Week 1 _ Tute Solutions

Chapter 1 An overview of auditing

1.17 How have corporate collapses influenced the role of auditing in recent years?

The corporate collapses in the US and Australia have had a fundamental impact on the role of auditing in recent years. Recent events have led to closer public scrutiny on the role of the auditor, audit independence, and the methodology on how an audit is carried out.

Significant changes have been made to emphasise the following: A clear objective to enhance and maintain the integrity of the profession; Clearly address the auditor interest to the public is as important as to the client, such as safeguarding independence by eliminating complex relationship with audit clients (i.e. limit to audit only); Reiterate ethical governance; A clear distinction of audit and non-audit engagements carried out by the auditor, this leads to legislation and self regulation being established to a ban on certain non-audit services for audit clients; Stronger regulation on auditors and audit firms as well as tougher enforcement on non-compliance; Increasing the forensic nature of audit and stronger awareness of corporate fraud; Relate audit risks to business risk

1.20 What are the current implications of the audit expectation gap? Can it be reduced?

The current implications of the audit expectation gap are the same as it has always been. A difference in expectations about what users think they are getting and what they are actually getting is going to be a problem – particularly for a service like auditing that is difficult to observe. There are three important areas where differences in perceptions occur and they are as follows:

1 Reporting internal control. Reporting on internal control has not been taken on in the Australian environment – unlike in the US with Sarbanes-Oxley. In fact, the most recent iteration of the audit report actually includes a specific disclaimer on the issue of reporting on internal controls.

2 Detection of fraud. This has been an area where auditors have expanded their responsibilities in recent years through the development of ASA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of a Financial Report

(ISA 240). However, it is still not seen as the core objective of an audit and the only responsibility that still exists in relation to fraud is material fraud. As stated by the Chairman of the FRC, Jeff Lucy: I would say there is, in fact, now a clear market expectation to this effect – that is, that auditors are bloodhounds not just watchdogs. Simply put, the market expects auditors to pick up instances of fraud.
3. Evaluation of going concern. Current auditors’ responsibilities include a consideration of going concern. However, they make no positive assurance about what they do in this regard. Despite not commenting on this issue, the fact is that users think auditors are guaranteeing the ongoing financial viability of a firm, which is not currently true. Reducing the gap has traditionally focused on educating users about what an audit is actually designed to provide. However, this has not been particularly successful and therefore in the future more substantive changes on what auditors do and provide to users would seem the main way that a reduction in the expectation gap could occur.

1.24 Audit objectives

Required

Comment on the audit partner’s view of auditing.

There are two assertions in the audit partner’s view that should be challenged:

Auditor provides assurance on the assets of the firm
This is part of what is provided by the auditor but the auditor provides an opinion on the whole set of financial statements. Therefore assurance is also provided on the income statement as well, which requires an examination of revenue and expenses of an entity. The auditor also obviously examines the firm’s liabilities and owners equity.

Support management
While there are many possible users of the audit report and the management are the ones that auditors are dealing with mostly on a day to day basis, there is no question that the audit is primarily designed for the current shareholders of a company as a group.

1.26 Value of auditing

Required

Would you obtain an audit for this company? Explain the reasons for your decision.

In an unregulated scenario like this, it is most appropriate to examine some of the theories underpinning the demand for auditing to assess whether it would be rational to obtain an audit.
Agency theory
This is the main theory that underpins auditing. The question is whether there is a significant information asymmetry between the principals and managers to justify the need for an audit. In looking at these facts, there are only a few wealthy businesspeople who have primarily financed the company. Under these circumstances they are most likely in a position to have a high degree of access to material within the company. Therefore there may not be sufficient information asymmetry to warrant an audit. The bank only has a claim over a moderate amount of the company and therefore probably could not justify forcing an audit on the company and may just rely on guarantees.

Information hypothesis
This relates to where there is a larger group of investors in a company and is not the case for this company at the moment. However, if the company is thinking of a public listing in the short to medium term future it may be appropriate to get an audit in readiness.

Insurance hypothesis
There is only a limited amount that can potentially be recovered from auditors if the company were to fail. However, given that this is a start up company it may be reasonable to get an audit to provide some sort ‘insurance’ coverage in the event of failure. The shareholders should be aware that the audit is not designed to provide a ‘guarantee’ on the financial viability of the company.

Case study

1.29 Carla’s Coffee Pty Ltd There are two sets of questions: 1 Set
(a) Who are the various parties with an interest in Carla’s Coffees? Outline what you think their interests, motivations and concerns would be.

Carla
- Her primary interest has been in the development of the company. It appears now that she wishes to do other things and divest herself of her shares. It is reasonable to assume that a primary interest for her would be to obtain a good share price. Customers

- Their primary interest would be in the ongoing supply of high quality, fair trade, organic coffee. The main concern to this group would be the reports from The Age suggesting that some of the assertions about this coffee are not true. Northpac Banking Corporation

- The primary interest of the bank would be to ensure that the capital value of their loan is secure. They would have a concern about such a major restructuring of the business potentially putting their investment at risk. Wendy the CFO

- Her interest would presumably be on her ongoing employment. One motivation for her would be the bonus she receives based on profitability targets achieved. Another motivation would be maintenance of the value of the company before selling her shares. A concern would be the uncertainty surrounding the possible new owners of the business. Dozen Potential Investors

- They would be interested in ensuring the ongoing profitability of the business and the truth in the previously reported financial statements. Their motivation would be to earn a profit on their possible investment. They would have a number of concerns: (1) the departure of Carla; (2) accuracy of previously reported financial statements; (3) the ability of the company to maintain recent high growth; (4) the number of senior people in the company wanting to sell their shares; and (5) recent
bad publicity.
(b) Who would demand an audit of Carla’s Coffee? Why would they want an audit?

The two main parties who would demand an audit would be: (1) Northpac Bank; and (2) the dozen potential investors.

The dozen potential investors would certainly want an audit. There is an information asymmetry between them and the management of the company. An audit provides an independent evaluation of the financial statements on behalf of the investors. This would provide them with assurance as to the reliability of the prior reported financial statements to give them more confidence in investing in the company. Sometimes under these circumstances the investors would ask for a ‘due diligence’ report which is even more extensive than a normal audit and would include a review of some of the future projections for the company.

Although the bank has first claim on the assets of the company, they would also be interested in an audit of the company in this changing environment. The audit would provide reliability on the prior financial statements which include reporting on the company assets over which the bank has a claim.

2nd Set

(a) Assume you have been appointed as an auditor for Carla’s Coffee. On what items in the financial statements would you be focusing your main attention to provide users with an opinion that the financial statements represent a ‘true and fair’ view of the economic performance of Carla’s Coffee?

There has obviously been significant growth in the company’s assets. These are important figures because the bank loan has a claim on these assets and it will be the most ‘tangible’ part of the business purchased by the investors.

The other aspect of the audit should focus on areas of potential earnings manipulation. Strong growth over five years is impressive but this also creates significant pressure to maintain this growth. Associated with this is the bonus scheme that rewards the CFO based on financial performance. The auditor should therefore ensure that only appropriate revenue has been recorded in the current period and also that all expenses have been properly recorded.
(b) Would you have any particular concerns if it was the ‘dozen potential investors’ who had engaged you to undertake the audit?

Although legal liability is discussed later in the text, being employed by the dozen potential investors does increase the risk for the auditor. They will be making their investment decision based on the audit. This is fine but the auditor should make it clear what exactly is provided by an audit so they do not over-rely on the audited information. The audit does not provide a guarantee on the future viability of a company but enhances the credibility of information disclosed to increase the reliability for the users of the financial statements.

(c) What other aspects of the above case would concern you as an auditor and why?

Auditors need to consider business risks to the extent that they will affect the financial statements. In this case there are two major risks to the company that the auditor should be aware of and give due consideration to in their planning. The first is the potential departure of the founder of the business. This is a big risk because often for these types of businesses there is significant reliance on the founder. The other risk is the recent bad publicity. An integral part of the development of the company has been associated with the provision of ‘high-quality, fair-trade, organic coffee’. If there are serious questions raised about any of these assertions it could have severe negative consequences for the company.