An Overview of Auditing

What is an audit?

“A systematic process of objectively obtaining and evaluating evidence regarding assertions made about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users”

American Accounting Association

Audit objective

• To express an opinion about whether the financial report is prepared in all material respects in accordance with a financial reporting framework

ASA 200
Structure of an audit

Auditor responsibility

- To express an opinion of the financial report
- Obtain sufficient appropriate audit evidence
- Assess risks of material misstatement
- State whether the financial report is prepared in all material respects in accordance with an applicable financial reporting framework

A demand for audits

- Agency theory
- Information hypothesis
- Insurance hypothesis
Agency theory

• “...a contract under which one or more persons engage another person to perform some service on their behalf which involves delegating some decision making authority to the agent”

  Jensen & Meckling

• Each party acts in their own interest

Agency theory

Agency relationship

Information hypothesis

• Investors demand quality information in assessing risks and returns of their investments
• Audits improve quality of information by risk reduction, improvements of decisions & increased profits
• Major reason for demand for assurance services
Insurance hypothesis

• "the ability to shift financial responsibility for reported data to an auditor lowers the expected loss from litigation or related settlements to managers, creditors who might demand an audit to show they are being prudent to insure against losses"
  
  Wallace

Interesting parties:
- Investors and creditors demand an audit to be prudent and insure against losses
- Regulators to insulate themselves from criticism by directing blame to auditors
  - Examples: OneTel, HIH, Westpoint Corporation, ABC Learning Centres

Regulation

• Annual audits required by:
  - Companies, registered schemes & disclosing entities (excludes small proprietary companies)
  - Commonwealth & state government departments, statutory authorities, government companies and business undertakings, municipalities
  - Not-for-profit organisations
Providers of audits

- Financial audits provided by independent auditors
- Must be registered with ASIC to be able to perform audits on reporting entities
- Criteria set out in s. 1280 Corporations Act
  - Educational qualifications
  - Work experience
  - Member of ICAA or CPA Australia

Assurance

- Where information is prepared by one party and then attested to its accuracy by another party
- Financial audits imply a reasonable level of assurance
- Level of assurance can vary according to the particular engagement
- May be financial or non-financial

Relationship between auditing and assurance
Assurance

AUASB 2010 defines an assurance engagement as:
"an engagement in which an assurance practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of subject matter against criteria"
Case law

• Early cases associated with detection of fraud
• Change of focus resulting from increased complexity, increasing size of businesses and separation of owners from managers
• Greater emphasis on ‘reasonable skill and care’

Case law

• Pacific Acceptance case 1970
  – Auditor should pay due regard to the possibility of fraud and actively investigate the possibility of fraud if suspicious circumstances exist
  – Concept of ‘reasonable care and skill’ called for changed standards to meet changed business conditions

Case law

• Early 2000s
• Corporate collapses resulted in a Royal Commission
• Recommendations incorporated in Corporate Law Economic Reform Program (CLERP 9)
Case law

- Audit quality is the 'market-assessed joint probability that an auditor will both
  (a) Discover the breach, and
  (b) Report the breach
- Regulatory changes focused on reporting issues
- Other issues involved fee dependence and importance of the auditor in corporate governance

Regulation

- Main changes under CLERP 9 were regarding:
  - Audit independence
    - Non-audit services
    - Audit partner rotation
    - Auditor working for the client
  - Quality related changes
    - Role of Financial Reporting Council
    - Annual general meetings

- Australian Securities and Investment Commission (ASIC)
  - Regulates corporate, markets & financial services sector
  - Advise on selling of and disclosure of financial products and services to consumers
  - Majority of work carried out under Corporations Act
Regulation

- Companies Auditors and Liquidators Disciplinary Board (CALDB)
  - Established under ASIC Act
  - Hears breaches under Corporations Act of auditors and liquidators
- Australian and Securities Exchange (ASX)

Auditing standards

- Clarity project
  - Begun by IAASB in 2004
  - Objective to improve the clarity of auditing standards
  - ASA Clarity standards legally binding from 1.1.2010
  - Main changes
    - Mandatory requirements in first part of standard
    - Includes overall standard objective
    - 41 standards
Does the audit meet demands of users?

- Government regulators
- Management of company
- Employees
- Shareholders
- Customers

Audit expectation gap

- Assessing value can be examined by asking:
  - How often are they associated with company failure?
  - Do auditors get the audit report correct?
  - How much do they cost?
  - Do audits provide economic value in the market?

Audit expectation gap

- Actual performance of auditors
- Targeted performance
- Reasonable costs
- Perceived performance of auditors
- Frequent audit failures
- Auditors get audit reports correct
- Audit provides economic value in the market
Audit expectation gap

"the difference between what auditors actually do when they conduct an audit and what shareholders and others think auditor’s do, or should do, in conducting the audit"

Report of HIH Royal Commission

Audit expectation gap

• Remedies to address unrealistic expectations:
  – Education of stakeholders about what an audit provides

• Remedies to address deficient standards:
  – Reporting on internal control
  – Detection of fraud
  – Evaluation of going concern