. Specifically, efficiency refers to the use of the minimum amount of inputs to achieve a given output. Finally, effectiveness refers to the achievement of certain goals or the production of a certain level of outputs. From an organisation's perspective it is important to perform well across all three dimensions and not allow one to dominate. For example, if buying cheap inputs results in an inefficient production process, efficiency may be seen to be sacrificed to achieve economic goals.

Performance audits are generally conducted by an organisation's internal auditors or they may be outsourced to an external audit firm. Performance audits are sometimes referred to as value for money audits, operational audits or efficiency audits.

1.2.4 Comprehensive audits

A **comprehensive audit** may encompass elements of a financial report audit, a compliance audit and a performance audit. For example, an auditor may report on whether an entity has met its efficiency targets. Comprehensive audits most commonly occur in the public sector where compliance with various regulations is examined when completing a financial report audit.

1.2.5 Internal audits

Internal audits are conducted to provide assurance about various aspects of an organisation's activities. The internal audit function is typically conducted by employees of the organisation being audited, but can be outsourced to an external audit firm. As such, the function of internal audit is determined by **those charged with governance** and management within the organisation. While the functions of internal audits vary widely from one organisation to another, they are often concerned with evaluating and improving risk management, internal control procedures and elements of the governance process. The internal audit function often conducts performance audits, compliance audits, internal control assessments and reviews. Many internal auditors are members of the Institute of Internal Auditors (IIA). The IIA is an international organisation, with more than 180 000 members, that provides guidance and standards to aid internal auditors in their work. When conducting the financial report audit, the external auditor will consider and often rely on the work done by the internal auditors (ASA 610 (ISA 610) *Using the Work of Internal Auditors*).

1.2.6 Corporate social responsibility (CSR) assurance

Corporate social responsibility (CSR) reporting is voluntary and is becoming more widespread (see section 1.6.4 of this chapter for a discussion of the demand for assurance in a voluntary setting). CSR disclosures include environmental, employee and social reporting. Some organisations choose to have their CSR disclosures assured by an independent assurance provider. The assurance of CSR disclosures is currently carried out by either auditors or specialist **consulting firms**. As these disclosures include non-financial as well as financial information, the skill set required to conduct these assurance services is quite broad. Whether a company chooses to provide additional voluntary environmental disclosures or not, an auditor must consider the impact of environmental issues on their clients' financial report when conducting the financial report audit.

ASAE 3000 (ISAE 3000) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* provides some guidance for auditors when assuring CSR and similar reports. ASAE 3000 (ISAE 3000) provides guidance on the client acceptance decision, quality control, the role of professional scepticism and professional judgement, planning and performing the assurance engagement, steps in evidence gathering, and forming an opinion based on conclusions drawn from the evidence gathered. An example of an assurance report relating to a CSR report is provided in figure 1.1.

CLOUD 9

Ron is not concerned about internal audits — his business is too small for a separate internal audit function. He is also not worried about CSR reporting or compliance and performance audits. His priority at the moment is to close the deal with Chip Masters, and he still does not know what he has to do about the audit.

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Independent Limited Assurance Report in relation to Telstra Group's 2014 Corporate Responsibility Reporting

To the Management and Directors of Telstra Group

We have carried out a limited assurance engagement in order to state whether anything has come to our attention to suggest that the agreed environmental, human resource and community data as reported in the Telstra Group's ('Telstra') 2014 Annual Report and Bigger Picture Sustainability Report (collectively referred to as 'the Report') has not been presented in accordance with the criteria listed below.

Subject Matter

The Subject Matter for our limited assurance engagement for the year ending 30 June 2014 is the 31 metrics and related performance disclosures included in the Report (refer to Attachment A for a list of the 31 metrics) and an assessment of Telstra's sustainability materiality assessment process.

Criteria

The following Criteria have been applied to the Subject Matter described above:

- The principle of materiality in the context of the Global Reporting Initiative ('GRI') framework
- *National Greenhouse and Energy Reporting Act 2007*
- *National Greenhouse and Energy Reporting Regulations 2008*
- *National Greenhouse and Energy (Measurement) Determination 2008*, including the *National Greenhouse and Energy Reporting (Measurement) Amendment Determination 2013 (No. 1)* (the 'Measurement Determination')
- National Greenhouse Accounts Factors, July 2013 for scope 1, 2 and 3 greenhouse gas emissions (the 'NGA Factors')
- UK Department for Environment Food and Rural Affairs (DEFRA) – 2013 greenhouse gas conversion factors for company reporting
- Telstra's reported criteria as detailed in the Glossary document at www.telstra.com/sustainability/report for:
    - Certain scope 3 greenhouse gas emissions
    - Carbon emissions intensity (CO_2-e/TB)
    - Network related emissions
    - Energy and emission savings
    - Air travel
    - Waste recycled
    - MobileMuster (mobility device recycling)
    - Paper consumption
    - Water consumption
    - Sensis – Yellow and White Pages metrics
    - Human resources and community metrics

The Responsibility of Management

The management of Telstra is responsible for the preparation and presentation of the Subject Matter in the Report in accordance with the above Criteria, and is also responsible for the selection of methods included in the Criteria. No conclusion is expressed as to whether the selected methods used are appropriate for the purpose described above. Further, Telstra's management is responsible for establishing and maintaining internal controls relevant to the preparation and presentation of the Subject Matter that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate criteria; maintaining adequate records and making estimates that are reasonable in the circumstances.

FIGURE 1.1 Example of an assurance report

FIGURE 1.1 (*continued*)

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Assurance Practitioner's Responsibility

Our responsibility is to express a limited assurance conclusion on the Subject Matter based on our assurance engagement in accordance with the Criteria. We conducted our limited assurance engagement in accordance with:

- *National Greenhouse and Energy Reporting (Audit) Determination 2009*
- *ISAE 3000 International Standards on Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*
- *ASAE 3410 Assurance Engagements on Greenhouse Gas Statements*
- *The terms of reference for this engagement as agreed with Telstra*

Our procedures were designed to obtain a limited level of assurance on which to base our conclusion and, as such, do not provide all the evidence that would be required to provide a reasonable level of assurance. The procedures performed depend on the assurance practitioner's judgement including the risk of material misstatement of the Subject Matter, whether due to fraud or error. While we considered the effectiveness of management's internal controls when determining the nature and extent of our procedures, our assurance engagement was not designed to provide assurance on internal controls.

We believe that the evidence we have obtained is sufficient and appropriate to provide a basis for our limited assurance conclusions.

Work Performed

Our assurance procedures included, but were not limited to:

- Gaining an understanding of the environmental, human resource and community reporting processes supporting the business activities
- Conducting site visits at three sample sites to identify material sources of energy and diesel consumption, and sources of greenhouse gas emissions, and understand the basis for measurement and preparation of the metrics and the Report
- Conducting interviews and collation of evidence to understand processes and controls supporting the data
- Checking that methodologies have been correctly applied as per the Measurement Determination, NGA Factors and methodologies outlined in the Glossary document at www.telstra.com/sustainability/report
- Undertaking analytical procedures to support the reasonableness of the data and disclosures
- Identifying and testing assumptions supporting the calculations
- Testing on a limited sample basis documentation supporting calculations to underlying source information
- Testing on a limited sample basis the effectiveness of the controls performed by Telstra
- Checking the appropriateness of the presentation of the information in the Report
- Checking Telstra's self-assessment of its sustainability material issues against GRI's principle of materiality

Use of our Report

Our limited assurance report has been prepared for distribution to the management and directors of Telstra. We disclaim any assumption of responsibility for any reliance on this assurance statement or on the Subject Matter to which it relates, to any person other than management and directors of Telstra, or for any purpose other than that for which it was prepared.

Independence, Competence and Experience

In conducting our assurance engagement we have met the independence requirements of the APES 110 Code of Ethics for Professional Accountants. We have the required competencies and experience to conduct this assurance engagement.

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Limitations

The Subject Matter of our work did not include any comparisons made against FY13 human resource and community data.

Matters Relating to Electronic Presentation of Information

Our limited assurance engagement included web-based information that was available via web links as of the date of this statement. We provide no assurance over changes to the content of this web-based information after the date of this assurance statement.

Conclusion

Based on our limited assurance procedures, nothing has come to our attention that causes us to believe that the Subject Matter as detailed above, and as presented in the Report is not presented fairly, in all material respects, in accordance with the Criteria as presented above.

Ernst & Young

Ernst & Young
Melbourne, Australia
12 August 2014

FIGURE 1.1 *(continued)*

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Attachment A

List of metrics assured as part of our limited assurance engagement:

Area	Metric
Environment	Total carbon emissions (scope 1, scope 2 and scope 3) (tCO_2-e)
	Emissions by source (tCO_2-e)
	Total energy use – stationary and transport (GJ)
	Stationary and transport energy by source (%)
	Emissions intensity (tCO_2-e/TB)
	Network related emissions (percentage of total emissions)
	Annualised emissions savings resulting from project initiatives in FY14 (tCO_2-e/year)
	Annualised network energy savings resulting from project initiatives (GJ)
	Annualised commercial energy savings resulting from project initiatives (GJ)
	Air travel (km)
	Total waste (t)
	Mobile Muster contribution (t)
	Total paper consumption (t)
	Water consumption (kL)
	Directory paper use for Yellow and White pages (t)
	Directory paper use for Yellow Pages in the Car (t)
	Cumulative customer opt-outs of Yellow and White Page directories (#)
	National directory recycling and reuse rate (%)
	Paper properties (grade and recycle content)
Human resource	Number of employees by geographic locations (%) (Telstra Group)
	Number of employees by age (%) (Telstra Corporation)
	Number of employees by employment level (%) (Telstra Corporation)
	Number of employees by type (%) (Telstra Corporation)
	Number of Telstra employees by contract type and coverage over bargaining agreements (%) (Telstra Corporation)
	Representation of women by employment level (# and %) (Telstra Corporation)
Community	Employee volunteering days on Telstra time (days)
	Employee matched payroll giving participation rates (%) and dollars donated ($)
	Number of pre-paid mobile phone recharge cards distributed and dollar value of program (# and $)
	Number of rebates provided on Telstra bills to financial hardship customers and dollar value of program (# and $)
	Number of people receiving discounts via our pensioner discount program and dollar value of program (# and $)
	Dollar value of our InContact program ($)

PROFESSIONAL ENVIRONMENT

Assurance engagements on carbon emissions information

Many companies now present CSR information in their annual reports or in separate corporate sustainability reports. In some cases, the reports include information about carbon emissions. However, the reporting and assurance of these reports is voluntary and largely unregulated, raising concerns about the quality of the information. One of these concerns is that the information being provided in CSR reports is not sufficiently reliable, particularly with respect to carbon emissions data.

The IAASB added a project to its agenda in February 2008 to develop a new International Standard on Assurance Engagements (ISAE) for assurance engagements on carbon emissions information. The rationale for the project is related to the growth in carbon trading, or emissions trading, schemes around the world, and the need for reliable information and a global approach for their efficient and effective operation. In addition, a new standard will likely be of assistance to financial statement auditors when considering the carrying value of emission trading rights in a financial statement audit.[1] Steps along the way to a new standard included: participant roundtables; the publication of an Issues Paper; and the establishment of the IAASB Emissions Task Force to develop a preliminary working draft of an ISAE. After the March 2012 meeting, the IAASB approved ISAE 3410 *Assurance Engagements on Greenhouse Gas Statements*. The new standard is effective for assurance reports covering periods ending on or after 30 September 2013. The equivalent Australian Standard (ASAE 3410) is effective for assurance periods commencing on or after 1 January 2015.

One of the most significant issues in the development of ISAE 3410 was the need to deal with both limited assurance and reasonable assurance greenhouse gas (GHG) engagements. The IAASB concluded that an explicit risk assessment of the engagement was required to determine which audit procedures are appropriate. Unlike in financial statement audits, the standard does not mandate certain types of procedures (such as inquiry and analytical procedures) as the primary means of obtaining evidence. This requirement recognises that GHG information is not capable of being subject to the rigor of a double entry bookkeeping system and is susceptible to different risks than historical financial information. In addition, the nature of assurance engagements on GHG statements can vary greatly. Auditing carbon emissions information creates new challenges for auditors and has the potential to change what it means to be an 'auditor' in the twenty-first century.

BEFORE YOU GO ON

- What are the three elements of a performance audit?
- What is the objective of a financial report audit?
- What are the most common functions of the internal audit function?

1.3 Different levels of assurance

LEARNING OBJECTIVE 1.3 Discriminate between different levels of assurance.

In this section we describe the different levels of assurance that a practitioner can provide when conducting assurance procedures. An assurance practitioner can provide reasonable assurance, limited assurance or no assurance. When providing reasonable and limited assurance, the practitioner's report is addressed to the party requesting assurance (for example, a company's shareholders). When an assurance practitioner performs a non-assurance engagement, a report on their findings is sent to the responsible party (that is, the organisation that prepared the information under consideration). The differences between reasonable, limited and no assurance are now explained.

1.3.1 Reasonable assurance

The objective of a **reasonable assurance** engagement is to gather sufficient evidence upon which to form a positive expression of an opinion regarding the truth and fairness of the information being assured. This means that the auditor has done adequate work to report with reasonable certainty that the information being assured is, or is not, reliable (ASA 200, para. 5; ISA 200, para. 5). This means that the auditor will conduct detailed testing of a client's control procedures and/or transactions and accounts to satisfy themselves that the information being assured is fairly presented. For example, an auditor is in the position to say whether in their opinion a financial report is in accordance with relevant law and accounting standards, and gives a true and fair view of the financial position of the reporting entity. Auditors can make such a positive statement only if they are reasonably sure that the evidence gathered is sufficient. The audit of a company's financial report is one example of a reasonable assurance engagement. ASA 700 (ISA 700) (Revised) *Forming an Opinion and Reporting on a Financial Report* provides guidance on the form and elements of the audit report.

The audit opinion will depend upon the auditor's findings while conducting the audit. A brief overview of the different opinions that an auditor may form when conducting a financial report audit are provided in the next section of this chapter. Reasonable assurance is the highest level of assurance provided; it is high but not absolute assurance.

Following public consultations in 2011, 2012 and 2013 the International Auditing and Assurance Standards Board (IAASB) decided to change the format of the audit report. The intention was to increase confidence in the audit and financial reports. The IAASB have indicated that the new format will increase the transparency and informational value of the audit, enhancing auditor communication with investors, increasing management attention to the disclosures in the financial reports referred to in the audit report and renewing the auditor focus with a view to enhancing professional scepticism.

The Auditing and Assurance Standards Board (AUASB) have adopted the new audit report format, and issued new auditing standards in 2015. Changes include moving the opinion section from the end of the report to the beginning of the report, the inclusion of a 'Key audit matters' section, where auditors communicate issues that were important in the current audit, and enhanced disclosures around the auditor's responsibilities when conducting the audit. According to ASA 701, key audit matters include areas of higher assessed risk of material misstatement, areas that involve significant judgement where there is high uncertainty around estimations and the effect of significant events on the audit (para. 9). The new audit report format is to be used for audits of financial reports for periods ending on or after 15 December 2016. An example of an audit report in the new format is provided in figure 1.2.

PROFESSIONAL ENVIRONMENT

Enhancing the value of auditor reporting

Are audit reports 'wholly uninformative'? The UK Financial Reporting Council believes that audit reports are an uninformative result of an opaque audit process.[2] The IAASB also believes that the 'current audit report provides little information about the procedures performed and the judgments exercised by the auditor in forming an audit opinion'.[3]

In May 2011, the IAASB released a consultation paper, 'Enhancing the value of auditor reporting: exploring options for change'. The consultation paper was an early step in a larger project investigating ways to increase the communication value of the standard audit report during a time of changing financial reporting regimes in several countries around the world. The final part of the project is a revised set of standards on audit reporting. The changes in financial reporting are, in part, a response to the global financial crisis in the first decade of the twenty-first century. Auditors generally survived the crisis without serious accusations of blame, but there were questions raised about the existing audit framework. Other significant publications in this period relating to the future role of audit include the European Commission (EC) green paper on audit policy issued in October 2010, and the International Organization of Securities Commissions (IOSCO) consultation report in September 2009 on audit communications.[4]

The IAASB believes that the 'expectation gap' is really an 'information gap'. The audit report system is like a traffic light system. The audit report either says 'go' or 'stop' (if there is an audit qualification), but does not provide an insight into the company's governance structures, financial health or risks within the company.[5] Audit firms, such as Grant Thornton, agree changes are necessary. However, although Grant Thornton agrees that 'auditors should provide better communication to investors' and that there should be more transparency about how audit opinions are reached, they believe that the company's audit committee should be responsible for enhanced reporting on the oversight of the financial reporting process and the external audit.[6]

The UK FRC agrees that audit committees have a vital role to play. A key recommendation in the FRC's proposals is that audit committees should make fuller reports to explain how they discharged their responsibilities for the integrity of the annual report and other duties.[7] Auditors will be wary of any change to their responsibilities that allows directors to retreat from theirs. The appropriate sharing of responsibilities between the auditors and company management for better financial and audit reporting is part of the process leading towards a revised set of audit reporting standards.

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Audit of the Financial Report

Opinion

We have audited the financial report of ABC Company Ltd. (the Company), which comprises the statement of financial position as at 30 June 20X1, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial report, including a summary of significant accounting policies, and the directors' declaration.
In our opinion:
the accompanying financial report of ABC Company Ltd, is in accordance with the *Corporations Act 2001*, including:

(a) giving a true and fair view of the company's financial position as at 30 June 20X1 and of its performance for the year ended on that date; and

(b) complying with Australian Accounting Standards and the *Corporations Regulations 2001*.

Basis for Opinion

We conducted our audit in accordance with Australian Auditing Standards. Our responsibilities under those standards are further described in the *Auditor's Responsibilities for the Audit of the Financial Report* section of our report. We are independent of the Company in accordance with the Corporations Act and the ethical requirements of the Accounting Professional and Ethical Standards Board's APES 110 *Code of Ethics for Professional Accountants* (the Code) that are relevant to our audit of the financial report in Australia. We have also fulfilled our other ethical responsibilities in accordance with the Code.
We confirm that the independence declaration required by the Corporations Act, which has been given to the directors of ABC Company Ltd, would be in the same terms if given to the directors as at the time of this auditor's report.
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the financial report of the current period. These matters were addressed in the context of our audit of the financial report as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[*Description of each key audit matter in accordance with ASA 701*]

Other Information

The directors are responsible for the other information. The other information comprises the information in the Company's annual report for the year ended 30 June 20X1, but does not include the financial report and the auditor's report thereon.
Our opinion on the financial report does not cover the other information and we do not express any form of assurance conclusion thereon.
In connection with our audit of the financial report, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the financial report or our knowledge obtained in the audit or otherwise appears to be materially misstated. If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Directors' Responsibilities for the Financial Report

The directors of the Company are responsible for the preparation of the financial report that gives a true and fair view in accordance with Australian Accounting Standards and the Corporations Act and for such internal control as the directors determine is necessary to enable the preparation of the financial report that gives a true and fair view and is free from material misstatement, whether due to fraud or error.
In preparing the financial report, the directors are responsible for assessing the Company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the directors either intend to liquidate the Company or to cease operations, or have no realistic alternative but to do so.

Auditor's Responsibilities for the Audit of the Financial Report

Our objectives are to obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with the Australian Auditing Standards will always detect a material misstatement when it exists. Misstatements can arise from fraud or

FIGURE 1.2 Example of an audit report in the new format

FIGURE 1.2 (*continued*)

error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of this financial report.

Report on the Remuneration Report

We have audited the Remuneration Report included in [paragraphs a to b or pages x to y] of the directors' report for the year ended 30 June 20X1. The directors of the Company are responsible for the preparation and presentation of the Remuneration Report in accordance with section 300A of the Corporations Act. Our responsibility is to express an opinion on the Remuneration Report, based on our audit conducted in accordance with Australian Auditing Standards.

Opinion on the Remuneration Report

In our opinion, the Remuneration Report of ABC Company Ltd., for the year [period] ended 30 June 20X1, complies with section 300A of the Corporations Act.
[*Auditor's name and signature*]

[*Date of the auditor's report*]

[*Auditor's address*]

Source: Auditing and Assurance Standards Board 2015, ASA 700 (Revised) *Forming an Opinion and Reporting on a Financial Report,* Appendix.

1.3.2 Limited assurance

The objective of a **limited assurance** engagement is to gather sufficient evidence upon which to form a negative expression of an opinion regarding the reliability of the information being assured. This means that the auditor has done adequate work to report whether or not anything came to their attention that would lead them to believe that the information being assured is *not* true and fair. The auditor will not conduct detailed testing when undertaking a limited assurance engagement and so they are not in a position to say that in their opinion the financial report *is* in accordance with the relevant law and accounting standards, and/or *does* give a true and fair view of the financial position and performance of the reporting entity. The auditor is only able to say that nothing makes them believe otherwise. To make a negative statement, auditors do not need to be *as* sure about the evidence as they must be to make a positive statement.

The review of a company's half-year financial report is an example of a limited assurance engagement (**review engagement**). ASRE 2410 (ISRE 2410) *Review of a Financial Report Performed by the Independent Auditor of the Entity* provides guidance on the form and elements of the review report. An example of a review report is provided in figure 1.3. The review report highlights the responsibilities of the directors for the preparation and fair presentation of the half-year report and the responsibility of the auditor to comply with ASRE 2410 when conducting their review. An explanation is provided of the procedures used in conducting the review. The report confirms the independence of the audit firm from their client. Finally, the review report includes the conclusion (opinion) of the auditor that they were not aware of any matter that made them believe that the half-year report was not true and fair (negative assurance).

In conducting a review an auditor will obtain an understanding of the entity under review including its internal controls; identify potential material misstatements where effort should be concentrated; and conduct analytical procedures, enquiries of entity personnel and other tasks to aid in the formulation of their opinion. The work done when conducting a review is a subset of the work done when conducting an audit. Specifically, an auditor will make enquiries of key personnel, apply analytical procedures and observe client staff. That is why an auditor can provide only limited (moderate) assurance after completing a review.

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Report on the Half-Year Financial Report

We have reviewed the accompanying half-year financial report of Telstra Corporation Limited, which comprises the statement of financial position as at 31 December 2014, the income statement, statement of comprehensive income, statement of changes in equity and statement of cash flows for the half-year ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the directors' declaration of the consolidated entity comprising the company and the entities it controlled at the half-year end or from time to time during the half-year.

Directors' Responsibility for the Half-Year Financial Report

The directors of the company are responsible for the preparation of the half-year financial report that gives a true and fair view in accordance with Australian Accounting Standards and the *Corporations Act 2001* and for such internal controls as the directors determine are necessary to enable the preparation of the half-year financial report that is free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express a conclusion on the half-year financial report based on our review. We conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity*, in order to state whether, on the basis of the procedures described, we have become aware of any matter that makes us believe that the financial report is not in accordance with the *Corporations Act 2001* including: giving a true and fair view of the consolidated entity's financial position as at 31 December 2014 and its performance for the half-year ended on that date; and complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*. As the auditor of Telstra Corporation Limited and the entities it controlled during the half-year, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of a half-year financial report consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

Independence

In conducting our review, we have complied with the independence requirements of the *Corporations Act 2001*. We have given to the directors of the company a written Auditor's Independence Declaration, a copy of which is included in the Directors' Report.

Conclusion

Based on our review, which is not an audit, we have not become aware of any matter that makes us believe that the half-year financial report of Telstra Corporation Limited is not in accordance with the *Corporations Act 2001*, including:

(a) giving a true and fair view of the consolidated entity's financial position as at 31 December 2014 and of its performance for the half-year ended on that date; and

(b) complying with Accounting Standard AASB 134 *Interim Financial Reporting* and the *Corporations Regulations 2001*.

Ernst & Young

SJ Ferguson
Partner
Sydney, Australia
12 February 2015

FIGURE 1.3 Example of a review report

Source: Telstra, Financial results for the half-year ended 31 December 2014, p. 40.

1.3.3 No assurance

An assurance provider may perform other services for clients for which no assurance is provided. In such circumstances an assurance provider must ensure when reporting their findings that they make clear that they are merely reporting the facts of their findings and are not providing assurance (*Framework for Assurance Engagements*, paras 20–21; *International Framework for Assurance Engagements,* paras 15–16). An example of an engagement where **no assurance** is provided is an **agreed upon procedures engagement** where an auditor completes a set of tasks requested by their client and reports on their findings to the client. The client, not the auditor, determines the nature, timing and extent of evidence gathered, and draws their own conclusions based upon the outcomes of the work conducted by the auditor. As no conclusion is arrived at by the auditor, no assurance is provided by the auditor. An example of an agreed upon procedures report is provided in figure 1.4.

CLOUD 9

As Ernie explains the differences between reasonable and limited assurance, Ron wonders if Chip will accept a review, rather than an audit, of the financial reports. If he will, it will be much easier and cheaper for Ron. However, Ron also realises that Chip would not get as much assurance from a review as he would get from an audit. Ron thinks Chip would know the difference between an audit and a review; because he asked for an audit Chip must need the additional assurance it provides.

BEFORE YOU GO ON

- What are the main differences between reasonable and limited assurance engagements?
- What is the level of assurance required for an annual financial report?
- What does negative assurance mean?

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REPORT OF FACTUAL FINDINGS

To Directors, Fishpond Airways Pty Ltd

Report of Factual Findings

We have performed the procedures agreed with you to report factual findings for the purpose of assisting you in assessing, in combination with other information obtained by you, the accuracy of accounts payable as at 30 July 2015. The procedures performed are detailed in the terms of the engagement of 2 August 2015 and described below with respect to the accounts payable of Fishpond Airways Pty Ltd as of 30 July 2015.

Management's Responsibility for the Procedures Agreed

Management are responsible for the adequacy or otherwise of the procedures agreed to be performed by us. You are responsible for determining whether the factual findings provided by us, in combination with any other information obtained, provide a reasonable basis for any conclusions which you or other intended users wish to draw on the subject matter.

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Assurance Practitioner's Responsibility
Our responsibility is to report factual findings obtained from conducting the procedures agreed. We conducted the engagement in accordance with Standard on Related Services ASRS 4400 *Agreed-Upon Procedures Engagements to Report Factual Findings*.

Because the agreed-upon procedures do not constitute either a reasonable or limited assurance engagement in accordance with Standards issued by the Auditing and Assurance Standards Board, we do not express any conclusion and provide no assurance on the accounts payable of Fishpond Airways Pty Ltd as of 30 July 2015. Had we performed additional procedures or had we performed an audit or a review of the accounts payable in accordance with Standards issued by the Auditing and Assurance Standards Board, other matters might have come to our attention that would have been reported to you.

Independence
We have complied with ethical requirements equivalent to those applicable to Other Assurance Engagements, including independence.

Factual Findings

The procedures were performed solely to assist you in evaluating the accuracy of the accounts payable. The procedures performed and the factual findings obtained are as follows:

Procedures Performed	Factual Findings	Errors or Exceptions Identified
1. We obtained and checked the addition of the trial balance of accounts payable as at 30 July 2015 prepared by Fishpond Airways Pty Ltd, and we compared the total to the balance in the related general ledger account.	We found the addition to be correct and the total amount to be in agreement.	None
2. We compared the attached schedule provided by Fishpond Airways Pty Ltd of major suppliers and the amounts owing at 30 July 2015 to each of the related names and amounts in the trial balance.	We found the amounts compared to be in agreement, except for the exception noted.	The amount included in the trial balance as owing to Hancy Aeronautical Parts Pty Ltd was $107,894. The amount included in the attached schedule as owing to Hancy Aeronautical Parts Pty Ltd was $57,894.
3. For 7 suppliers haphazardly selected from the attached schedule we obtained suppliers' statements or requested suppliers to confirm balances owing at 30 July 2015.	We found there were suppliers' statements for all such suppliers.	None

FIGURE 1.4 Example of an agreed upon procedures report

FIGURE 1.4 (*continued*)

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4. We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from Fishpond Airways Pty Ltd. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and payments, each of which was greater than $10,000. We agreed outstanding invoices over $10,000 for suppliers selected to accounts payable for the subsequent period, invoices subsequently received and either credit notes or payment made.	We found the amounts agreed, or with respect to amounts which did not agree, we found Fishpond Airways Pty Ltd had prepared reconciliations and that the credit notes, invoices and payments over $10,000 as agreed to reconciling items.	None

Restriction on Distribution and Use of Report

This report is intended solely for the use of Fishpond Airways Pty Ltd for the purpose set out above. As the intended user of our report, it is for you to assess both the procedures and our factual findings to determine whether they provide, in combination with any other information you have obtained, a reasonable basis for any conclusions which you wish to draw on the subject matter. As required by ASRS 4400 *Agreed-Upon Procedures Engagements to Report Factual Findings* , distribution of this report is restricted to those parties that have agreed the procedures to be performed with us and other intended users identified in the terms of the engagement (since others, unaware of the reasons for the procedures, may misinterpret the results).

Our report may be relied upon by Fishpond Airways Pty Ltd for the purpose set out above only pursuant to the terms of our engagement letter dated 2 August 2015.

We disclaim all responsibility to any other party for any loss or liability that the other party may suffer or incur arising from or relating to or in any way connected with the contents of our report, the provision of our report to the other party or the reliance upon our report by the other party.

EY

EY
Melbourne

23 September 2015

Source: EY 2015.

1.4 Different audit opinions

LEARNING OBJECTIVE 1.4 Categorise different audit opinions.

Chapter 12 contains a detailed discussion of the different types of audit opinion at which an auditor can arrive when completing their audit. The purpose of this section is to present a very brief overview of those opinions to show where we are heading.

The most common audit report includes an **unmodified opinion**. This type of opinion is arrived at when the auditor believes that the financial report is true and fair, it presents fairly the financial position of the company, and the information provided is in accordance with Australian Accounting Standards and interpretations and the Corporations Act.

An audit report may be modified with the inclusion of an 'emphasis of matter' paragraph (ASA 706 (ISA 706) (Revised) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*). An emphasis of matter paragraph does not affect the auditor's opinion that the financial report is true and fair. It draws the attention of the reader to an issue that the auditor believes has been adequately and accurately explained in a note to the financial report. The purpose of the emphasis of matter paragraph is to ensure that the reader pays appropriate attention to the issue when reading the financial report.

Finally, an audit report may be **modified** with a qualified, adverse or disclaimer opinion (ASA 705 (ISA 705) (Revised) *Modifications to the Opinion in the Independent Auditor's Report*). These types of modifications do affect the auditor's opinion. A **qualified opinion** is issued when the auditor believes that 'except for' the effects of a matter that is explained in the audit report, the financial report can be relied upon by the reader. A qualified opinion is used when the matter of concern can be identified, quantified and explained in the audit report. In this case the matter of concern is material but not pervasive to the financial report. In this context 'pervasive' refers to misstatements that are not confined to individual accounts or elements of a financial report, or, if confined, the misstatements affect an extensive portion of a financial report or are disclosures that are vital to a user's understanding of the financial report. More serious matters require an adverse opinion or disclaimer of opinion. An adverse opinion is appropriate if the auditor has evidence that identified misstatements, individually or in aggregate, are material and pervasive to the financial report. A disclaimer of opinion is used when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and concludes that the possible effects on the financial report could be material and pervasive. Although these opinions are used in different circumstances, in both instances the matter or matters of concern are so material and pervasive to the financial report that the auditor cannot issue a qualified, 'except for' opinion.

The different audit opinions are illustrated in table 1.1.

TABLE 1.1 **Different audit opinions**

Nature of matter giving rise to the modification	Auditor's judgement about the pervasiveness of the effects or possible effects on the financial report	
	Material but not pervasive	**Material and pervasive**
The financial report is materially misstated	Qualified opinion	Adverse opinion
Inability to obtain sufficient appropriate audit evidence	Qualified opinion	Disclaimer of opinion

Source: Auditing and Assurance Standards Board 2015, ASA 705 (Revised) *Modifications to the Opinion in the Independent Auditor's Report*, para A1.

CLOUD 9

Ron worries that an auditor might not be able to give an unmodified opinion on his business's financial reports. The whole point of getting an audit would be to give Chip sufficient assurance that the financial reports give a true and fair view of his business's financial position and performance, and thus agree to pay a good price for the business. If the auditor gives a disclaimer of opinion or an adverse opinion, Chip could either change his mind about the business, or offer only a very low price because he can't be sure that the business is as profitable and as solvent as Ron claims. Even getting a qualified opinion would be serious. Ernie assures Ron that disclaimers are extremely rare; in fact, he has never seen one. Adverse opinions are also rare, and if Ron's belief about his good financial records and tight control over assets is well founded, then there should not be any major problems.

BEFORE YOU GO ON

- When will an unmodified opinion be issued?
- What are the different types of modified audit opinions?
- What is the purpose of an emphasis of matter paragraph?

1.5 Preparers and auditors

LEARNING OBJECTIVE 1.5 Discriminate between the different role of the preparer and the auditor, and discuss the different firms that provide assurance services.

In this section we explain and contrast the different responsibilities of financial report preparers and auditors. We provide details of the role that each group plays in ensuring that the financial report is an accurate representation of the company in question. Following this discussion is an overview of the different firms that provide assurance services.

A financial report includes the balance sheet (statement of financial position), income statement (statement of comprehensive income), statement of cash flows, statement of changes in equity and accompanying notes. It is the responsibility of those charged with governance (generally the board of directors and management of an entity) to prepare the financial report. They must ensure that the information included in the financial report is true and fair and complies with Australian Accounting Standards and interpretations and the Corporations Act. According to paragraph A2 of ASA 200 (ISA 200), it is the responsibility of those charged with governance to identify the financial reporting framework to be used in the preparation and presentation of their financial report, establish and maintain internal controls that are effective in preventing and detecting material misstatements finding their way into the financial report, selecting and applying appropriate accounting policies and making reasonable accounting estimates.

1.5.1 Preparer responsibility

It is the responsibility of those charged with governance to ensure that the information contained in their financial report is relevant, reliable, comparable, understandable and true and fair. Each of these concepts is now discussed.

Relevant

The information included in the financial report should be relevant to the users of that report. Information is relevant if it has an impact on the decisions made by users regarding the performance of the entity. Users require information that helps them evaluate past, present and future events relating to the entity. They are interested in evaluating past decisions made by management and predicting whether the entity will remain viable (that is, a going concern) into the future. Users can use current information to estimate future share price movements, likely dividend payments and the ability of the entity to meet its immediate obligations.

Reliable

The information included in the financial report should be reliable to the users of that report. Information is reliable when it is free from material misstatements (errors or fraud). If users perceive that the information presented is unreliable, for whatever reason, the financial report cannot be used to make the types of decisions outlined above. The information must be unbiased; it must not be presented in such a way as to influence the decision-making process of the user. An independent audit of the financial report is one method of improving the reliability of the financial report.

Comparable

The information included in the financial report should be comparable through time. Users need to be able to trace an entity's performance to identify any trends that may influence their perception of how well the entity is doing. Users also need to be able to benchmark the performance of the entity against other similar organisations to assess its relative performance. To enable such comparisons, information must be presented consistently across time and across entities. Any changes in accounting policies must be clearly disclosed so that appropriate adjustments can be made. Consistent application of Australian Accounting Standards by all entities over time aids these comparisons.

Understandable

The information included in the financial report should be understandable. Users need to understand the information presented in order to make appropriate decisions. The notes to the financial report are used to provide additional details to aid in the interpretation of the accounting information provided. The details included in the notes must be phrased in such a way as to impartially inform users to aid their decision making.

True and fair

The information included in the financial report should be true and fair. 'Truth and fairness' or 'presented fairly' refers to the consistent and faithful application of accounting standards or an applicable framework when preparing the financial report.

It is the responsibility of the auditor to form an opinion on the truth and fairness or fair presentation of the financial report. In doing so, the auditor will assess the accounting policies selected by those charged with governance of the entity. Specifically, the auditor will evaluate whether those accounting policies are consistent with the financial reporting framework used by the entity. The auditor will also consider the accounting estimates made by those charged with governance and management to determine whether the estimates are reasonable. The auditor will assess the relevance, reliability, comparability and understandability of the information presented in the financial report.

1.5.2 Auditor responsibility

When undertaking an audit, the auditor should use professional scepticism, professional judgement and due care. Each of these concepts is now defined and explained.

Professional scepticism

Professional scepticism is an attitude adopted by the auditor when conducting the audit. It means that the auditor remains independent of the entity, its management and its staff when completing the audit work. In a practical sense, it means that the auditor maintains a questioning mind and thoroughly investigates all evidence presented by their client. The auditor must seek independent evidence to corroborate information provided by their client; they must be suspicious when evidence contradicts documents held by their client or enquiries made of client personnel (including management and those charged with governance).

Professional judgement

Professional judgement relates to the level of expertise, knowledge and training that an auditor uses while conducting an audit. An auditor must utilise their judgement throughout the audit. For example, an auditor must determine the reliability of an information source, and decide on the sufficiency and appropriateness of evidence gathered, the procedures to be used in testing and an appropriate sample size.

Due care

Due care refers to being diligent while conducting an audit, applying technical and statute-backed standards, and documenting each stage in the audit process.

1.5.3 Assurance providers

Assurance services are provided by accounting and other consulting firms. The largest accounting firms in Australia are known collectively as the 'Big-4' or the first-tier. The firms that comprise the Big-4 are Deloitte, EY, KPMG and PwC. These four firms operate internationally and dominate the assurance market throughout the world. The first-tier once comprised eight firms, but after a series of mergers and the collapse of Arthur Andersen, the Big-8 became the Big-4. These four firms dominate the audits of Australia's largest companies.

The next tier of accounting firms is known as the mid-tier or second-tier. The firms that comprise the mid-tier have a significant presence nationally and most have international affiliations. The firms that make up the mid-tier in Australia include, among others, Crowe Horwath, BDO, PKF Australia, Grant Thornton, Pitcher Partners, Moore Stephens, Nexia and RSM Bird Cameron. These firms service medium-sized and smaller clients.

The next tier of accounting firms is made up of regional and local accounting firms. These firms service clients in their local areas and range in size from single-partner firms to several-partner firms with professionally qualified and trained staff.

All of these accounting firms provide non-assurance (or non-audit) services as well as assurance (or audit) services. These non-assurance services include management consulting, mergers and acquisitions, insolvency, tax and accounting services. The *Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004* (CLERP 9) specifies a number of requirements when an accounting firm provides non-audit services to their audit clients. These rules were established to increase the transparency of the extent of services being provided by an accounting firm to their audit clients following the collapse of several high-profile companies including Enron (in the United States) and HIH (in Australia). The collapse of Arthur Andersen (previously a first-tier accounting firm) raised concerns that the provision of non-audit services to an audit client may affect the independence and objectivity of the auditor.

A company's annual report (which contains their financial report) includes the directors' report. CLERP 9 requires that the directors' report must include a section headed 'non-audit services' or similar. That section must include:

- details of the amount paid or payable to the company's auditor for non-audit services (each non-audit service must be listed separately along with the amount paid or payable for that service)
- a statement of whether the directors are satisfied that the provision of non-audit services by the auditor does not affect the auditor's independence
- if the directors are satisfied that auditor independence has not been impacted by the provision of non-audit services, a statement of the directors' reasons for being satisfied.

Accounting firms are not the only providers of assurance services. A number of consulting firms provide assurance services primarily of corporate social responsibility disclosures, including some combination of environmental disclosures, carbon emissions, community engagement, charitable activities and employee welfare. Consulting firms employ staff with a variety of expertise including, for example, engineers, accountants, sociologists, scientists and economists.

CLOUD 9

Ernie stresses to Ron that any financial reports prepared for McLellan's Shoes are Ron's responsibility, even if they are audited. The auditor has to be sceptical about the claims made by Ron in the financial reports. These claims include, for example, that the assets shown on the balance sheet exist and are valued correctly, and that the balance sheet contains a complete list of the business's liabilities. In other words, the auditor is not just going to believe whatever Ron tells them. Auditors must gather evidence about the financial reports before they can give an audit opinion. Ernie also explains to Ron that because his business is relatively small, he has a choice between large and small audit firms. Very large companies must choose a Big-4 auditor because often the other auditors are too small to do the work and still maintain their independence. If a small audit firm audits a large company it is open to the criticism that it will not be sufficiently sceptical because it does not want to lose the fees from that client. A large audit firm has many other clients, so the fees from any one client are a relatively small part of its revenue. Ron likes the idea that the smaller audit firms are generally less expensive.

BEFORE YOU GO ON

- A financial report must be relevant and reliable. What do these terms mean in this context?
- What three characteristics should an auditor have when conducting an audit?
- What are non-audit services?

1.6 Demand for audit and assurance services

LEARNING OBJECTIVE 1.6 Justify the demand for audit and assurance services.

In this section we will firstly provide an overview of the key financial report users and their requirements. This is followed by a description of why these users may demand an audit of the financial report. Three theoretical frameworks that have been used to encapsulate these sources of demand are next described. Finally, the demand for assurance services in a voluntary setting is explored.

1.6.1 Financial report users

Financial report users include current and potential investors (shareholders if the entity is a company), suppliers, customers, lenders, employees, governments and the general public. Each of these groups will read the financial report for a slightly different reason. Each group of users and their reasons for reading a company's financial report is described below.

Investors

Investors generally read a financial report to determine whether they should invest in, or buy, hold or sell shares in the case of a company, the entity being reported on. They are interested in the return on their investment and are concerned that the entity will remain a going concern into the foreseeable future. Investors may also be interested in the capacity of the entity to pay a dividend. Prospective investors read financial reports to determine whether they should buy shares in the entity.

Suppliers

Suppliers may read a financial report to determine whether the entity can pay them for goods supplied. They are also interested in whether the entity is likely to remain a going concern (that is, is likely to continue to be a customer of the supplier), and continue to be able to pay its debts as and when they fall due.

Customers

Customers may read a financial report to determine whether the entity is likely to remain a going concern if the customer relies on the entity for their business.

Lenders

Lenders may read a financial report to determine whether the entity can pay the interest and principal on their loans as and when they fall due.

Employees

Employees may read a financial report to determine whether the entity can pay their wages or salaries and other entitlements (for example, holiday pay). They may also be interested in assessing the future stability and profitability of the entity, as this affects their job security.

Governments

Governments may read a financial report to determine whether the entity is complying with regulations, is paying a fair amount of taxation given its reported earnings and to gain a better understanding of the entity's activities. An entity in receipt of government grants may provide a copy of their financial report when applying for a grant and when reporting on how grant funds have been spent.

The general public

The general public may read a financial report to determine whether they should associate with the entity (for example, as a future employee, customer or supplier), and to gain a better understanding of the entity, what it does and its plans for the future.

1.6.2 Sources of demand for audit and assurance services

Financial report users and their needs, as outlined in the previous section, are many and varied. There are a number of reasons why some or all of these users would demand an audit of a financial report. These include remoteness, complexity, competing incentives and reliability. Each of these concepts is now explained.

Remoteness

Most financial report users do not have access to the entity under review. This makes it difficult to determine whether the information contained in the report is a fair presentation of the entity and its activities for the relevant period.

Complexity

Most financial report users do not have the accounting and legal knowledge to enable them to assess the reasonableness of complex accounting and disclosure choices being made by the entity.

Competing incentives

Management has an incentive to disclose the information contained in the financial report in a way that helps them achieve their own objectives; for example, to present their performance in the best possible light. Users may find it difficult to identify when management is presenting biased information.

Reliability

Financial report users are concerned with the reliability of the information contained in the financial report. As they use that information to make decisions that have real consequences (financial and otherwise, such as assessing the future viability of the company) it is very important that users are able to rely on the facts contained in the financial report.

An independent third-party review of the information contained in the financial report by a team of auditors, who have the knowledge and expertise to assess the truth and fairness of the information being presented by the preparers, aids users across all of these issues. Auditors have access to entity records, so they are not remote. They are trained accountants and so have detailed knowledge about the complex technical accounting and disclosure issues required to assess the choices made by the financial report preparers. Independent auditors have no incentives to aid the entity in presenting their results in the best possible light. They are concerned with ensuring that the information contained in the financial report is reliable and free from any significant (material) misstatements (error or fraud).

CLOUD 9

Ron tells Ernie that he has no remote users, such as shareholders or lenders, and his business is not very complex. He is the owner and the manager of McLellan's Shoes and therefore has no competing incentives. For all these reasons, he has never felt the need to purchase an audit to assure users of the reliability of his business's financial information. Ernie agrees, but points out that there is now a user who is very interested in the reliability of the financial information — Chip Masters.

1.6.3 Theoretical frameworks

The reasons for demanding audit and assurance services outlined in the previous section have led to the development of three theoretical frameworks that have been used to explain why audits occurred prior to regulations requiring that they be done, why users may demand an audit from a certain type of firm (for example, a first-tier or an industry specialist firm) and why users may demand assurance of voluntarily disclosed information (for example, environmental reports). The three theories are agency theory, the information hypothesis and the insurance hypothesis. Each is described in turn.

Agency theory

When an individual is an owner-manager of their own business there are no competing incentives. The owner (principal) and manager (agent) are one. When an owner hires a manager to run the business on their behalf, potential conflicts arise. The manager has an incentive to provide favourable results. If there is one owner, they can more easily monitor the activities of their manager. When there are several owners (such as shareholders of a large company) it is difficult for the owners to monitor the activities of the management. Agency theory tells us that due to the remoteness of the owners from the entity, the complexity of items included in the financial report and competing incentives between the owners and managers, the owners (principals) have an incentive to hire an auditor (incur a monitoring cost) to assess the truth and fairness of the information contained in the financial report prepared by their managers (agents). Managers also have an incentive to hire an auditor to demonstrate to their shareholders that they have prepared true and fair financial reports free of fraud and error.

Information hypothesis

Financial report users require access to high-quality information to make a variety of decisions. That information is used to determine whether to hold or sell shares in the entity, whether to lend money to the entity, what rate of interest to charge the entity on money lent and so on. The greater the perceived quality of the information contained in the financial report, the more likely it is relied upon by the users of that information. The information hypothesis tells us that due to the demand for reliable, high-quality information, various user groups including shareholders, banks and other lenders will demand that financial reports be audited to aid their decision making.

Insurance hypothesis

Investors take on a risk when buying shares. If the entity fails, investors could lose the money invested. According to the insurance hypothesis, an audit is one way for investors to insure against at least part of their loss should the company they invest in fail. As auditors are required to take out professional indemnity insurance policies they are seen as having 'deep pockets' (that is, access to money), should an investor be able to prove that audit negligence was to blame, at least in part, for their loss. The insurance hypothesis tells us that investors will demand that financial reports be audited as a way of insuring against some of their loss should their investment fail. In chapter 2, we discuss the legal liability of the auditor and provide details of cases where investors have sued auditors seeking compensation after they have suffered a loss.

CLOUD 9

Cloud 9 is considering buying McLellan's Shoes from Ron. In effect, it is considering investing in the business. If the business fails, the shareholders of Cloud 9 will lose their money. The new investors have competing incentives to Ron. If Ron purchases an audit, he is providing assurance to the potential new investors about the truth and fairness of the financial reports. The audit also increases the perceived reliability of the information in the financial reports. For example, the outsiders know that Ron will have to convince an auditor of the appropriateness of the reporting decisions he is making.

Purchasing an audit is also a way of taking insurance against any possible loss by creating the opportunity for investors to recover their investment from the auditor. In reality, the auditor is not guaranteeing the success of the business, only providing reasonable assurance that the financial report complies with the relevant laws and standards and gives a true and fair view of the business's financial position and performance. There is little chance of a successful legal action against an auditor unless it can be established that the auditor failed to perform to a reasonable standard.

1.6.4 Demand in a voluntary setting

While the main focus of this text is the audit of company financial reports, assurance providers (including auditors and consultants) provide other assurance services (as outlined in section 1.2). The theories outlined above are now being used to understand more about the demand for assurance of CSR disclosures including environmental, sustainability and carbon emissions reports.

It is becoming more common for companies to voluntarily disclose CSR information in their annual reports, on their websites and in separate stand-alone reports. This trend of increased disclosures has been in response to stakeholder (shareholder, lender, employee, customer, supplier and public) demand that companies be more accountable for their impact on the environment and on society. Stakeholders are concerned about more than just profits and returns on shareholder funds. They want to know what impact companies are having on our environment and what actions are being taken by those companies to reduce that impact.

Stakeholders are concerned about the reliability of environmental and other CSR disclosures. Just as the provision of these disclosures is voluntary, so is the assurance. Companies are not required to have their environmental and other CSR disclosures assured. Yet, a number of companies do. Assurance is provided to meet user demands for high-quality, reliable information, and to also demonstrate a high level of corporate responsibility.

BEFORE YOU GO ON

- Who are the main users of company financial reports?
- Why might financial report users demand an audit?
- What are the three most common theories used to explain the origins of the demand for audit and assurance services?

1.7 The role of regulators and regulations

LEARNING OBJECTIVE 1.7 Compare the different regulators and regulations surrounding the assurance process.

In this section we discuss the regulators and regulations that affect the audit process.

1.7.1 Regulators

A number of regulators have an impact on the audit process, either directly or indirectly. They include the Financial Reporting Council (FRC), the Auditing and Assurance Standards Board (AUASB), the Accounting Professional and Ethical Standards Board (APESB), the Australian Securities and Investments Commission (ASIC), the Australian Securities Exchange (ASX), the Companies Auditors and Liquidators Disciplinary Board (CALDB), Chartered Accountants Australia and New Zealand (CAANZ), CPA Australia and the Institute of Public Accountants (IPA). Each regulator will now be discussed in turn.

Financial Reporting Council (FRC)

The FRC is a statutory body. Its activities are determined by the *Australian Securities and Investments Commission (ASIC) Act 2001* amended by the CLERP Act. The FRC oversees the process used for setting accounting standards (by the Australian Accounting Standards Board (AASB)) and auditing standards (by the AUASB). The FRC also monitors and reports regularly on matters concerning auditor independence. To ensure standard-setter independence, the ASIC Act specifically prohibits the FRC from becoming involved in technical issues around the standard-setting process.

Auditing and Assurance Standards Board (AUASB)

In accordance with section 336 of the Corporations Act, the AUASB is responsible for the formulation of auditing and assurance standards. Auditing standards include mandatory requirements, which are legally enforceable under the Corporations Act. Members of the AUASB are appointed by the FRC. The chair of the board is appointed by the Minister for Superannuation and Corporate Law. The AUASB significantly revised and redrafted the Australian Auditing Standards (ASAs) to bring them in line with International Standards on Auditing (ISAs), which are issued by the International Auditing and Assurance Standards Board (IAASB). The IAASB undertook a redrafting of the ISAs, placing them in a 'clarity' format to improve the consistent application of International Auditing Standards worldwide. As well as issuing ASAs, the AUASB is responsible for issuing Auditing Standards on Review Engagements (ASREs), Standards on Assurance Engagements (ASAEs) and Guidance Statements (GSs).

Accounting Professional and Ethical Standards Board (APESB)

The APESB was established in 2006 by CPA Australia and the Institute of Chartered Accountants (now CAANZ). The Institute of Public Accountants (IPA) is now also a member of the APESB. The APESB was established as an independent body to issue professional and ethical standards and to actively advocate the professional and ethical behaviour of accountants. Accountants who are members of the professional accounting bodies (CAANZ, CPA Australia and the IPA) are required as a condition of their membership to comply with the ethical and professional standards approved by the APESB. APES 110 *Code of Ethics for Professional Accountants* and other APESB professional standards and guidance notes are binding on all members of the professional accounting bodies. Broadly, these standards aim to regulate members' ethical conduct and the performance of professional services across various types of professional and business engagements. The APESB follows pronouncements issued by the International Ethics Standards Board for Accountants (IESBA) as a base for its proposed professional and ethical standards, and in doing so seeks to maintain conformity of its standards with those of the IESBA. As ASA 210 (ISA 210) *Agreeing the Terms of Audit Engagements* requires compliance with ethical standards, they too are legally enforceable under the Corporations Act.

Australian Securities and Investments Commission (ASIC)

ASIC is an independent Commonwealth Government body. ASIC was established by the ASIC Act. ASIC administers the ASIC Act and conducts much of the work required by the Corporations Act. ASIC regulates Australia's corporate, markets and financial services sectors. The ASIC Act requires that ASIC:

- maintain, facilitate and improve the performance of the financial system
- promote confident and informed participation by investors and consumers in the financial system
- administer the law effectively and with minimal procedural requirements
- enforce and give effect to the law
- receive, process and store, efficiently and quickly, information provided by others
- make information about companies and other bodies available to the public as soon as practicable.

ASIC also plays a role in overseeing the audit function. ASIC registers auditors, processes annual statements from registered auditors, enforces independence requirements and provides a whistleblowing facility for the reporting of contraventions of the Corporations Act. CLERP 9 requires that ASIC conducts an audit inspection program to report on audit quality and make recommendations for continued improvement. In response to this requirement, ASIC visits a selection of audit firms annually to gain an understanding of their policies and procedures in relation to their independence, audit quality, methodologies and training programs.

Australian Securities Exchange (ASX)

The ASX was formed in 1987 by the merging of six independent stock exchanges that operated in the state capital cities. Each of those exchanges had a history of share trading dating back to the nineteenth century. The ASX aims to help listed companies raise funds, provide opportunities for investors to build wealth and enable buyers and sellers to transact with confidence. The ASX reports that about half of Australians own shares either directly or indirectly through managed funds or self-managed superannuation funds. The detail contained in published audited financial reports is one important source of information for investors in companies that trade on the ASX. The ASX has published guidelines and recommendations for good corporate governance. These recommendations aim to improve, among other things, the reliability of published financial reports. These guidelines are discussed in detail in chapter 3.

Companies Auditors and Liquidators Disciplinary Board (CALDB)

The CALDB was established in 1990 to replace state-based boards by the Corporations Act and the ASIC Act. The CALDB can respond only to applications made by ASIC (regarding an auditor) or the Australian Prudential Regulation Authority (regarding a liquidator) stating that the individual concerned has breached the Corporations Actor the ASIC Act. In particular, the CALDB is involved when it is believed an auditor or liquidator has not carried out their duties properly, is not a fit and proper person, is subject to disqualification or should not remain registered for some other reason. In response, the CALDB may cancel or suspend the individual's registration, give the individual a warning or ask them to make an undertaking to improve their conduct.

Chartered Accountants Australia and New Zealand (CAANZ)

CAANZ is a professional body with more than 100 000 members working in public practice (including the Big-4 and mid-tier chartered accounting firms), industry, academia and government. CAANZ was formed in 2014 following the amalgamation of the Institute of Chartered Accountants Australia (ICAA) and the New Zealand Institute of Chartered Accountants (NZICA). Its members work in Australia, New Zealand and more than 100 other countries. To become a chartered accountant it is necessary to undertake the Chartered Accountants (CA) Program, which combines study and mentored work experience. After completing an accounting course accredited by CAANZ and work experience supervised by a chartered accountant mentor, it is possible to commence the CA program. After completing the CA

Program and three years of work experience supervised by a chartered accountant mentor, it is possible to apply for membership of CAANZ.

The CA Program

The CA Program includes five modules and a practical experience component. The first four modules can be taken in any order but the fifth must be done last:

1. audit and assurance
2. financial accounting and reporting
3. management accounting and applied finance
4. taxation
5. capstone.[8]

The practical experience component comprises three years full-time experience in a relevant accounting role at an accredited organisation continuously mentored by a member of CAANZ or a member of an overseas accounting body recognised by CAANZ.

CPA Australia

CPA Australia is a professional body with more than 150 000 members working as finance, accounting and business professionals, academics and public servants in Australia and around the world. A number of professional bodies, dating back to the late 1880s, merged to create a combined body in the early 1900s. Various versions of that professional body operated under a variety of names, before becoming CPA Australia in 2000. To become a CPA it is necessary to undertake the CPA Program and have three years of work experience mentored by a member of CPA Australia.

The CPA Program

The CPA Program comprises six segments; four compulsory and two electives. The four compulsory segments are:

1. ethics and governance
2. strategic management accounting
3. financial reporting
4. global strategy and leadership (must be done last).

The two electives can be chosen from:

1. advanced audit and assurance
2. advanced taxation
3. contemporary business issues
4. financial risk management.[9]

The CPA Program also requires that candidates complete three years full time mentored relevant practical experience.

Institute of Public Accountants (IPA)

The IPA is a professional body with more than 26 000 members working in industry, commerce, government, academia and public practice. The IPA was formed in the early twentieth century as the Institute of Factory and Cost Accountants.

To become a member of the IPA, a graduate with an approved degree needs to complete four units and three years of mentored work experience. The four units include two electives and:

1. strategic planning and management
2. professional ethics.[10]

1.7.2 Regulation

In this section we provide a broad overview of some of the key regulations that impact the audit process. Auditing standards and pronouncements, the Corporations Act and CLERP 9 are discussed in turn.

Auditing standards and pronouncements

Auditing standards are issued by the AUASB in Australia. These standards provide minimum requirements and guidance for auditing and assurance services. The standards comprise Australian Auditing Standards (ASAs), Standards on Review Engagements (ASREs), Standards on Assurance Engagements (ASAEs) and Standards on Related Services (ASRSs). ASAs were developed and are regularly updated to guide financial report audits and apply to all audits of historical financial information where reasonable assurance is provided. ASREs apply to the review of a financial report and other historical financial information where limited assurance is provided. ASAEs apply to assurance engagements dealing with subject matter other than historical financial information, such as the effectiveness of internal controls, where either reasonable or limited assurance is provided. ASRSs apply to engagements involving agreed upon procedures where no assurance is provided. The AUASB also issues a standard on quality control for firms that perform audits and reviews (ASQC1) and Guidance Statements on audit, review, assurance and related services matters.[11] Figure 1.5 provides an overview of the pronouncements issued by the AUASB.

Corporations Act

The Corporations Act provides guidance on the audit of a company's financial report. Section 301 requires that certain financial reports be audited. Section 307 specifies that the audit report must state whether the financial report is in accordance with accounting standards and whether it provides a true and fair view. Section 307A stipulates that auditing standards must be followed when conducting an audit. Section 307B requires the retention of audit working papers for seven years and section 307C requires that the auditor declare their independence from the company being audited. The Act empowers the auditor to gain access to information required as part of their audit and requires that the auditor must report to ASIC when they believe that the company being audited has not complied with the Corporations Act or has somehow attempted to interfere with the audit.

CLERP 9

The CLERP 9 Act came into effect on 1 July 2004. CLERP 9 delivered significant changes to a number of Acts, including the Corporations Act and the ASIC Act. It contains a number of amendments affecting the audit profession. Establishing the Auditing and Assurance Standards Board was part of this change giving auditing standards the force of law for the purposes of the Corporations Act.

Some of the other changes brought about by CLERP 9 include:

- financial report disclosure of non-audit services provided by a company's auditors
- additional disclosure in the directors' report regarding the auditor
- enhanced auditor independence requirements
- restrictions on an auditor becoming an officer of their client within two years of ceasing employment with their audit firm
- auditor rotation for those that play a significant role in the audit of a client in five out of seven years.

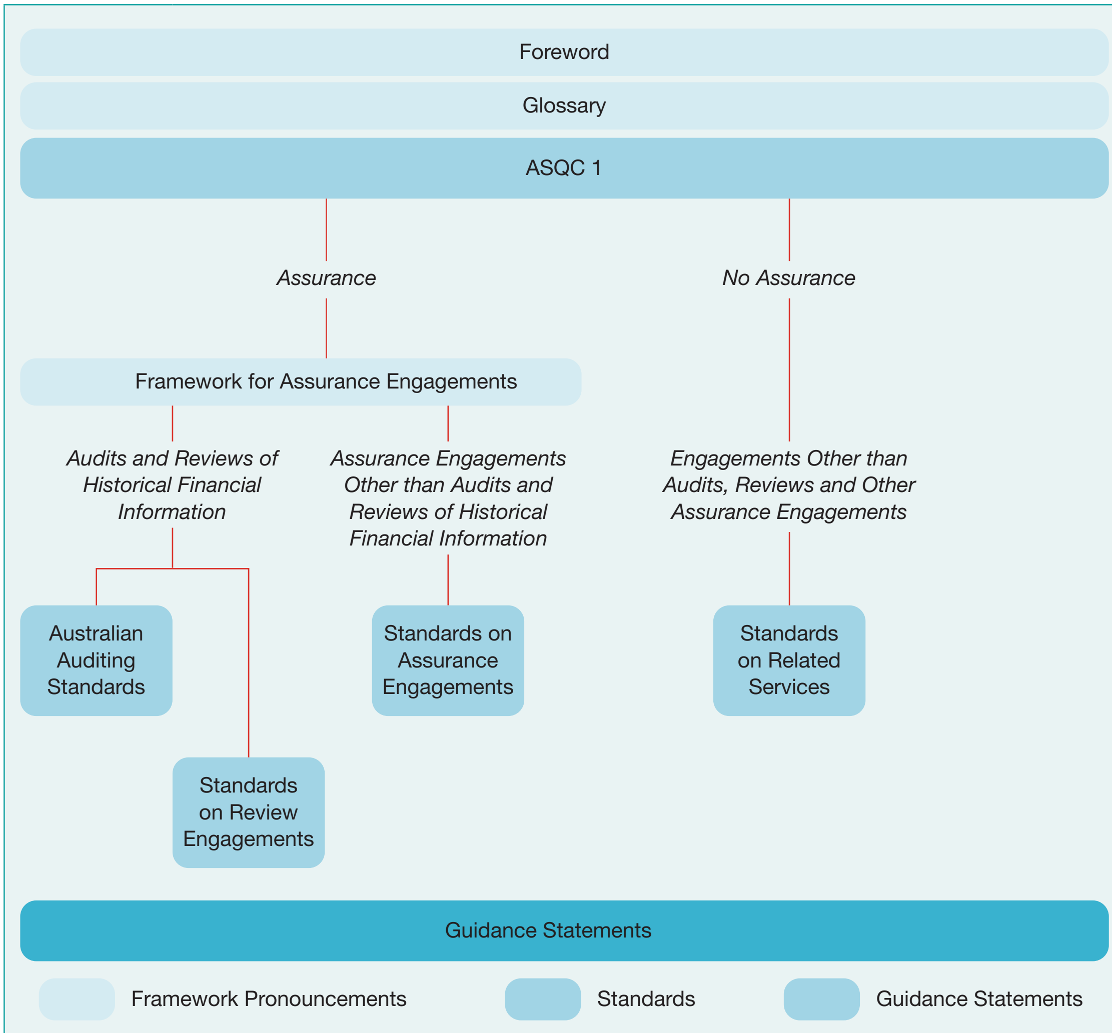

FIGURE 1.5 Structure of pronouncements issued by the AUASB

Source: Auditing and Assurance Standards Board 2014, *Framework for Assurance Engagements*, 'Appendix 1', p. 25.

CLOUD 9

Ernie explains that, in general, the regulators and regulations that apply to companies are not relevant to McLellan's Shoes because it is not incorporated. However, any auditor Ron engages would be also performing company audits and would be a member of at least one of the professional accounting bodies. The auditor would apply the auditing and accounting standards that are relevant to an audit engagement when auditing a small business. The auditor would apply strict professional standards to Ron's audit and should perform the audit to a reasonable standard.

BEFORE YOU GO ON

- Name the three professional accounting bodies in Australia.
- What is the FRC and what is its role?
- What are the main functions of the CALDB?

1.8 The audit expectation gap

LEARNING OBJECTIVE 1.8 Categorise the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial report users. The gap occurs when user beliefs do not align with what an auditor has actually done. In particular, the gap is caused by unrealistic user expectations such as:
- the auditor is providing complete assurance
- the auditor is guaranteeing the future viability of the entity
- an unmodified audit opinion is an indicator of complete accuracy
- the auditor will definitely find any fraud
- the auditor has checked all transactions.

The reality is that:
- an auditor provides reasonable assurance
- the audit does not guarantee the future viability of the entity
- an unmodified opinion indicates that the auditor believes that there are no material (significant) misstatements (errors or fraud) in the financial report
- the auditor will assess the risk of fraud and conduct tests to try to uncover any fraud, but there is no guarantee that they will find a fraud, should one have occurred
- the auditor tests a sample of transactions.

The audit expectation gap is represented graphically in figure 1.6.

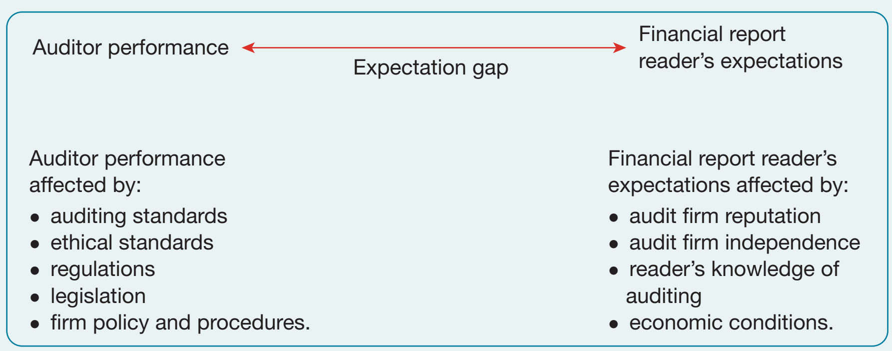

FIGURE 1.6 Audit expectation gap

The audit expectation gap can be reduced by:
- auditors performing their duties appropriately, complying with auditing standards and meeting the minimum standards of performance that should be expected of all auditors
- peer reviews of audits to ensure that auditing standards have been applied correctly
- auditing standards being reviewed and updated on a regular basis to enhance the work being done by auditors
- education of the public
- enhanced reporting to explain what processes have been followed in arriving at an audit (reasonable assurance) or a review (limited assurance) opinion (significant improvements have been introduced by standard setters improving assurance reporting)
- assurance providers reporting accurately the level of assurance being provided (reasonable, limited or none).

It is anticipated that the new audit report format will reduce the expectation gap.

As described in this chapter, financial report users rely on an audited financial report to make a variety of decisions. They use the report to assess the performance of the company, the appropriateness of the remuneration paid to management, the adequacy of dividends declared and the likely future viability of the company. Following the corporate collapses of the early 2000s (for example, Enron and HIH) user confidence in auditors and audited financial reports hit a low. The Australian federal government responded by asking Professor Ian Ramsay to write a report on the state of auditor independence in Australia. At that time the government also announced that a Royal Commission would inquire into the circumstances surrounding the failure of the HIH Insurance Group. The results of the HIH Royal Commission and Ramsay's report (2001) have been incorporated in CLERP 9, as described in this chapter.

The standard setters have also responded to public demands that auditors pay greater attention to the risk that a material fraud may occur. ASA 240 (ISA 240) *The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report* requires that auditors consider the risk of material fraud on every audit. The auditor must assess the risk that a material fraud could occur and gauge the adequacy of the client's system of internal control to prevent or detect such a fraud. If the auditor is not satisfied with the client's system of internal control, their audit procedures must be designed to aid in the detection of any material suspected frauds.

While highlighting the importance of considering fraud in every audit, standard setters also highlight that the primary responsibility for fraud prevention and detection remains with those charged with governance (generally the client's management) (ASA 240, para. 4; ISA 240, para. 4). They also emphasise the inherent limitation of any audit, making fraud detection less than certain (ASA 240, para. 5; ISA 240, para. 5).

CLOUD 9

Ron believes that Chip Masters would know what an audit can provide, and what it cannot, because Chip is an experienced vice-president of a large international company. He would deal with auditors on a regular basis. However, would a US businessperson have different expectations from those of an Australian businessperson? Ernie does not think so. The large audit firms operate in both the United States and Australia, and although there are differences in the laws, the basic principles are the same. The large audit firms use the same fundamental methodology, or approach, for all their clients around the world, and the audit reports are similar.

Ron thanks Ernie for his time. Ernie has helped him to understand that preparing more detailed financial reports and engaging an auditor to perform a financial report audit would not be as bad as he first thought. Ron now understands why Ernie thinks audits are valuable, and not just another business expense. If Chip Masters thinks that Ron's financial reports are more credible with an audit, then it is likely that he will be prepared to pay a higher price for Ron's business.

BEFORE YOU GO ON

- Define the audit expectation gap.
- What has caused the audit expectation gap?
- What can be done to reduce the audit expectation gap?

SUMMARY

1.1 Describe an assurance engagement.

An assurance engagement involves an assurance provider arriving at an opinion about some information being provided by their client to a third party. A financial report audit is one type of assurance engagement. This engagement involves an auditor arriving at an opinion about the truth and fairness of the financial report. Their audit report is addressed to the shareholders of the company being audited, but other users may read the financial report.

1.2 Discriminate between different types of assurance services.

Assurance services include financial report audits, compliance audits, performance audits, comprehensive audits, internal audits, and assurance on corporate social responsibility (CSR) disclosures.

1.3 Discriminate between different levels of assurance.

The different levels of assurance include reasonable assurance, which is the highest level of assurance, limited assurance or no assurance. Reasonable assurance is provided on an audit of a company financial report. Limited assurance is provided on a review of a company's half-year financial report. No assurance is provided on an agreed upon procedures engagement.

1.4 Categorise different audit opinions.

An auditor can issue an unmodified report; a modified report that does not affect the auditor's opinion, known as an emphasis of matter opinion; or a modified report that does affect the auditor's opinion and contains a qualified opinion, an adverse opinion or a disclaimer of opinion.

1.5 Discriminate between the different role of the preparer and the auditor, and discuss the different firms that provide assurance services.

It is the responsibility of a company's governing body to ensure that their financial report is relevant, reliable, comparable, understandable, and true and fair. It is the responsibility of the auditor to form an opinion on the truth and fairness or fair presentation of the financial report. In doing so the auditor must maintain their professional scepticism, and utilise professional judgement and due care.

The different firms that provide assurance services include the Big-4 international firms, the mid-tier national firms (with international links), local and regional firms, and consulting firms that tend to specialise in assurance of CSR and environmental disclosures.

1.6 Justify the demand for audit and assurance services.

Financial report users include investors (shareholders), suppliers, customers, lenders, employees, governments and the general public. These groups of users demand audited financial reports due to their remoteness from the entity, accounting complexity, competing incentives between them and the entity's managers, and their need for reliable information on which to base decisions. The theories used to describe the demand for audit and assurance services are agency theory, the information hypothesis and the insurance hypothesis.

1.7 Compare the different regulators and regulations surrounding the assurance process.

Regulators of the assurance process include the Financial Reporting Council (FRC), the Auditing and Assurance Standards Board (AUASB), the Accounting Professional and Ethical Standards Board (APESB), the Australian Securities and Investments Commission (ASIC), the Australian Securities Exchange (ASX), the Companies Auditors and Liquidators Disciplinary Board (CALDB), Chartered Accountants Australia and New Zealand (CAANZ), CPA Australia and the Institute of Public Accountants (IPA). Regulations of the assurance process include auditing standards and pronouncements, Corporations Law and CLERP 9.

1.8 Categorise the audit expectation gap.

The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial report or other users. The gap occurs when user beliefs do not align with what an auditor has actually done.

KEY TERMS

Agreed upon procedures engagement An auditor completes a set of tasks from which no conclusion is drawn and no assurance is provided to users.

Assurance engagement An engagement performed by an auditor or consultant to enhance the reliability of the subject matter.

Compliance audit An audit to determine whether the entity has conformed with regulations, rules or processes.

Comprehensive audit An audit that encompasses a range of audit and audit-related activities, such as a financial report audit, performance audit and compliance audit.

Consulting firms Non-audit firms that provide assurance services on information such as corporate social responsibility and environmental disclosures.

Corporate social responsibility (CSR) Includes a range of activities undertaken voluntarily by a corporation. CSR disclosures include environmental, employee and social reporting.

Financial report audit Provides reasonable assurance about whether the financial report is prepared in all material respects in accordance with a financial reporting framework.

Internal audit A semi-independent service within an entity which generally evaluates and improves risk management, internal control procedures and elements of the governance process.

Limited assurance Moderate assurance on the reliability of the subject matter.

Modified report When an auditor includes an emphasis of matter paragraph in their report or issues a qualified opinion, an adverse opinion or a disclaimer of opinion.

No assurance When an auditor completes a set of tasks requested by their client and they report factually on the results of that work.

Performance audit An assessment of the economy, efficiency and effectiveness of an organisation's operations.

Qualified opinion Provided when the author concludes that the financial report contains a material (significant) misstatement.

Reasonable assurance High but not absolute assurance on the reliability of the subject matter.

Review engagement The auditor does adequate work to report whether or not anything came to their attention, which would lead them to believe that the information being assured is not true and fair.

Those charged with governance Generally the board of directors and management of an entity.

True and fair view Refers to the consistent and faithful application of accounting standards in accordance with the financial reporting framework, where applicable, when preparing the financial report.

Unmodified opinion When the auditor concludes that the financial report is prepared, in all material respects, in accordance with the applicable financial reporting framework.

MULTIPLE-CHOICE QUESTIONS

1.1 The parties relevant to an assurance engagement are: **LO5**

(a) users, responsible party, subject matter.
(b) assurance practitioner, responsible party, criteria.
(c) assurance practitioner, responsible party, users, subject matter.
(d) assurance practitioner, users, responsible party.

1.2 When performing an audit required under section 301 of the Corporations Act the auditor has a responsibility to: **LO5**

(a) form an opinion on the subject criteria.
(b) form an opinion on the independence of the directors.
(c) form an opinion on the truth and fairness of the financial report.
(d) all of the above.

1.3 Performance audits are useful because they: **LO2**
(a) include a comprehensive audit.
(b) allow the auditor to demonstrate how well they are performing.
(c) are concerned with the economy, efficiency, and effectiveness of an organisation's activities.
(d) involve gathering evidence to ascertain whether the entity under review has followed the rules, policies, procedures, laws or regulations with which they must conform.

1.4 The function of internal audit is determined by: **LO2**
(a) the IIA.
(b) the government.
(c) the external auditor.
(d) those charged with governance and management.

1.5 Negative assurance means: **LO3**
(a) the auditor has conducted an audit and provides an opinion that the financial reports are true and fair.
(b) the auditor has conducted sufficient work to conclude that the appropriate outcome is an adverse audit report.
(c) the auditor has done adequate work and nothing came to their attention which would lead them to believe that the information being assured is not true and fair.
(d) the auditor disclaims responsibility for the audit opinion because they are unable to do sufficient work to conclude that the information being assured is true and fair.

1.6 An auditor disclaims responsibility when: **LO4**
(a) the users cannot rely on the financial report.
(b) the audit opinion is unqualified and unmodified.
(c) the auditor is unable to obtain sufficient evidence about a potentially material and pervasive matter.
(d) the audit opinion is unqualified and the auditor includes a paragraph in the audit report to emphasise something important.

1.7 Those charged with governance have a responsibility to ensure that the information in financial report is: **LO5**
(a) true and fair.
(b) relevant and reliable.
(c) comparable and understandable.
(d) all of the above.

1.8 Agency theory explains that audits are demanded because conflicts can arise between: **LO6**
(a) auditors and owners.
(b) owners and principals.
(c) agents and managers.
(d) managers and owners.

1.9 The insurance hypothesis means: **LO6**
(a) an audit acts as insurance.
(b) owners must take insurance.
(c) managers must take insurance.
(d) none of the above.

1.10 The audit expectation gap occurs when: **LO8**
(a) the public is well educated about auditing.
(b) user beliefs do not align with what an auditor has actually done.
(c) auditors perform their duties appropriately and satisfy users' demands.
(d) peer reviews of audits ensure that auditing standards have been applied correctly and the standards are at the level that satisfy users' demands.

REVIEW QUESTIONS

1.11 What does 'assurance' mean in the financial reporting context? **LO1**

1.12 Explain the difference between a financial report audit and an assurance engagement. **LO2, 3**

1.13 Who are the three parties relevant to an assurance engagement in the financial reporting context? Explain why each party is interested in the result of an audit. **LO5**

1.14 An assurance engagement involves evaluation or measurement of subject matter against criteria. What criteria are used in a financial report audit? **LO2, 3**

1.15 Who would request a performance audit? Why? **LO2**

1.16 What steps can an organisation take to increase the independence of its internal auditors? **LO2**

1.17 What is an 'emphasis of matter' paragraph? When do you think an auditor would use it? **LO4**

1.18 Compare the financial report users and their needs for a large listed public company with those of a sporting club (for example, a football club). Are the users' needs the same in each case? Explain. **LO6**

1.19 What international standards or guidelines are relevant to the assurance of corporate social responsibility disclosures? **LO2**

1.20 Explain the system of reviewing the quality of audits performed by registered company auditors. **LO7**

1.21 Explain the difference between the IAASB and the AUASB. **LO7**

1.22 Explain the 'audit expectation gap'. What causes the gap? **LO8**

PROFESSIONAL APPLICATION QUESTIONS

★ BASIC | ★★ MODERATE | ★★★ CHALLENGING

1.23 AUDIT REPORTS ★ **LO2, 3, 4, 5, 8**

Find a copy of a recent audit report and a review report for an Australian company listed on the ASX.

Required

(a) Explain the relevance of the paragraphs 'Directors' responsibility for the financial report' and 'Auditor's responsibility' in the audit report to the audit expectation gap.
(b) Find the lines in the audit report that express the auditor's opinion. What sort of opinion is it?
(c) Find the lines in the review report that express the auditor's conclusion. Is it an audit opinion? Is it a positive or negative statement?
(d) Make a list of the other differences between the audit report and the review report.

1.24 NON-ASSURANCE SERVICES ★ **LO5**

All companies are required to disclose in their annual reports the amounts paid to their auditors for both the financial report audit and any other services performed for the company.

Required

Obtain a copy of a recent annual report (most companies make their annual reports available on the company's website) and find the disclosures explaining the amounts paid to auditors. How much was the auditor paid for the audit and non-assurance, or other, services?

1.25 TYPES OF ASSURANCE ENGAGEMENTS ★ **LO1**

Find an example of a financial report review report issued by an auditor for a publicly listed company.

Required

(a) What level of assurance is provided by the financial report review?
(b) Why would a review be appropriate for a set of half-yearly financial reports?

1.26 CORPORATE SUSTAINABILITY REPORTING ASSURANCE ★ **LO2, 3, 5**

Find an example of a recent corporate sustainability assurance report for a large company and any audit or review of that report by an auditor.

Required

(a) Who wrote the assurance report?
(b) What level of assurance is provided?

1.27 BIG-4 VS NON-BIG-4 ASSURANCE PROVIDERS ★ LO5, 6

Most audit firms maintain a website that explains the services offered by the firm and provides resources to their clients and other interested parties. The services offered by most firms include both audit and non-audit services.

Required

Find the websites for:
(a) a Big-4 audit firm
(b) a mid-tier audit firm.

Compare them on the:

i. range of services provided
ii. geographic coverage (i.e. where their offices are located)
iii. number of staff and special skills offered
iv. industries in which they claim specialisation
v. publications and other materials provided to their clients or the general public
vi. marketing message.

1.28 NON-ASSURANCE SERVICES ★ LO5

Potter and Partners are a chartered accounting firm with offices in capital cities in most states. The head of the business development department is seeking to grow the firm's revenue from non-audit services.

Required

What non-audit services could a chartered accounting firm provide to its listed company clients? Explain why a company would buy these services from its audit firm instead of another consulting firm.

1.29 CORPORATE SUSTAINABILITY REPORTING ASSURANCE ★ LO2, 3, 5

Climate Balance Pty Ltd is a consulting firm specialising in sustainability and climate change issues. It offers sustainability report assurance services to a variety of organisations, including listed companies. It is not a registered company auditor and does not provide company audits.

Required

Why would a listed company obtain sustainability assurance services from a consulting firm and its company audits from a chartered accounting firm?

1.30 BIG-4 VS NON-BIG-4 ASSURANCE PROVIDERS ★★ LO5, 6

Section 301 of the Corporations Act requires companies to have their financial reports audited. Academic research suggests that Big-4 auditors charge higher fees than other auditors and their audit reports are more credible than those issued by other auditors.[12]

Required

In times of economic recession would you expect:
(a) the demand for audits to increase or decrease?
(b) clients to shift from large (Big-4) auditors to smaller auditors, or from smaller auditors to Big-4 auditors? Why or why not?

1.31 CORPORATE SUSTAINABILITY REPORTING ASSURANCE STANDARDS ★★ LO2, 3, 5

Providers of corporate sustainability assurance reports often state that the work was performed in accordance with ISAE 3000 and/or ASRE 2405. Obtain a copy of each of these documents.

Required

Explain why ISAE 3000 and ASRE 2405 would be useful in CSR assurance.

1.32 EXPECTATIONS GAP ★★ LO8

MaxSecurity Limited (MaxSecurity) has been an audit client of Smith & Associates (S&A) for the past 15 years. MaxSecurity is based in Wollongong, where it manufactures high-tech armour-plated personnel carriers. MaxSecurity often has to go through a competitive market tender process to win large government contracts. Its main product, the small but powerful Terrain Master, is highly specialised and MaxSecurity does business only with nations that have a recognised, democratically elected government. MaxSecurity maintains a highly secure environment because of the sensitive and confidential nature of its vehicle designs and its clients.

Clarke Field has been the engagement partner on the MaxSecurity audit for the last five years. Clarke is a specialist in auditing clients in the defence industry and intends to remain as review partner when the audit is rotated next year to a new partner (Sally Woodrow, who is to be promoted to partner to enable her to sign-off on the audit).

The board of MaxSecurity is considering issuing half-yearly financial reports in addition to its full-year financial reports and has approached the audit partner, Clarke Field, to discuss the possibility of engaging the firm to discuss the audit implications. Clarke suggests that S&A could review the half-yearly financial reports.

MaxSecurity's end of financial year is 30 June.

Source: Adapted from the CA Program's *Audit & assurance exam*, May 2008.

Required

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

1.33 BEING AN AUDITOR ★★ — LO3, 5, 8

You have recently graduated from your university course and start work with an audit firm. You meet an old school friend, Nga, for dinner — you haven't seen each other for several years. Nga is surprised that you are now working as an auditor because your childhood dream was to be a ballet dancer. Unfortunately, your knees were damaged in a fall and you can no longer dance. The conversation turns to your work and Nga wants to know how you do your job. Nga cannot understand why an audit is not a guarantee the company will succeed. Nga also thinks that company managers will lie to you in order to protect themselves, and as an auditor you would have to assume that you cannot believe anything a company manager says to you.

Required

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

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

1.34 COMPANY AUDITOR REGISTRATION ★★ — LO7

Anyone wishing to become a registered company auditor has to comply with certain requirements, as outlined in section 1280 of the Corporations Act. The requirements were changed by the passage of the CLERP 9 legislation in 2004, potentially making it easier for auditors in regional or rural areas to meet the experience requirements. You have graduated from your accounting course and believe that although you have not had much experience working with auditors, you are capable of meeting all the requirements and being a good auditor.

Required

Visit the ASIC website (www.asic.gov.au) and locate the guidance for meeting the regulatory requirements for company auditor registration. Summarise those requirements and explain what is required for registration for anyone with a completed accounting degree.

1.35 ASIC AND THE CALDB ★★★ — LO7

You are a trainee auditor working for a small audit firm. You completed your accounting degree at the end of last year and although you have not yet had much experience, you are concerned at some of the practices and procedures adopted at your audit firm. You overhear the two partners, Alex and Riley, discussing some problems they are facing with a particular client. Alex is advising Riley to 'get the paperwork right' on the audit, otherwise they will be in trouble if they get selected for the ASIC inspection program. Alex is also concerned that 'the CALDB will be after them'. After the conversation, Riley comes to you to ask if you, as a recent graduate, know anything about the ASIC inspection program and the CALDB. Riley confesses that he hasn't been keeping up to date.

Required

Write a report to Riley explaining (i) ASIC's audit inspection program and (ii) the CALDB and how it operates.

1.36 DEMAND FOR ASSURANCE ★★★ **LO6**

In 2002, the audit firm Arthur Andersen collapsed following charges brought against it in the United States relating to the failure of its client, Enron. Some other clients announced that they would be dismissing Arthur Andersen as their auditor even before it was clear that Arthur Andersen would not survive.

Required

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

1.37 PERFORMANCE AND COMPLIANCE AUDITS ★★★ **LO2**

Chan and Partners Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2017 year, Chan and Partners gained a new client, Medical Services Holdings Group (MSHG), which owns 100 per cent of the following entities:

- Shady Oaks Hospital, a private hospital group
- Gardens Nursing Home Pty Ltd, a private nursing home
- Total Cancer Specialists Limited (TCSL), a private oncology clinic that specialises in the treatment of cancer.

Year end for all MSHG entities is 30 June.

TCSL owns two relatively old linear accelerators used in radiation therapy. Recently, radiographers using these linear accelerators have raised concerns that they have adverse radiation effects on patients.

TCSL also wishes to purchase a new, more technologically advanced linear accelerator. The Department of Health funded half the purchase price on the basis that TCSL followed the Department's 'Guidelines for procurement of medical equipment' when purchasing the accelerator. The Department of Health has engaged the Auditor-General to check that TCSL met the terms of the funding agreement.

The Auditor-General has also been asked to conduct a performance audit that examines how well hospitals manage waste. Hospitals generate significant amounts of waste, both general and clinical. General waste is not dangerous and can be disposed of more cheaply than clinical waste.

Five years ago, the federal government measured the amount of hospital waste produced in terms of quantity and cost of disposal. The government then set an objective for hospitals to improve how they manage waste and published a document titled 'Waste management guidelines'.

The aims of the Auditor-General's performance audit include assessing whether:

1. improvements have occurred
2. hospitals have reduced the amount of waste produced
3. hospitals have reduced the cost of waste disposal.

The Auditor-General's preliminary findings indicate that many hospitals do not have processes for segregating general and clinical waste. These hospitals treat all waste as clinical waste.

Source: Adapted from the CA Program's *Audit & assurance exam*, December 2008.

Required

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

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

CASE STUDY — CLOUD 9

Ron McLellan established his business, McLellan's Shoes, in 1980. Since then he has run his business as a sole trader. Ron keeps records and his wife helps him prepare basic accounting records. As McLellan's Shoes has no outside owners, Ron has never seen the need to have his accounts audited.

When Chip Masters from Cloud 9 Inc. expressed an interest in buying McLellan's Shoes in 1995, Ron was asked to provide audited financial reports. Ron discussed his concerns about having an audit with his friend Ernie Black. Ernie is concerned that Ron may forget their conversations and has asked you to prepare a summary of the issues listed below for Ron.

Required

(a) What are the main differences between a financial report audit, an environmental audit and an efficiency audit?
(b) What is the difference between reasonable assurance and limited assurance?
(c) Why would Chip ask that Ron have the financial report for McLellan's Shoes audited rather than reviewed?
(d) What factors should Ron consider when selecting an accounting firm to complete the McLellan's Shoes audit?

RESEARCH QUESTION

Chong and Pflugrath conducted a study of different audit report formats and their effects on the audit expectation gap. They investigated whether report length (long or short), the location of the audit opinion (at the start or the end) and plain language (instead of technical language) affect shareholders' and auditors' perceptions of the audit. They surveyed a sample of shareholders and auditors and concluded that the responses indicate there are only minor effects on the audit expectation gap from using different report formats.[13]

Required

(a) In your view, what should be contained in an audit report that conveys realistic explanations of the auditor's role and the assurance provided by the audit report?
(b) Do you believe that auditors are correct in dismissing users' expectations as 'unrealistic'? Should auditors be trying to meet these expectations by rethinking their role and changing their approach?

FURTHER READING

Ramsay, I 2001, *Independence of Australian company auditors*, Department of Treasury, Canberra.

Financial Reporting Council 2011, *Annual report 2010–2011,* Chapter 3 'Monitoring auditor independence', Commonwealth of Australia, www.frc.org.au.

European Commission 2010, *Audit Policy: Lessons from the crisis*, Brussels, http://ec.europa.eu.

Public Company Accounting Oversight Board (PCAOB) 2011, *Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Release No. 2011–006*, 16 August, http://pcaobus.org.

SOLUTIONS TO MULTIPLE-CHOICE QUESTIONS

1. d, 2. c, 3. c, 4. d, 5. c, 6. c, 7. d, 8. d, 9. a, 10. b.

NOTES

1. IAASB 2012, *Assurance on a Greenhouse Gas Statement*, www.ifac.org/IAASB.
2. Financial Reporting Council 2011, *Effective company stewardship: Next steps*, September, www.frc.org.uk.

3. De Beer, L 2011, 'A future predicted: Changing scope of the audit report', *Accountancy*, August, www.accountancysa.org.za.
4. ibid.
5. ibid.
6. Thornton, G 2011, 'Consultation paper — enhancing the value of auditor reporting: Exploring options for change', *Submission to the Auditing and Assurance Standards Board*, 17 August, www.auasb.gov.au.
7. Financial Reporting Council, op cit., p. 6.
8. These details are correct at the time of writing. Visit the CAANZ website for current information on the CA Program (www.charteredaccountantsanz.com).
9. These details are correct at the time of writing. Visit the CPA Australia website for current information on the CPA Program (www.cpaaustralia.com.au).
10. These details are correct at the time of writing. Visit the IPA website for current information on the IPA Program (www.publicaccountants.org.au).
11. Ethical standards are also important regulations concerning auditors. These are discussed in detail in chapter 2 of this text.
12. Francis, JR 2004, 'What do we know about audit quality?' *The British Accounting Review*, 36, pp. 345–68.
13. Chong, KM & Pflugrath, G 2008, 'Do different audit report formats affect shareholders' and auditors' perceptions?' *International Journal of Auditing*, 12, pp. 221–41.

ACKNOWLEDGEMENTS

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