CHAPTER 1

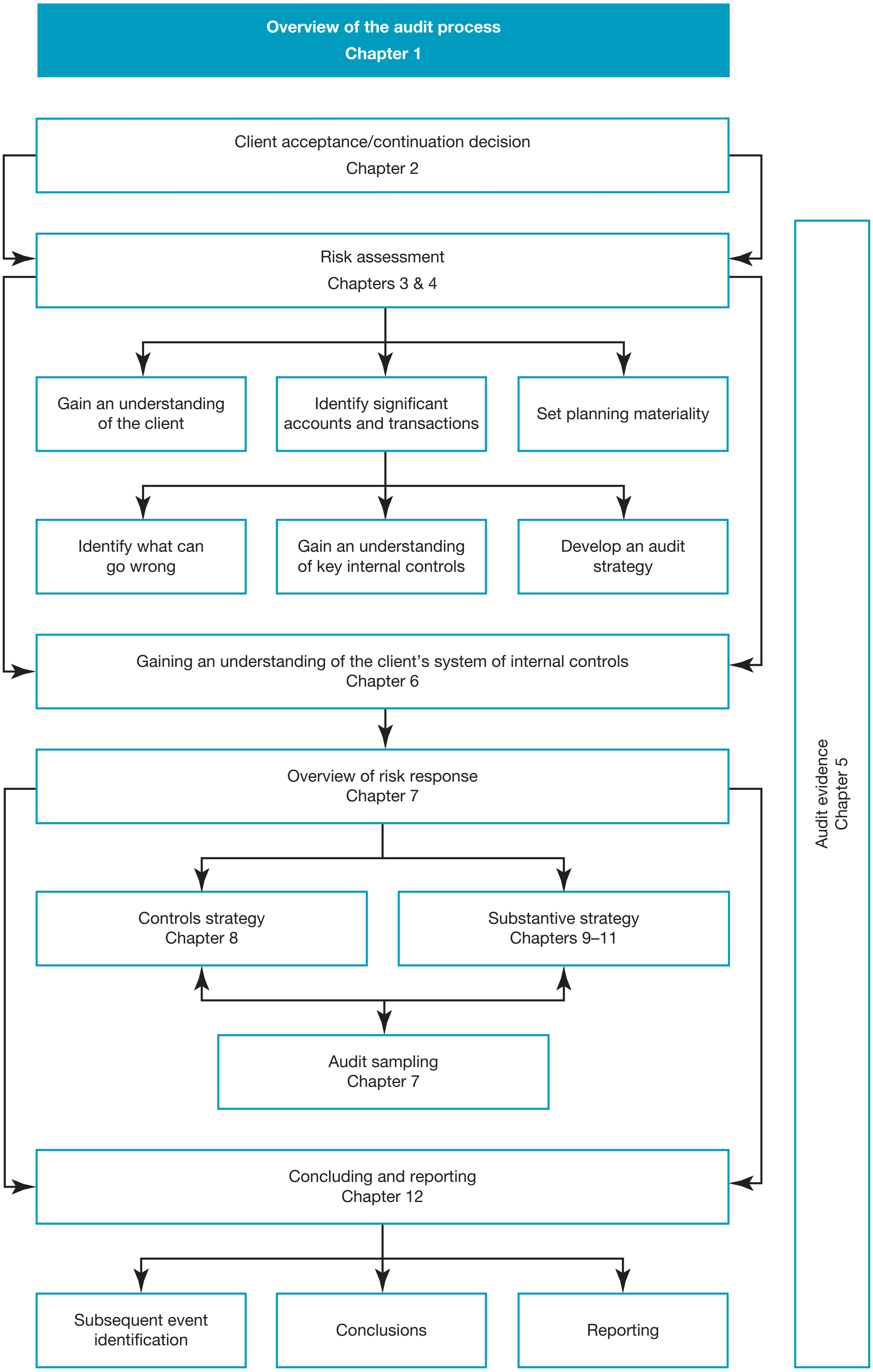
Introduction and overview of audit and assurance

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 roles 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 (including Independence Standards)*	*International Code of Ethics for Professional Accountants (including Independence Standards)*
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 *(Revised) Assurance Engagements Other than Audits or Reviews of Historical Financial Information*	ISAE 3000 *(Revised) Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*
ASAE 3410 *(Revised) Assurance Engagements on Greenhouse Gas Statements*	ISAE 3410 *(Revised) 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
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Gaining an understanding of the client's system of internal controls
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Substantive strategy
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Subsequent event identification
Conclusions
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Audit evidence
Chapter 5

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 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. We explain these concepts further in this chapter.

We explain and contrast the roles of the financial report preparer and auditor. We then provide an overview of the different firms that provide assurance services. That section contains details of both accounting and consulting firms and the different services they provide. We then describe the factors that explain why there is a demand for audit and assurance services before providing an overview of assurance regulators and their regulations. Finally, we explain the audit expectation gap in the last section of this chapter.

1.1 Auditing and assurance defined

LEARNING OBJECTIVE 1.1 Describe an assurance engagement.

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). Other key intended users include analysts, debtors, creditors, bankers and employees. 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. We now explain each in turn.

1.2.1 Financial report audits

According to 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*), 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 (www.aasb.gov.au) 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. A14; ISA 200, para. A15).

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 are presented fairly or give a **true and fair view** (this concept is discussed in more detail later in this chapter). A fair presentation or 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. 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 sets out the requirement to have an audit of the financial report. 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, sections 3–5).

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 requirement to conduct the audit 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. Perpetrators of fraud may withhold or modify evidence. It can be difficult for an auditor to determine whether a fraud has occurred and documents have been altered, as those committing a fraud generally hide evidence. Auditors use sampling techniques when testing transactions and account balances. If a sample is not representative of all items available for testing, there is a risk that 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 carefully plan the audit, an auditor can spend adequate time 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 determines 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 employees follow certain processes when completing a function. For example, a company may have policies and procedures for the hiring of new staff. In that case the organisation may call upon its internal auditors 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. 16). 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, it may appear that the organisation is sacrificing efficiency to achieve economic goals.

An organisation's internal auditors generally conduct performance audits. Alternatively, an organisation can outsource its performance audits to an external audit firm. Other terms used to describe performance audits are 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 auditors examine compliance with various regulations when completing a financial report audit.

1.2.5 Internal audits

Internal audits 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. Together with management, **those charged with governance** determine internal audit activities. While internal audit activities 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. Internal auditors generally conduct 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 185 000 members, that provides guidance and standards to aid internal auditors in their work. When conducting the financial report audit, the external auditor will consider the work done by internal auditors (ASA 610 (ISA 610) *Using the Work of Internal Auditors*).

TECHNOLOGY INSIGHT

Using the Internet of Things (IoT) for inventory management — impact on internal audit

The Internet of Things (IoT) has evolved so quickly over recent years that International Data Corporation (IDC) predicts that by 2025 there will be 41.6 billion devices generating 79.4 zettabytes of data.[1] The IoT is an environment in which 'things' are able to connect to other devices or the internet to transfer data without human interaction. Devices are able to interact, collaborate and learn from each other's experience. The IoT's connectivity and real-time analytics make it ideal to use for inventory management.

Inventory is one of the most important assets for a retail business and keeping track of fast- and slow- moving inventory is vital, especially during busy periods as empty shelves result in lost sales. To overcome this issue, some retailers are using IoT technology to create digital shelves. These digital shelves have sensors that understand the level of inventory on the shelf by reading smart tags on the products. Additional sensors can be used to read passing foot traffic to determine whether the placement of the product is attracting enough passers-by.

Digital shelving also enables return shipments to be rerouted to stores with high demand and a low inventory level for the product. This results in the retailer avoiding the extra time and cost associated with processing returns that would otherwise be shipped back to distribution before being processed and sent to stores in need. Rerouting shipments in this manner means the product can get to the customers quicker.

Many retailers use a multichannel marketing strategy, offering customers purchases from a store, a website, comparison shopping sites, interactive television, telephone ordering, mail ordering and catalogue ordering. Multichannel retailers need to be able to track their inventory across the supply chain in real time. They need to know where products are available so that they can supply the right product at the right time in the right place.

According to a 2017 study by Zebra Technologies, 67 per cent of retailers have implemented IoT technologies to provide real-time visibility across their supply chain to manage their inventory.[2] Digital shelves using IoT technology can boost both accuracy and profit due to improved inventory management. Roberti (2017) claims IoT technology can boost inventory accuracy to 95 per cent, thereby reducing the discrepancy between electronic records and physical inventory — this makes it ideal for retail inventory management.[3]

Connected devices and systems, such as the digital shelf, may result in internal auditors needing to evaluate the design and operating effectiveness of automated controls rather than relying on manual controls.[4] Consumer-facing devices connecting to business systems impact on the flow of transactions and introduce new risks. Internal auditors need to consider the volume of IoT transactions and their related processes and controls. For example, do they have unique processes or are they similar to other e-commerce transactions?

Internal auditors will need to monitor emerging risk areas as the IoT evolves into the Internet of Everything (IoE). As internal auditors take on a more strategic business partner role in their organisation, they will be expected to become an advocate for IoT opportunities and be able to assess the associated risks. One such risk is distributed denial of service (DDoS) attacks in which attackers flood a web server, aiming to make the online service unavailable to users. Other IoT risks include:

- insecure web interface
- insufficient authentication
- insecure network services
- privacy concerns
- insecure cloud interface
- insecure mobile interface.[5]

The internal auditor will play a vital role in helping the business manage these IoT risks.

In addition to the impact on internal audit, an entity’s use of IoT inventory management systems will need to be considered by the external auditor when assessing the risk of material misstatement during the risk assessment phase of the audit. In addition, the external auditor will need to assess the application controls and cybersecurity risks involved with using this technology to manage inventory. In doing so, the external auditor may consider the work done by internal auditors.

1.2.6 Corporate social responsibility (CSR) assurance

Corporate social responsibility (CSR) or sustainability reporting is voluntary and is becoming more widespread (a later section of this chapter discusses 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. Auditor or specialist **consulting firms** conduct CSR assurance. As CSR 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) (Revised) *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. ASAE 3410 (ISAE 3410) (Revised) *Assurance Engagements on Greenhouse Gas Statements* provides guidance on assurance procedures to be used for greenhouse gas (GHG) statements, which sets out information regarding the amount of GHGs emitted over a period. An example of an assurance statement relating to a sustainability report is in figure 1.1.

Integrated reports include quantitative and qualitative information from across an organisation. Financial and non-financial information appear together in one report. The aim of integrated reporting is to provide details on how an organisation creates value over time. Integrated reports can report using capitals to categorise their activities. Capital types can include financial, manufactured, human, social, natural and intellectual.

FIGURE 1.1 Example of a sustainability assurance statement

EY
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Independent Limited Assurance Statement to the Management and Directors of Wesfarmers Limited

Our Conclusion:

Ernst & Young was engaged by Wesfarmers Limited ('Wesfarmers') to undertake limited assurance, as defined by Australian Auditing Standards and hereafter referred to as a 'review', over selected sustainability information disclosed in Wesfarmers' FY19 Sustainability Reporting, including selected sustainability information disclosed on the sustainability website, for the financial year ended 30 June 2019 ('2019 Sustainability Reporting'). Based on our review, nothing came to our attention that causes us to believe that the subject matter for our review has not been prepared and presented fairly, in all material respects, in accordance with the criteria defined below.

What our review covered

Ernst & Young ('EY' or 'we') reviewed:

- Wesfarmers approach to defining report content ('materiality assessment')
- Wesfarmers' reported alignment to 'core' level of 'in accordance' requirements of the Global Reporting Initiative's (GRI) Sustainability Reporting Standards ('GRI Standards')
- Sustainability information, including the performance metrics set out in the table below, presented on Wesfarmers' website under Sustainability.wesfarmers.com.au as at 14 October 2019 excluding any content related to the Coles business or operations

Performance metrics
Scope 1, Scope 2, and Scope 3 greenhouse gas emissions in tonnes of carbon dioxide equivalent (tCO_2-e)
Waste disposed and recycled (tonnes)
Water consumption (megalitres)
Energy consumption (petajoules)
Workplace health and safety data (including number of workers' compensation claims, lost time injury frequency rate [LTIFR], employee hours worked, and total recordable injury frequency rate [TRIFR])
Community contributions (AUD)
Aboriginal and Torres Strait Islander employee numbers
Aboriginal and Torres Strait Islander procurement spend (AUD)
Ethical sourcing audit program data

Criteria

In preparing its 2019 Sustainability Reporting, Wesfarmers applied the following criteria:

- GRI Standards, including the Reporting Principles for defining report quality and content
- National Greenhouse and Energy Reporting Act 2007 (for Scope 1 and 2 greenhouse gas data) and Scope 3 GHG Protocol guidance (for Scope 3 greenhouse gas data)
- Other selected Criteria, as determined by Wesfarmers, and as set out in its Sustainability Reporting.

Key responsibilities

EY's responsibility and independence

Our responsibility was to express a conclusion on the 2019 Sustainability Reporting based on our review.

We were also responsible for maintaining our independence and confirm that we have met the requirements of the *APES 110 Code of Ethics for Professional Accountants*, including independence, and have the required competencies and experience to conduct this assurance engagement.

Wesfarmers' responsibility

Wesfarmers' management ('management') was responsible for selecting the Criteria and preparing and fairly presenting the 2019 Sustainability Reporting in accordance with that Criteria. This responsibility includes establishing and maintaining internal controls, adequate records, and making estimates that are reasonable in the circumstances.

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Our approach to conducting the review

We conducted our review in accordance with the Australian Auditing and Assurance Standards Board's *Australian Standard on Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* ('ASAE 3000'), *Assurance Engagements on Greenhouse Gas Statements* ('ASAE 3410'), and the terms of reference for this engagement as agreed with Wesfarmers on 21 February 2017.

Summary of review procedures performed

A review consists of making enquiries, primarily of persons responsible for preparing the 2019 Sustainability Reporting and related information, and applying analytical and other review procedures. Our procedures included:

- Assessing Wesfarmers' adherence to the GRI Standards Reporting Principles for defining report quality and report content, including the processes involved at a Divisional and Corporate level
- Determining whether material topics and performance issues identified during our procedures had been adequately disclosed
- Performing site visits to corporate and divisional offices and sites, interviewing selected personnel, including senior leaders, to understand the key sustainability issues related to the subject matter and processes for collecting, collating and reporting the Performance Data during the reporting period
- Where relevant, gaining an understanding of systems and processes for data aggregation and reporting
- Performing analytical tests and detailed substantive testing to source documentation for material qualitative and quantitative information
- Checking the accuracy of calculations performed
- Obtaining and reviewing evidence to support key assumptions in calculations and other data
- Reviewing selected management information and documentation supporting assertions made in the subject matter
- Checking that data and statements had been accurately transcribed from corporate systems and/or supporting evidence
- Reviewing the presentation of claims, case studies and data against the relevant GRI principles contained in the criteria

We believe that the evidence obtained was sufficient and appropriate to provide a basis for our limited assurance conclusion.

Limited Assurance

Procedures performed in a limited assurance engagement vary in nature and timing from, and are less in extent than, for a reasonable assurance engagement. Consequently, the level of assurance obtained in a limited assurance engagement is substantially lower than the assurance that would have been obtained had a reasonable assurance engagement been performed. Our procedures were designed to obtain a limited level of assurance on which to base our conclusion and do not provide all the evidence that would be required to provide a reasonable level of assurance.

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. Our procedures did not include testing controls or performing procedures relating to checking aggregation or calculation of data within IT systems.

Use of our Assurance Statement

We disclaim any assumption of responsibility for any reliance on this assurance report to any persons other than management and the Directors of Wesfarmers, or for any purpose other than that for which it was prepared.

The extent of our review included the information available at www.sustainability.wesfarmers.com.au as at 14 October 2019. We provide no assurance over changes to the content of this web-based information after the date of this assurance statement, nor over any information available through web-links that are beyond the boundary of the Wesfarmers 2019 Sustainability Reporting.

Ernst & Young

Dr Matthew Bell
Brisbane, Australia
14 October 2019

Source: Wesfarmers and EY, 2019.

To enable a more consistent application of ISAE 3000 *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information* to emerging external reporting (EER), the International Auditing and Assurance Standards Board (IAASB) has undertaken a project to provide guidance on applying ISAE to assurance of EER and is working with other international organisations to align on related projects. EER includes, for example, integrated reports, sustainability reports, CSR reports and other non-financial reports. The IAASB EER Assurance Project addresses issues including: determining the scope of an EER assurance engagement; obtaining evidence for narrative and future-oriented information; exercising professional scepticism and professional judgement; obtaining the competence necessary to perform the engagement; and communicating effectively in the assurance report.

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 addresses their report to the party requesting assurance (for example, a company's shareholders). When an assurance practitioner performs a non-assurance engagement, they send a report on their findings to the responsible party (that is, the organisation that prepared the information under consideration). We now explain the differences between reasonable, limited and no assurance.

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 assured information. This means that the auditor has done adequate work to report with reasonable certainty that the assured information is, or is not, free from material misstatement (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 assured information is presented fairly. 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 (Revised) *Forming an Opinion and Reporting on a Financial Report* (ISA 700 *Forming an Opinion and Reporting on Financial Statements*) 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 is 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 IAASB changed the format of the audit report. The intention was to increase confidence in the audit and financial reports. The IAASB has indicated that the new format increases 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) has adopted the new audit report format. The audit report now includes the opinion section at the beginning of the report, a 'Key audit matters' section where auditors communicate issues that were important in the current audit, and disclosures around the auditor's responsibilities when conducting the audit. According to ASA 701 (ISA 701) *Communicating Key Audit Matters in the Independent Auditor's Report*, 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). An example of an audit report appears in figure 1.2.

FIGURE 1.2 Example of an audit report

Notes to the financial statements (continued)

Telstra Financial Report 2019

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8 Exhibition Street
Melbourne VIC 3000 Australia
GPO Box 67 Melbourne VIC 3001

Tel: +61 3 9288 8000
Fax: +61 3 8650 7777
ey.com/au

Independent Auditor's Report to the Shareholders of Telstra Corporation Limited

Report on the Audit of the Financial Report

Opinion

We have audited the financial report of Telstra Corporation Limited (the Company) and its subsidiaries (collectively the Group), which comprises the consolidated statement of financial position as at 30 June 2019, the consolidated income statement, consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated statement of cash flows for the year then ended, notes to the financial statements, including a summary of significant accounting policies and the Directors' Declaration.

In our opinion:

the accompanying financial report of the Group is in accordance with the *Corporations Act 2001*, including:

a. Giving a true and fair view of the consolidated financial position of the Group as at 30 June 2019 and of its consolidated financial 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 Group in accordance with the auditor independence requirements of the *Corporations Act 2001* and the ethical requirements of the Accounting Professional and Ethical Standards Board's APES110 *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 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 judgment, were of most significance in our audit of the financial report of the current year. These matters were addressed in the context of our audit of the financial report as a whole, and in forming our opinion thereon, but we do not provide a separate opinion on these matters. For each matter below, our description of how our audit addressed the matter is provided in that context.

We have fulfilled the responsibilities described in the *Auditor's Responsibilities for the Audit of the Financial Report* section of our report, including in relation to these matters. Accordingly, our audit included the performance of procedures designed to respond to our assessment of the risks of material misstatement of the financial report. The results of our audit procedures, including the procedures performed to address the matters below, provide the basis for our audit opinion on the accompanying financial report.

Key audit matter	How our audit addressed the matter
Revenue recognition	
Australian Accounting Standard AASB 15 *Revenue from Contracts with Customers* (AASB 15) applied to the Group from 1 July 2018. Upon adoption of AASB 15, there are five areas where the Group exercises significant judgment relating to revenue recognition: • accounting for new products and plans including multiple element arrangements; • accounting for large Network Application Services (NAS) contracts; • accounting for NBN revenue under the revised Definitive Agreements (DAs) with nbn co and the Commonwealth Government; • determination of standalone selling prices for products sold in multiple element arrangements; and • assessment of significant financing components. Disclosures relating to revenue recognition can be found at Notes 2.1 and 2.2 and disclosure of the impact of the adoption of the new revenue accounting standard can be found within Notes 1.5 and 7.1. The accuracy and completeness of amounts recorded as revenue is an inherent industry risk due to the complexity of billing systems, the complexity of products and services, and the combination of products sold and price changes in the year.	We evaluated the effectiveness of key controls over the capture and measurement of revenue transactions across all material revenue streams, including evaluating the relevant IT systems and new process and controls implemented during the current year for the appropriate recognition of revenue under AASB 15. We examined the process and controls over the capture and assessment of the timing of revenue recognised for new products and plans, as well as performed testing of a sample of new plans to supporting evidence. For all key revenue streams, we obtained supporting evidence such as customer contracts, statements of work, invoices and service detail records to test the occurrence and measurement for a sample of revenue transactions. For the major NAS contracts, we focused our work on those which we regarded as higher risk because of the nature of the contract, its stage of delivery or the quantum of the related assets and those which were significant by size.

Key audit matter	How our audit addressed the matter
The complexity of the billing systems was also considered as part of the reliance on automated processes and controls Key Audit Matter below.	In performing this testing, we assessed the appropriateness of the assumptions and estimates underpinning the accounting for these major contracts as follows: • We tested the effectiveness of controls that operate across the contract life cycle for major contracts. • We obtained and read the relevant sections of certain contracts, to identify the contracted revenues, key provisions in the event of contract termination (such as penalties or the ability for the Group to recover costs) and other significant obligations. • We ensured the future forecasts reflected the contract terms, testing any significant changes (such as new services) to contract amendments or other supporting documentation. • We tested a sample of recorded revenue and cost transactions by agreeing them to supporting evidence, which for revenue included evidence of delivery and/or customer acceptance. • We compared the historical forecast results of certain contracts with the actual results to assess the performance of the contract and the historical accuracy of forecasting. • We considered the future forecast profitability and the contractual terms to assess the recoverability of the contract-specific assets and to determine if any contracts required loss provisions. We assessed the appropriateness of the assumptions and estimates underpinning the accounting for the revised DAs including understanding the timing of disconnections, the progress of the NBN rollout and the transfer of the copper and Hybrid Fibre Coaxial (HFC) networks to nbn co. We assessed the Group accounting policies as set out in Note 2.2, and the adequacy of disclosures for compliance with the revenue recognition requirements of Australian Accounting Standards.
Reliance on automated processes and controls	
A significant part of the Group's financial processes are heavily reliant on IT systems with automated processes and controls over the capturing, valuing and recording of transactions. This is a key part of our audit because of the: • Complex IT environment supporting diverse business processes; • Mix of manual and automated controls; • Multiple internal and outsourced support arrangements; and • Complexity of the billing systems which result in revenue being recognised.	Our IT specialists assessed the Group's manual and automated controls relating to IT systems relevant to financial reporting, including the recognition of revenue. When testing controls was not considered an appropriate or efficient testing approach, alternative audit procedures were performed on the financial information being produced by systems.
The Group continues to enhance its IT systems and during the year implemented new systems which were significant to our audit.	Our IT specialists analysed the impact on our audit of new systems that are significant to our audit. This included assessing the design of relevant automated processes and controls. We evaluated the effectiveness of the controls in the new systems.
Impairment of goodwill and intangible assets	
Given the dynamic nature of the industry in which the Group operates, there is a risk that there could be material impairment to goodwill, other intangible asset balances, investments and other non-current assets.	We evaluated the Group's impairment calculations including the testing of the recoverable amount of each CGU where there were indicators of impairment, or there were significant goodwill or indefinite life intangible asset balances.
Determination as to whether or not there is an impairment relating to an asset or Cash Generating Unit (CGU) involves significant judgment about the future cash flows and plans for these assets and CGUs. Further disclosure regarding the Group's impairment testing can be found in Note 3.2.	We evaluated the Group's assessment of indicators of impairment or impairment reversal. Where we or the Group determined indicators existed, we evaluated the Group's calculation of the recoverable amount of each CGU. We assessed the reasonableness of the Board approved cash flow projections used in the impairment models as well as the reliability of the Group's historical cash flow forecasts. We involved our valuation specialists to assess the impairment models and evaluated the reasonableness of key assumptions including the discount rate, terminal growth rates and forecast growth assumptions. We also performed sensitivity analysis around the key drivers of the cash flow projections. Having determined the change in assumptions (individually or collectively) that would be required for the CGUs to be impaired, we considered the likelihood of such a movement in those key assumptions arising. We evaluated the adequacy of impairments that had been recognised during the financial year. We evaluated the adequacy of the disclosures included in Note 3.2.

<table>
<tr><th colspan="2">Capitalisation of assets, including useful lives, amortisation and impairment</th></tr>
<tr><td>There are a number of areas where judgments significantly impact the carrying value of property, plant and equipment, software intangible assets and their respective depreciation and amortisation profiles. These areas are as follows:
• the decision to capitalise or expense costs;
• the annual asset life review;
• the timeliness of the transfer from assets in the course of construction; and
• significant changes that have taken place during the period or are expected to take place in the near future, which will impact the extent to which, or manner in which, an asset is used or is expected to be used.
Changes in these judgments have a significant impact on the results of the Group. Accordingly, this was considered a key audit matter.
Disclosures relating to the capitalisation and write-off of assets can be found at Notes 3.1 and 3.2.</td><td>Our audit procedures included the following:
• Assessed the effectiveness of the Group’s controls over the acquisition and disposal of fixed assets.
• Evaluated the appropriateness of capitalisation policies.
• Selected a sample of costs capitalised during the year to determine whether capitalisation was appropriate.
• Assessed the appropriateness of the date from which assets commenced being depreciated.
We assessed the application of the Group’s annual asset life review. This included assessing judgments made by the Group on:
• the nature of underlying costs capitalised; and
• the appropriateness of assets lives applied in the calculation of depreciation and amortisation.
We evaluated management’s impairment assessment of property, plant and equipment and software intangible assets. This included assessing judgments made by the Group on:
• the nature and impact of changes on the business from the Telstra 2022 (T22) strategy, including which specific assets are impacted;
• the extent of the impact of these changes on the carrying value of identified property, plant and equipment, software intangible assets; and
• the completeness of the listing of impacted assets.
We evaluated the adequacy of disclosures included in Notes 3.1 and 3.2.</td></tr>
</table>

Information Other than the Financial Statements and Auditor's Report Thereon

The directors are responsible for the other information. The other information comprises the information included in the Group’s 2019 Annual Report other than the financial report and our auditor’s report thereon. We obtained the Directors’ Report that is to be included in the Annual Report, prior to the date of this auditor’s report, and we expect to obtain the remaining sections of the Annual Report after the date of this auditor’s report.

Our opinion on the financial report does not cover the other information and we do not and will not express any form of assurance conclusion thereon, with the exception of the Remuneration Report and our related assurance opinion.

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 on the other information obtained prior to the date of this auditor’s report, 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.

Responsibilities of the Directors 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 2001* 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 Group’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 Group 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 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.

As part of an audit in accordance with the Australian Auditing Standards, we exercise professional judgment and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the financial report, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group’s internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Directors.
- Conclude on the appropriateness of the Directors’ use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group’s ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor’s report to the related disclosures in the financial report or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor’s report. However, future events or conditions may cause the Group to cease to continue as a going concern.
- Evaluate the overall presentation, structure and content of the financial report, including the disclosures, and whether the financial report represents the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the financial report. We are responsible for the direction, supervision and performance of the Group audit. We remain solely responsible for our audit opinion.

We communicate with the Directors regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Directors with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated to the Directors, we determine those matters that were of most significance in the audit of the financial report of the current year and are therefore the key audit matters. We describe these matters in our auditor’s report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be

Report on the Audit of the Remuneration Report

Opinion on the Remuneration Report

We have audited the Remuneration Report included in the Directors' Report for the year ended 30 June 2019.

In our opinion, the Remuneration Report of Telstra Corporation Limited for the year ended 30 June 2019, complies with section 300A of the *Corporations Act 2001*.

Responsibilities

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 2001*. Our responsibility is to express an opinion on the Remuneration Report, based on our audit conducted in accordance with Australian Auditing Standards.

Ernst & Young

Ernst & Young

Andrew Price
Partner
Melbourne
15 August 2019

Source: EY, 2019.

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.[6] 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’.[7]

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.[8]

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.[9] 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.[10]

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.[11] 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.

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 assured information. 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 assured information 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.

FIGURE 1.3 Example of a review report

EY
Building a better working world

Ernst & Young
8 Exhibition Street
Melbourne VIC 3000 Australia
GPO Box 67 Melbourne VIC 3001

Tel: +61 3 9288 8000
Fax: +61 3 8650 7777
ey.com/au

Independent Auditor's Report to the Members of Telstra Corporation Limited

Report on the Half-Year Financial Report

Conclusion

We have reviewed the accompanying half-year financial report of Telstra Corporation Limited (the Company) and its subsidiaries (collectively the Group), which comprises the statement of financial position as at 31 December 2018, 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.

Based on our review, which is not an audit, nothing has come to our attention that causes us to believe that the half-year financial report of the Group is not in accordance with the *Corporations Act 2001*, including:

a. giving a true and fair view of the consolidated financial position of the Group as at 31 December 2018 and of its consolidated financial 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*.

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 control as the directors determine is 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, anything has come to our attention that causes us to believe that the half-year financial report is not in accordance with the *Corporations Act 2001* including: giving a true and fair view of the Group's consolidated financial position as at 31 December 2018 and its consolidated financial 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 the Group, 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*.

Ernst & Young

Ernst & Young

Andrew Price
Partner
Melbourne
14 February 2019

Source: EY, 2019.

The review of a company's half-year financial report is an example of a limited assurance engagement (**review engagement**). 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*) provides guidance on the form and elements of the review report. An example of a review report appears in figure 1.3. The review report includes the conclusion (opinion) of the auditor that nothing came to their attention that caused them to believe that the half-year report was not true and fair (negative assurance). 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 (ISRE 2410) when conducting their review. The auditor provides an explanation of the procedures used in conducting their review. The report confirms the independence of the audit firm from their client.

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.

1.3.3 No assurance

An assurance provider may perform other services for clients for which they provide no assurance. In such circumstances an assurance provider must ensure when reporting their findings that they make it clear 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 the auditor does not arrive at a conclusion, they provide no assurance.

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?

1.4 Different audit opinions

LEARNING OBJECTIVE 1.4 Categorise different audit opinions.

The chapter on completing and reporting on the audit 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 auditor can modify their report 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 a note to the financial report adequately and accurately explains. 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. An auditor issues a **qualified opinion** when they believe that ‘except for’ the effects of a matter explained in the audit report, the reader can rely on the financial report. An auditor issues a qualified opinion when the audit report includes an identified, quantified and explained matter of concern. In this case the matter of concern is material but not pervasive to the financial report. In this context ‘pervasive’ refers to misstatements 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. An auditor issues a disclaimer of opinion when they are unable to obtain sufficient appropriate audit evidence on which to base their opinion, and they conclude that the possible effects on the financial report could be material and pervasive. Although an auditor uses these opinions 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 appear in table 1.1.

TABLE 1.1 Different audit opinions

	Auditor’s judgement about the pervasiveness of the effects or possible effects on the financial report	
Nature of matter giving rise to the modification	**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.

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 roles 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 A4 of ASA 200 (ISA 200, para. A3), 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.

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, they cannot use the financial report to make the types of decisions outlined. The information must be unbiased; it must not aim 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, the consistent presentation of information across time and across entities is critical. Clear disclosure of any changes in accounting policies allows users to make appropriate adjustments. 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. Users rely on the notes to the financial report to provide additional details to aid in the interpretation of the accounting information provided. The phrasing of details included in the notes must 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). It is important that the auditor search for evidence that challenges, and not just confirms, management's assumptions.

The IAASB has produced a series of communiqués that deal with professional scepticism. They highlight that it is critical that auditors are unbiased when gathering evidence. This means that auditors should not favour evidence that *corroborates* client accounts and they should not avoid evidence that *contradicts* client accounts. The IAASB also emphasises the importance of documenting the use of scepticism when gathering and evaluating evidence.

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

Accounting and other consulting firms provide assurance services. 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. 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.

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 next.

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 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). Table 1.2 summarises the demand for audit and assurance services and the ways that auditors respond to each demand.

TABLE 1.2 Demand for audit and assurance services

Demand	Response
Remoteness — financial report users generally do not have access to entity financial information to assess the truth and fairness of the financial report.	Auditors gain access to entity financial information, as well as external documentation, used to verify the information included in financial reports.
Complexity — even if provided access to relevant financial information, financial report users generally do not have the knowledge or expertise required to assess the truth and fairness of the financial report.	Auditors have accounting qualifications and receive extensive training regarding the appropriate techniques to use when verifying the information included in financial reports.
Competing incentives — even if provided access to relevant financial information, financial report users generally do not have the experience necessary to gauge when management may have an incentive to disclose information in a certain way or which accounts will most likely be affected in those circumstances.	Auditors have experience across many entities and become very familiar with the types of incentives that may inform the way that a financial report is compiled. They gain an understanding of the accounts most at risk and how best to conduct audit testing in response. They are independent and so have no incentive to aid the entity in reporting financial information in any particular way.
Reliability — even if provided access to relevant financial information, financial report users generally do not have the experience necessary to gauge the reliability of the information included in the financial report or the supporting evidence available from the entity.	Auditors can test the information included in financial reports and determine whether or not it can be relied upon by financial report users.

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, sustainability 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 an upcoming chapter, 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.

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 an earlier section). The theories outlined are now being used to understand more about the demand for assurance of CSR disclosures including environmental, sustainability and carbon emissions reports.

It is common for companies to voluntarily disclose CSR information in their annual reports, on their websites and in separate stand-alone reports. These disclosures were originally made 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 those companies are taking 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, to demonstrate that they take their impact on the environment seriously and to 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 Disciplinary Board (CADB), Chartered Accountants Australia and New Zealand (CA ANZ), CPA Australia and the Institute of Public Accountants (IPA). We now discuss each regulator 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.

In relation to audits, an objective of the FRC is to ensure that auditing standards provide guidance to help auditors form an opinion on whether financial reports comply with the provisions of the Corporations Act. The FRC is also concerned with making sure that auditing standards require auditors to report their findings in a reliable and easy to understand way to facilitate financial report users' decision-making.

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 Federal Treasurer. Australian Auditing Standards (ASAs) are in line with International Standards on Auditing (ISAs), which are issued by the International Auditing and Assurance Standards Board (IAASB). The AUASB actively participates in the formulation of ISAs. The FRC sets the AUASB's broad strategic direction and approves its priorities, but does not direct the AUASB in relation to the development of any standards. 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 CA ANZ). 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 (CA ANZ, 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 (including Independence Standards)* 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 a later chapter.

Companies Auditors Disciplinary Board (CADB)

The Companies Auditors and Liquidators Disciplinary Board (CALDB) was established in 1990 by the Corporations Act and the ASIC Act to replace state-based boards. It was renamed the Companies Auditors Disciplinary Board (CADB) in 2017 following the *Insolvency Law Reform Act 2016*, which transferred to ASIC the role of disciplining liquidators. The CADB can respond only to applications made by ASIC or the Australian Prudential Regulation Authority (APRA) stating that the auditor concerned has breached the Corporations Act or the ASIC Act. In particular, the CADB is involved when it believes an auditor 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 CADB may cancel or suspend an auditor’s registration, give the individual a warning or ask them to make an undertaking to improve their conduct.

Chartered Accountants Australia and New Zealand (CA ANZ)

CA ANZ is a professional body with more than 120 000 members working in public practice (including the Big-4 and mid-tier chartered accounting firms), industry, academia and government. CA ANZ 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 CA ANZ 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 CA ANZ.

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.[12]

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 CA ANZ or a member of an overseas accounting body recognised by CA ANZ.

CPA Australia

CPA Australia is a professional body with more than 160 000 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 associate, members must 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. Australia taxation
2. Australia taxation — advanced
3. advanced audit and assurance
4. contemporary business issues
5. financial risk management
6. financial planning fundamentals
7. superannuation and retirement planning
8. investment strategies
9. risk advice and insurance.[13]

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 35 000 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.

The IPA program has two stages. After completing the first stage, associate members become members of IPA. Members can then progress by completing the second stage — a Master of Business Administration (MBA).

The first-stage program is designed to be undertaken while working with a mentor. The six units offered in the first stage of the program are:
1. ethics, governance and fraud (core unit)
2. professional research and analysis (core unit)
3. accounting standards and practice
4. strategic management accounting
5. assurance and audit services
6. applied business finance.[14]

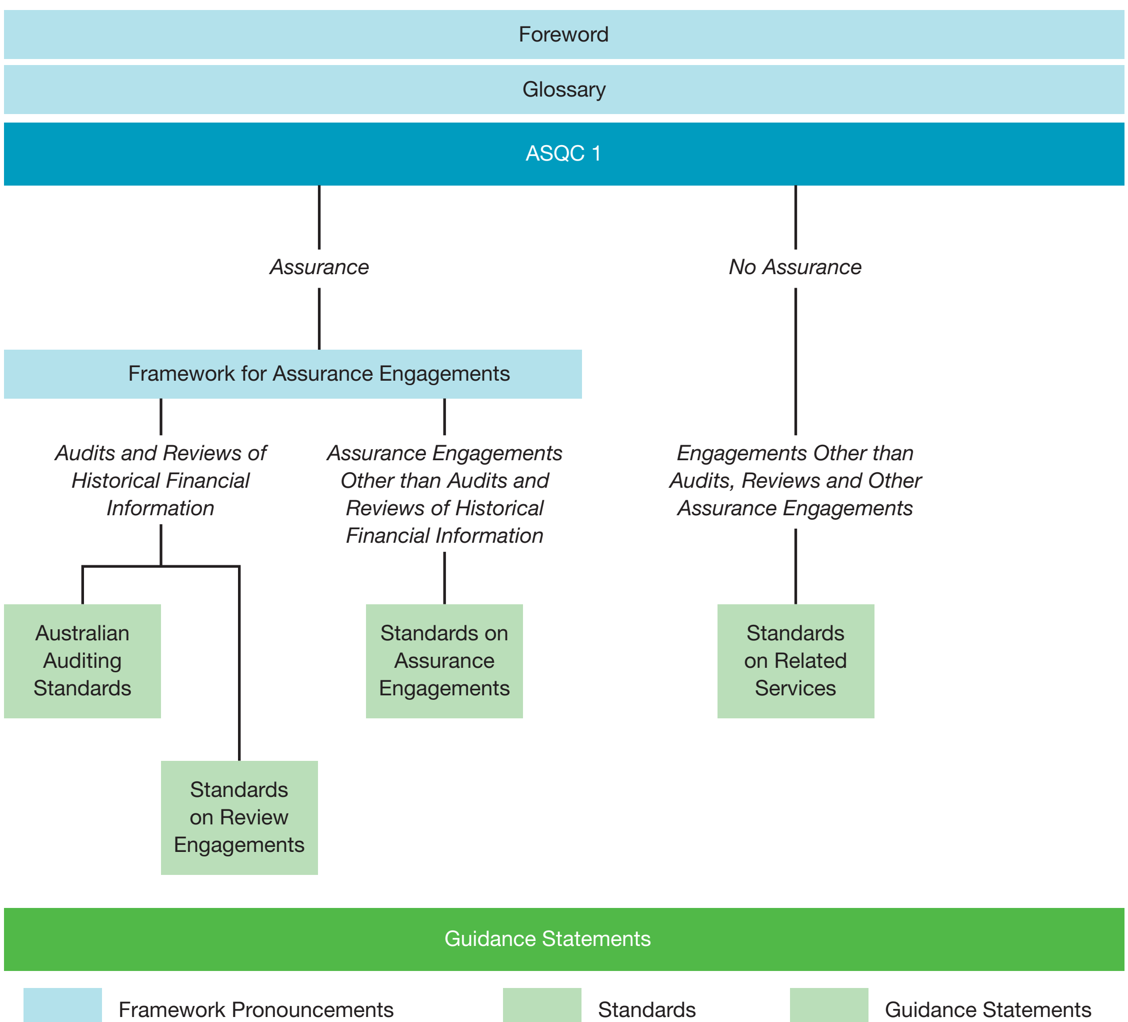
1.7.2 Regulation

In this section we provide a broad overview of regulations and ways they are enforced and reviewed that impact the audit process. We now discuss auditing standards and pronouncements, the Corporations Act, CLERP 9, ASIC inspections and Parliamentary inquiries 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 (ASQC 1) and Guidance Statements on audit, review, assurance and related services matters.[15] Figure 1.4 provides an overview of the pronouncements issued by the AUASB.

FIGURE 1.4 Structure of pronouncements issued by the AUASB



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

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 rules 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.

ASIC inspections

The Australian Securities and Investments Commission (ASIC) conducts regular inspections of audit firms and audit files. Their aim is to improve and maintain the quality of audits delivered by audit firms. The focus is on audits of financial reports prepared under the Corporations Act. ASIC selects audit engagements and inspects the audit files for those engagements to assess whether the audits comply with auditing standards and regulations.

ASIC provides each firm inspected with a report outlining areas where it believes the firm did not obtain sufficient appropriate evidence to support the audit findings. ASIC makes recommendations to each firm for future improvements to improve audit quality, and issues a public report on its findings across all firms inspected on a regular basis. These reports are available online at www.asic.gov.au.

Parliamentary inquiries

The Parliament of Australia regularly undertakes inquiries into areas of importance. In 2019, the Parliament commenced an inquiry into audit regulation. The terms of reference (issues considered) included:

- the relationship between auditing and consulting services and potential conflicts of interests
- other potential conflicts of interests
- the level and effectiveness of competition in audit and related consulting services
- audit quality, including valuations of intangible assets
- matters arising from Australian and international reviews of auditing
- changes in the role of audit and the scope of audit products
- the role and effectiveness of audit in detecting and reporting fraud and misconduct
- the effectiveness and appropriateness of legislation, regulation and licensing
- the extent of regulatory relief provided by the Australian Securities and Investments Commission through instruments and waivers
- the adequacy and performance of regulatory, standards, disciplinary and other bodies
- the effectiveness of enforcement by regulators.

The Parliament accepted submissions to inform the inquiry's deliberations. It received submissions from regulators, standard setters, professional bodies, audit firms, academics and other interested parties.

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 CADB?

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 1.5.

FIGURE 1.5 Audit expectation gap

Auditor performance ⟷ Expectation gap ⟷ **Financial report reader's expectations**

Auditor performance affected by:

- auditing standards
- ethical standards
- regulations
- legislation
- firm policy and procedures.

Financial report reader's expectations affected by:

- audit firm reputation
- audit firm independence
- reader's knowledge of auditing
- economic conditions.

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
- independent 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
- assurance providers reporting accurately the level of assurance being provided (reasonable, limited or none).

The enhanced audit report format aims to reduce the expectation gap by providing details about key audit matters identified during the audit and the audit processes used to assess those matters.

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.

Standard setters have responded to public demands that auditors pay greater attention to the risk that a material fraud may occur. 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*) 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).

The Parliamentary inquiry into audit regulation (2019–2020) was conducted with a view to identifying how best to regulate audits, assess the effectiveness of existing regulations and enhance current regulations.

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 roles 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 Disciplinary Board (CADB), Chartered Accountants Australia and New Zealand (CA ANZ), 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 a 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 Provided 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 the 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**

Thwin 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**

Livable Endeavours 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.[16]

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**

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

Myah Roberts has been the engagement partner on the IdealProtect audit for the last five years. Myah 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 (Theo Luna, who is to be promoted to partner to enable him to sign-off on the audit).

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

IdealProtect'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 IdealProtect. Consider the existence of any special interests of the users of IdealProtect'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, Lena, for dinner — you haven't seen each other for several years. Lena is surprised that you are now working as an auditor because your childhood dream was to be a flamenco dancer. Unfortunately, your knees were damaged in a fall and you can no longer dance. The conversation turns to your work and Lena wants to know how you do your job. Lena cannot understand why an audit is not a guarantee the company will succeed. Lena 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 Lena 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 Lena 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 CADB ★★★ **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, Harrison and Nixon, discussing some problems they are facing with a particular client. Harrison is advising Nixon to 'get the paperwork right' on the audit, otherwise they will be in trouble if they get selected for the ASIC inspection program.

Harrison is also concerned that 'the CADB will be after them'. After the conversation, Nixon comes to you to ask if you, as a recent graduate, know anything about the ASIC inspection program and the CADB. Nixon confesses that he hasn't been keeping up to date.

Required

Write a report to Nixon explaining (i) ASIC's audit inspection program and (ii) the CADB 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**

Canterlot Chartered Accountants is a successful mid-tier accounting firm with a large range of clients across Australia. During the 2020 year, Canterlot gained a new client, Cloudsdale Medical Group (CMG), which owns 100 per cent of the following entities:

- Everfree Forest Hospital, a private hospital group
- Calendula Care Pty Ltd, a private nursing home
- Tempo Cancer Treatment Limited (TCTL), a private oncology clinic that specialises in the treatment of cancer.

Year-end for all CMG entities is 30 June.

TCTL 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.

TCTL also wishes to purchase a new, more technologically advanced linear accelerator. The Department of Health funded half the purchase price on the basis that TCTL 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 TCTL 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 TCTL'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 — CREST OUTFITTERS

Crest Outfitters is a relatively young company, started in 2010 out of the garage of Peter Crest. Peter is a photographer and travels for 10 months of the year around the world capturing images for publications such as National Geographic and various other agencies. Peter was frustrated with the accessories available for his camera equipment out in the field. They weren't constructed for easy access, fast adjustment or long hikes and Peter began sketching out ideas for new accessories to help photographers focus on taking great shots and worrying less about their gear. Peter approached Anjani Pulapaka, a friend from university, and together they designed the One Camera Strap (OCS), a strap that was easily adjustable, non-slip and could be easily attached to and removed from any camera.

Peter and Anjani used their own savings to build 3D printed prototypes of the metal and plastic components for the OCS. However, they did not have funds to take their prototype to mass production. Peter and Anjani turned to Felix Wong, a Chartered Accountant and photography enthusiast. Felix outlined three potential sources of funding: obtaining a loan from a bank, using their own savings or seeking investors. Peter and Anjani had used their savings to build and test a prototype but the banks were reluctant to loan them funds based on that alone. Felix advised them that they could seek private investors; however, Anjani had recently seen a piece online about crowdsourcing funds for projects like theirs. Rather than seek a small number of large dollar private investors, they could approach the general public for funds. They investigated crowdfunding platforms and decided to use Kickstarter.

Kickstarter is an online platform that allows designers to obtain funds from the general public to help them create a new product. Those who agree to support a campaign are called 'backers' and they 'pledge' funds to a Kickstarter campaign and receive some 'reward' in return. That reward could be as small as a shout-out on a website or social media, but is most commonly (for physical goods) receiving one of the project's products at a discount. Kickstarter acts as a connection platform — the company doesn't take any responsibility for whether creators actually make the product they're seeking to crowdfund. Kickstarter earns its revenue by taking a small percentage of funds that creators receive.

In 2011, Crest Outfitters created a Kickstarter campaign for \$50 000 to help bring the OCS to market. The response on the platform was overwhelming and in 30 days, Crest Outfitters had received pledges for \$560 000. Peter and Anjani used these funds (less fees paid to Kickstarter) to begin mass production of their product, and sold and shipped 3500 units across the world. All remaining funds, after paying for production, shipping and other costs, were used to invest in new product designs. The company also pledged 1 per cent of all profits to be donated to environmental protection causes.

Crest Outfitters has created a loyal customer base through constant contact and communication using the Kickstarter platform and other social media outlets such as Facebook and YouTube. Products were gifted to influential photographers for reviews and write-ups online. The Crest Outfitters customer community has regular input into what products the company should produce next and each year the company launches a new Kickstarter campaign for their latest product to help finance initial manufacturing costs.

The Crest Outfitters brand now has a cult following among photographers and social media influencers worldwide. By 2020, Crest Outfitters had grown to employ 35 people in Australia and another 18 around the globe. Anjani now acts as the Chief Executive Officer (CEO) and Peter is Chief Product Design Officer (CPDO). The company has created other camera accessories such as bags and tripods and is also moving into general travel accessories.

Crest Outfitters wants to spearhead a new era of corporate social responsibility, even though it is are a privately-owned company (with long-term employees as shareholders) and there are no plans to list on a public stock exchange or accept venture funding capital — the company wants to promote transparency in their financial and non-financial information. Peter Crest is on the Board of Directors of Climate Neutral, an independent not-for-profit that provides a certificate for companies and brands whose products and services are climate neutral. Crest Outfitters will be one of the first organisations to receive Climate Neutral certification and will require assurance over their climate emissions report.

Crest Outfitters has approached Felix Wong's accounting practice AuditTek to conduct the assurance engagement required to help them achieve their business objectives. While Felix did provide some accounting advice to Crest Outfitters in its early days, he has not been involved in the operations and now must consider how to provide this potential client with the services they need.

In preparation for a meeting with Anjani and Peter, Felix plans to recommend that Crest Outfitters have its financial statements audited and climate emissions report assured to the Climate Neutral standards. It will be critical to clearly explain audit and assurance engagements to Anjani and Peter so that there is no confusion about the services and outputs they will receive.

AuditTek is a medium sized practice that focuses on providing accounting services to its clients and has three divisions based on the services it provides: audit and assurance, tax and bookkeeping. Staff in these divisions work in separate areas of the AuditTek offices. The bookkeeping division consists of three Australian-based staff members and another 10 staff based in Manila, the Philippines. All audit and assurance and tax staff are based in Australia. The largest part of AuditTek's business is providing audit and assurance engagements.

Anjani and Peter are listening to Felix's presentation about the types of assurance engagements they might purchase to help them fulfil their desires for financial and non-financial transparency. They understand that the *Corporations Act 2001* does not require them to produce any of these reports, but they want their company to be a leader in this area and go above and beyond. Ben James, Crest Outfitters' Chief Financial Officer (CFO), is also present at this meeting.

Anjani and Peter are slightly confused when Felix begins to discuss with them the various types of audit opinions, using terms such as 'unmodified' versus 'modified' and explaining what exactly 'unqualified' means. However, Ben understands this language, having previously worked as a financial controller at a publicly listed firm.

Anjani has some questions for Ben and Felix, including:

- Will AuditTek be reporting on the quality of their decision-making as company executives?
- Will customers and users of the financial statements and the audit report understand what the technical language means?
- Would receiving a modified opinion affect Crest Outfitters' ability to raise funds on Kickstarter in any way?
- How might the company convey this information in a format and language that is more digestible for the everyday person?

Ben reminds Anjani and Peter that the preparation of the financial statements is their responsibility as the management of Crest Outfitters — that Felix and his team can only suggest what changes could or should be made based on their audit. Anjani, as the CEO, agrees that to go above and beyond what is legally required. Crest Outfitters will prepare an annual report and financial information as if it were a public interest entity or publicly listed company, and then will go beyond the regulatory requirements by reporting on its emissions and exactly how the company meets Climate Neutral certification requirements, and by obtaining reasonable assurance on that report in accordance with ASAE 3410 (ISAE 3410) *Assurance Engagements on Greenhouse Gas Statements*.

The Crest Outfitters executives (Anjani, Peter and Ben) receive a rough quote from Felix as to the cost of both of these engagements. Peter comments that the cost seems quite high; however, Felix explains that audits and reasonable assurance require the auditors to conduct detailed work and collect evidence to support their opinion. Unlike marketing expenses, where an increase in sales can be seen from a successful campaign, the direct impact of assurance on financial and non-financial information is more difficult to measure.

Felix suggests to the Crest Outfitters executives that they may wish to develop some marketing materials around their decision to voluntarily obtain assurance over information that they are not required by law to attain. Anjani points out to Peter that they should engage with their customer base to gather their perspectives on this decision.

Required

(a) Why might Crest Outfitters wish to disclose information — both financial and non-financial — to the public when the Corporations Act doesn't require them to? What benefit is it to the company? Could there be any negative consequences?

(b) How would Felix explain the differences between the various types of assurance engagements? In answering this question, differentiate between a financial report audit and assurance on the climate emissions report and climate neutral certification.

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.[17]

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

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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.

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13. 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).
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ACKNOWLEDGEMENTS

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