Overview of the audit of financial statements

The appointment of an independent auditor

- The Corporations Act 2001 governs the appointment of the independent auditor section and important issues include:
  - The basic principles of auditor appointment as well as the applicable statutory provisions
  - Registration of auditors
  - Removal and resignation of auditors

Principles of the appointment of auditors

- Directors of public and large proprietary companies are required to appoint an auditor
- The duration of the first appointment is only until the first annual general meeting, during which the members appoint an auditor (s. 327)
- An auditor holds office until his or her death, removal or resignation (s. 327)
The removal and resignation of auditors

• An auditor may be removed from office only by resolution of the company at a general meeting, for which special notice under s. 329 has been given
• When a company receives special notice of a resolution to remove an auditor, it must send a copy of the notice to the auditor and lodge a copy with ASIC as soon as possible

The removal and resignation of auditors

• The auditor is then given 7 days to make representation in writing, with copies of the representation being sent to all members entitled to attend the meeting
• The auditor also has the right to be heard at the meeting
• Where an auditor is removed from office at a general meeting, the company may appoint another auditor at that meeting by a resolution passed by at least a three-quarter majority, or at an adjourned meeting

The removal and resignation of auditors

• These provisions regarding the removal of an auditor have the effect of strengthening the auditor’s independence
• The auditor can therefore qualify the accounts or argue an accounting position without the potential threat of immediate dismissal by the directors
• An auditor must apply to ASIC for consent to resign, stating the reasons
Registration of auditors

- Corporations Act sets out educational, level of training and experience required to register as registered company auditor

Duties of an independent auditor

- When an auditor accepts an appointment, he or she enters into a contractual relationship with the company
- The audit engagement letter, agreed to and signed by the auditor and the client, details some of the duties of an auditor for a company
- See ASA 210 Terms of Audit Engagements

Duties of an independent auditor

- There are express or implied terms in such contracts that the auditor will:
  - exercise a reasonable degree of care and skill
  - be independent of the company
  - report to members his or her opinion, as to whether the financial statements are properly drawn up so as to give a true and fair view of the company’s financial position, in accordance with the Corporations Act and applicable accounting standards
  - comply with auditing standards and other professional standards
The audit opinion

• The auditor must express an opinion on ‘whether the financial report is prepared, in all material respects, in accordance with the applicable financial reporting framework.’
• The opinions expressed in an auditor’s report must be in accordance with ASA 700 (ISA 700) The Auditor’s Report on a General Purpose Financial Report

The audit opinion

• The audit opinion can be either unmodified or modified (qualified) in some way
• An unmodified opinion can, however, have an ‘emphasis of matter’ paragraph
• According to ASA 705 Modifications to the Opinion in the Independent Auditor’s Report, modifications are expressed as:
  – a qualified opinion
  – an adverse opinion
  – a disclaimer of opinion
  – Also by inclusion of an ‘emphasis of matter’ or ‘other matter’ paragraph

Duty to report

• Auditor has a statutory duty to report to members on the company’s financial statements
• Must notify ASIC if there are reasonable grounds to suspect a contravention of the Corporations Act
Auditing standards

• Auditors reply on a codified set of auditing standards prepared by the Auditing and Assurance Standards Board (AUSASB)
• Uniformity with international auditing standards
• Standards indicate the minimum level of care required in performing an audit. Ultimately the courts determine whether the level of care provided is adequate.

Clarity standards introduced October 2009

Structure:
• Mandatory components
  – Application
  – Operative date
  – Objectives
  – Definition
  – Requirements
• Explanatory material
Auditing standards

Independent auditor relationships

- In a financial statement audit, the auditor maintains professional relationships with four important groups
  - the shareholders
  - the board of directors and audit committee
  - the internal auditors
  - management

The shareholders

- Shareholders rely on the audited financial statements for assurance that management has properly discharged its stewardship responsibility
- *The auditor, therefore, has an important responsibility to shareholders of the company*
- In theory, the directors’ powers to appoint the auditor are limited; in practice, the shareholders of the company generally accept the recommendations of the directors
The board of directors

- The board of directors of an entity is responsible for seeing that the entity operates in the best interests of the shareholders.
- The auditor’s relationship with the directors largely depends on the composition of the board and best works when the majority are outside or non-executive directors.

The audit committee

- The Australian Stock Exchange now requires all listed companies in the Top 300 to have an audit committee.
- Audit committees have an important role in corporate governance.
- The Audit Committees: Best Practice Guide was developed by the AUASB to assist companies in setting up audit committees.

The audit committee

- The main objectives of an appropriately established and effective audit committee usually include the following:
  - assisting the board of directors in discharging its responsibility to exercise due care, diligence and skill in relation to the entity’s reporting of financial information, accounting policies, internal control system and risk management system.
The audit committee

• improving the credibility and objectivity of the accountability process (including financial reporting)
• providing a formal forum for communication between the board of directors and senior financial management
• improving the effectiveness

Internal auditors

• From the perspective of the independent auditor, internal auditing is a component of the entity’s control environment
• As an independent unit within the entity, the internal auditor examines, evaluates and monitors the adequacy and effectiveness of the internal control structure
• ASA 610 Considering the Work of Internal Audit requires the independent auditor to assess the work of the internal auditor
• This is done for the purpose of planning the audit and developing an effective audit approach

Management

• During the course of an audit, there is extensive interaction between the auditor and management
• The typical approach of the auditor towards management's assertions may be characterised by professional scepticism
• This means the auditor should neither disbelieve management’s assertions nor thoughtlessly accept them without concern for their truthfulness
• The auditor should also consider ASA 580 Written Representations when considering management representations during an audit.

• As stated in ASA 580.14, representations by management cannot be a substitute for other audit evidence that the auditor could reasonably expect to be available.

• Auditors should ensure that they do not rely on management representations for the sake of convenience when alternative evidence is available.

Management and auditor responsibilities

• The Corporations Act (s. 294) stipulates that directors must make a declaration which states:
  – that the financial statements and notes comply with accounting standards
  – that the financial statements and notes give a true and fair view
  – that the financial statements comply with the Corporations Act
  – that there are reasonable grounds to believe that the company will be able to pay its debts as and when they fall due.

Relationship between accounting and auditing

- Financial reporting
  - Prepare financial statements for presentation to shareholders
  - Prepare annual report
  - Prepare financial statements for government use
  - Prepare financial statements for tax purposes
  - Prepare financial statements for other purposes

- Auditing
  - Examine company records
  - Examine internal controls
  - Examine financial statements
  - Express an opinion on the financial statements
  - Issue a report to the board
  - Issue a report to the shareholders
  - Issue a report to the tax authorities
## Benefits of an audit

1. **Access to capital markets** — public companies must satisfy statutory audit requirements in accordance with the Corporations Act.

2. **A lower cost of capital** — potential creditors may offer lower interest rates and potential investors may be willing to accept a lower rate of return on their investment.

3. **Audited financial statements improve an entity’s credibility and therefore reduce risks for investors and creditors**.

4. **Deterrent to inefficiency and fraud** — financial statement audits can be expected to have a favourable effect on employee efficiency and honesty.
   - Knowledge that an independent audit is to be performed is likely to result in fewer errors in the accounting process and reduce the likelihood of employee misappropriation of assets.

5. **Control and operational improvements** — The independent auditor can suggest how controls could be improved and how greater operating efficiencies within the entity’s organisation may be achieved.
   - Weaknesses in controls and suggestions for improvement are usually outlined in the management letter (discussed later).

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### Audited financial statements

- Improve an entity’s credibility.
- Reduce risks for investors and creditors.

### Deterrent to inefficiency and fraud

- Financial statement audits can have a favourable effect on employee efficiency and honesty.
- Knowledge of an independent audit performed reduces the likelihood of error and misappropriation.

### Control and operational improvements

- Auditors can suggest improvements in controls and operational efficiencies.
- Weaknesses in controls and suggestions for improvement are outlined in the management letter.

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### Further Reading

- [Corporations Act](https://corporations.act.gov.au/)
- [Auditing Standards Board](https://asb.asn.au/)
- [Financial Statement Audits](https://www.icas.org.uk/)

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*31-Oct-2011*
Limitations of an audit

• **Time lapse** - A common criticism of the audit function is that the lapse of time between balance date and the presentation of the audit report may be up to 4 months – the Corporate Law Reform Act 1994, provides investors with more up-to-date information about a company by requiring the ongoing or continual disclosure of relevant information.

Limitations of an audit

• **Audit testing on selective sample** - risk that the sample drawn from the population may not be representative of the sample (sampling risk)

• **Assessment of materiality** - requires a high degree of professional judgement and requires quantitative and qualitative considerations
  – No universally agreed upon guidelines

Limitations of an audit

• **Highly specialised areas** - auditors may be required to form a professional opinion in highly specialised areas or that are not dealt adequately with in accounting or auditing standards e.g. Valuation of intangible assets, environment-related accounting items
Limitations of an audit

• Report format limitations
  – The audit report and the body of the financial statements are subject to interpretation
  – The standard format of the audit report may not reflect fully the complexities involved in the audit process and the decision of the audit opinion
  – Despite these limitations, an audit of the financial statements adds credibility to the financial information