

Chapter 1

Assurance and auditing: an overview

Resources

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Learning objectives

- 1.1 Understand the framework for assurance engagements and the types of assurance engagements that can be provided.
 - 1.2 Define auditing and appreciate the fundamental principles underlying an audit.
 - 1.3 Appreciate the attributes of accounting information and understand the reasons giving rise to demand for assurance.
 - 1.4 Explain the concept of the expectation gap, especially in the areas of auditors' report messages, corporate failures, fraud and communicating different levels of assurance, and appreciate the relationships between the auditor, the client and the public.
 - 1.5 Appreciate the role of auditing standards and their authority under the *Corporations Act 2001*.
 - 1.6 Obtain an overview of other applications of the assurance function, including compliance engagements, performance engagements, comprehensive engagements, internal auditing and forensic auditing, as well as providing assurance on subject matter other than historical financial information.
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Major chapter sections

The framework for assurance engagements and the types of assurance engagements

Auditing—definition and fundamental principles

Attributes of accounting information and the demand for assurance

The auditor–client–public relationship and the expectation gap

The role and authority of auditing standards

Other applications of the assurance function

Lecture plan

When students arrive at the first lecture, they usually have little understanding of what assurance and auditing entail. We find that the first class is very important for capturing students' attention and stimulating their interest in the subject. (Generally, they have also not read Chapter 1 before the first class.)

It is important to summarise the many things that are currently happening with the auditor's role, especially with the demand for increased accountability, and therefore additional information, in the areas of sustainability reporting and climate-related information. However, it is not good enough to just report on this information. The information needs to be credible, and this is the role of assurance.

This provides the opportunity to emphasise how important the auditing and assurance profession is currently perceived to be with regard to the role it plays in society, and to set the scene for what students can expect during the course. You should outline the learning objectives for this chapter and walk the students through the flowchart of the overall auditing and assurance framework.

[Use slides 1-2 to 1-3]

LO 1.1: Understand the framework for assurance engagements and the types of assurance engagements that can be provided.

With increasing demands for assurance to cover a wide range of subject matters, the International Auditing and Assurance Standards Board (IAASB), and the Australian Auditing and Assurance Standards Board (IAASB) has revised its framework for assurance engagements. This framework covers audits as well as reviews of historical financial information, and also other assurance engagements, such as assurance on corporate social responsibility reports or greenhouse gas reports, both of which are increasingly demanded by society. This framework provides independent and expert auditors and assurance practitioners with criteria against which to examine reports.

This section helps students understand the fundamentals of auditing and assurance before tackling the course. It also shows how the framework relates to both financial report audits and other assurance services.

The section:

- provides an explanation of *assurance engagement* and its five elements
- outlines the need for members of the profession to be independent; that is, without interests that may create risks of material bias with respect to the quality or content of information, and be expert in both auditing/assurance techniques and the subject matter being assured. It is important to exercise professional judgment and professional scepticism to maintain assurance services quality.

Slide 1-6 contains a diagrammatic depiction of the parties to an insurance engagement, which can be found at Figure 1.2 of the textbook.

[Use slides 1-4 to 1-9]

Types of assurance standards

To help students gain a deeper understanding of assurance, this section looks at the types of assurance standards and pronouncements. It reviews the two different types of assurance: *reasonable assurance engagements* (an audit) and *limited assurance engagements* (a review). This synopsis of *audits* and *reviews* will be useful for students to compare and contrast. It also outlines that there are engagements that provide no assurance, agreed-upon procedures.

This section also outlines the difference between attestation and direct engagements.

[Use slides 1-10 to 1-12]

LO 1.2: Define auditing and appreciate the fundamental principles underlying an audit

We have used and expanded on the definition in A Statement of Basic Auditing Concepts (ASOBAC) here because it nicely captures the major components and the important parts of the audit process (outlined on slide 1-13), rather than simply stating the objective. Students should be encouraged to compare this definition with the one contained in the Auditing and Assurance Standards Board (AUASB) glossary/ISA Glossary of Terms. It should be pointed out that these definitions are similar, although the profession's definition is more technical and does not use the word assertion (recognising that there are direct engagements as well as attestation engagements).

[Use slides 1-13 and 1-14]

LO 1.3: Appreciate the attributes of accounting information and understand the reasons giving rise to demand for assurance

If students are to thoroughly understand the audit process as it relates to accounting information, it is crucial for them to appreciate the role of accounting information and the process of communication through financial reports.

This section highlights the fundamental characteristics of information that enables objective financial reporting:

- relevance
- faithful representation.

It also highlights the enhancing characteristics of information that enable objective financial reporting:

- comparability
- verifiability
- timeliness
- understandability.

[Use slide 1-15]

Demand for assurance

It is worthwhile spending a reasonable amount of time during the first lecture discussing why there is a demand for assurance beyond the legal requirements. It is important that students have a basic understanding of the agency relationship that leads to auditing.

[Use slides 1-16 to 1-18]

Benefits of assurance

There are benefits of assurance related to the improved relevance and reliability of the assured information and the consequential reduction in information risk. This should result in reduced cost of capital. Financial analysts should also make more accurate and informed recommendations. Both of these benefits should result in an improved allocation of investment resources over the range of investment opportunities.

There are other benefits resulting from an assurance engagement, in addition to increasing users' confidence in reported information. These include recommendations to improve efficiency and effectiveness and a positive influence on the behaviour of people with audited entities.

[Use slides 1-19 and 1-20]

LO 1.4: The auditor–client–public relationship and the expectation gap

Students should be introduced to the relationship between the auditor, the client and the public.

The expectation gap and the information gap

Exposing students at an early stage of the course to the expectation gap and where gaps commonly occur usually encourages them to use critical thinking as they proceed through the course. A diagrammatic representation of the expectation gap is provided in Figure 1.5 on slide 1-24. This expectation gap has been referred to by the IAASB/AUASB in considering auditing standards developments in going concern and fraud.

[Use slides 1-21 to 1-24]

LO 1.5: The role and authority of auditing standards

Students should be introduced to the various auditing standards and guidance standards: auditing standards (ASAs/ISAs); and Guidance Statements (GSs). Under the *Corporations Act 2001*, Australian Auditing Standards have legislative backing. The implications of this should be briefly introduced.

[Use slide 1-25]

Auditor's responsibilities under the *Corporations Act 2001*

The emphasis in most auditing and assurance courses is on audits of financial statements, undertaken in Australia in accordance with the *Corporations Act 2001*, which is the cornerstone assurance service on which standards and methodologies are developed, which can then be applied to assurance services on other information. It is worthwhile letting students know that this will be covered in more detail in the course, and in the textbook in Chapters 2-12.

[Use slide 1-26]

LO 1.6: Other applications of the assurance function

The uses of audit evidence-gathering methods are not confined to an expression of opinion on financial reports. This section takes the students through their other uses.

These include commentaries on:

- compliance engagements
- performance engagements

- comprehensive engagements
- internal audits
- forensic audits
- assurance on subject matter other than historical financial information, including sustainability and climate related information.

Students are usually very interested in the greater accountability around the sustainability and climate related information, which is covered in detail in Chapter 13 of the text. Instructors should outline the extent to which these assurance services are covered in the course.

As these assurance services are discussed in more detail later in the course, at this stage this should be no more than a very brief introduction.

[Use slides 1-27 and 1-28]

Summary

We provide a summary slide of the main learning takeaways in this chapter.

[Use slide 1-29]

Solutions to review questions

- 1.1** Paragraph 10 of the *Framework for Assurance Engagements (International Framework for Assurance Engagements)* defines an assurance engagement as “an engagement in which a 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”.
- Paragraph 26 of the *Framework for Assurance Engagements (International Framework for Assurance Engagements)* identifies the following five elements of an assurance engagement:
1. Three party relationship, comprising:
 - assurance practitioner (auditor)—in Australia this would be a member of a recognised accounting body (CPA Australia, Chartered Accountants ANZ or the IPA), and one who is bound by the profession’s code of ethics
 - responsible party—the person or persons responsible for the underlying subject matter. For example, in Australia it is the board of directors that is responsible for the preparation of the financial report
 - intended users—the person or persons expected to use the assurance practitioner’s report. Often the intended user will be the addressee of the assurance practitioner’s report, although there will be circumstances where there will be other identified users.
 2. An appropriate underlying subject matter, which can take many forms, such as:
 - financial position and performance
 - non-financial performance
 - physical characteristics
 - systems and processes
 - behaviour.
 3. Suitable criteria, such as the standards or benchmarks used to measure and evaluate the underlying subject matter of an assurance engagement. Criteria are important in the reporting of a conclusion by an assurance practitioner as they establish and convey to the intended user the basis on which the conclusion has been formed.
 4. Sufficient appropriate evidence that must be obtained by the assurance practitioner about whether the subject matter information is free of material misstatement.
 5. A written assurance report that provides a level of assurance about the subject matter based on the conclusions drawn by the assurance practitioner.
- 1.2** The assurance framework outlines that an audit practitioner can provide two levels of assurance for an assurance engagement: reasonable assurance and limited assurance. For assurance services on historical financial information, a reasonable assurance engagement is commonly termed an audit, and a limited assurance engagement is commonly termed a review engagement. The objective of a reasonable assurance engagement (audit) is to reduce assurance engagement risk to an acceptably low level, and this is associated with a positively expressed assurance opinion (such as that the financial information is true and fair). The objective of a limited assurance engagement (review) is to reduce assurance engagement risk to a level that is acceptable in the circumstances—but where the remaining risk is greater than with a reasonable assurance engagement. The conclusion is expressed in

a form that conveys whether, based on procedures performed and evidence obtained, any matter has come to the auditor's attention to persuade them that the information has been materially misstated.

- 1.3** An agreed-upon procedures engagement uses assurance techniques such as evidence-collection procedures, but does not attempt to communicate a level of assurance. The auditor does not have discretion to undertake evidence-collection procedures outside those that have been agreed upon. The auditor therefore only issues a report of factual findings to the parties that have agreed to the procedures being performed, in which no conclusion is communicated and which therefore, expresses no assurance. However, it provides the user with information to meet a particular need, from which they can draw conclusions and derive their own level of assurance as a result of the auditor's procedures.
- 1.4** An *attestation engagement* requires a party other than the auditor to measure or evaluate the underlying subject matter against the criteria—the auditor's report covers that measurement or evaluation by the responsible party. A general-purpose financial report audit is an example of an attestation engagement. A *direct engagement* requires the auditor to directly measure or evaluate the underlying subject matter against the criteria. For example, an auditor's report could be issued on the adequacy of internal control where management does not measure or evaluate the adequacy of internal control. Therefore, the auditor is required to report directly on its adequacy and the engagement is classed as a direct engagement.
- 1.5** ASA 200.11 (ISA 200.11) states that the objectives of the auditor in undertaking a financial report audit are:
 - (a) To obtain reasonable assurance about whether the financial report as a whole is free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework; and
 - (b) To report on the financial report and communicate as required by the Australian Auditing Standards (International Standards on Auditing), in accordance with the auditor's findings.
- 1.6** The fundamental characteristics of accounting information include:
 - *Relevance*. This requires that the information provided must be helpful to financial report users in making and evaluating decisions about allocating scarce resources and assessing the accountability of those who prepare these reports.
 - *Faithful representation*. This is the extent to which the information presented to users represents, without bias or undue error, the underlying transactions and events that have occurred.The enhancing characteristics of accounting information include:
 - *Comparability*. For information to be useful, financial report users should be able to compare aspects of an entity at one time and over time, and between entities at one time and over time.
 - *Verifiability*. Different knowledgeable and independent observers could reach consensus that a particular depiction is a faithful representation.
 - *Timeliness*. Information is available to decision makers in a timely fashion so it can influence their decisions.
 - *Understandability*. Classifying, characterising and presenting information clearly and concisely.

The auditor's report provides users with reasonable assurance that these characteristics have been met.

- 1.7** The demand for an independent financial report audit arises from the following conditions:
- *Conflict of interest.* The user may perceive an actual or potential conflict with the preparer. For example, management could have an incentive to present biased information in a financial report because these reports are a means of conveying information about management's performance or may impact on their bonus. An independent, third-party examination reduces the likelihood of bias and therefore enhances the credibility of the information.
 - *Consequence.* When a user is contemplating using information to make decisions of significant consequence, the quality of that information is of direct concern.
 - *Complexity.* The subject matter and the process by which the data (for example, transactions) is converted into information (for example, financial reports) is complex, increasing the possibility of error and the need for a high level of expertise (which the average user of the financial information does not possess) to judge the quality of information.
 - *Remoteness.* The separation of owner and manager, and therefore the user and the preparer of the financial report, prevents the user from assessing the quality of the information.
- 1.8** An assurance service can improve the efficiency and effectiveness of the operations of an entity whose activities are being assured in several ways. An assurance engagement such as a performance audit may be constructed so that its major objective is to identify material inefficiencies and ineffectiveness. In order to do this, the assurance practitioner would need to have criteria outlining what an efficient and effective operation looks like. However, even if the objective of an assurance engagement was not to identify inefficiency and ineffectiveness, an assurance engagement may result in identifying deficiencies in the activities assured and making recommendations for possible improvements in performance. Also, efficiency and effectiveness may be improved by positively influencing the behaviour of the people whose activities are being assured; people can be more inclined to conform to established procedures when they know their work will be examined for this.
- 1.9** Although in theory auditors are appointed by shareholders, in practice, auditors are often effectively selected and paid by the people affected by their work, i.e. management, with shareholders merely endorsing those decisions. Further, a financial report audit requires the auditor to have a close working relationship with management and an intimate knowledge of many of management's actions, decisions and judgments, which have a significant effect on the financial report. Therefore, an auditor is subject to conflicting pressures—total independence is very difficult to achieve. The auditor depends on fees from clients and necessarily has a close relationship with clients, but may need to persuade a client to disclose unfavourable information in fulfilling their audit duties.
- 1.10** The expectation gap is the difference between society's expectations of auditors and auditors' performance as perceived by society. The expectation gap consists of three gaps:
- *Knowledge gap.* The difference between what the public thinks auditors do and what auditors actually do.
 - *Performance gap.* Where auditors do not do what the auditing standards or the regulations require.

- *Evolution gap.* Areas of the audit where improvement is needed, taking into consideration the general public's demands, technological advances, and how the overall audit process could be enhanced to add more value.

1.11 It has been suggested that the way that auditors communicate their findings to users of the financial report creates a communications gap. This reflects differences between what users desire and understand and what, and how, findings are communicated by the assurance provider. For example, because the standard auditor's report uses generic language to describe the auditor's work effort, users do not get a complete picture about the extent of the auditor's procedures on a particular audit. Therefore, there is a gap between what is actually done and what users perceive is done in connection with the audit.

1.12 A common misperception of the audit process is that external auditors should provide the general public with early warning of corporate failures. While an entity's financial report is normally prepared based on the assumption that it is a going concern, and the auditor will undertake procedures to satisfy themselves of the reasonableness of this assumption, this does not necessarily mean that the entity will continue in existence. Situations may occur later, or not be apparent at the time when the auditor issues their report, which result in the entity ceasing to exist.

1.13 Auditing and assurance standards prescribe the basic principles and essential procedures governing an auditor's professional conduct. Therefore, the standards govern the way in which an assurance service is provided, and outline what the assurance service provider is required to do.

Auditing and assurance standards help an individual auditor by providing a benchmark against which to assess individual performance, and provide the courts with an authoritative benchmark against which to measure an auditor's performance in the event of an auditor's work being subject to litigation. The standards also make it clear to third parties that the profession has expectations to which its members must adhere. In addition, the auditing standard-setting bodies are able to improve the quality of auditing practice by updating their standards and informing individual auditors about changes in the audit function.

Complying with auditing and assurance standards is mandatory for all members of the accounting bodies for all audit and assurance engagements under APES 210. Compliance is legally enforceable under section 307A of the *Corporations Act 2001* for statutory audits and reviews of the financial reports of companies.

1.14 Forensic auditing involves detecting, investigating and deterring fraud and white-collar crime. Some situations in which forensic auditors are involved include:

- analysing financial transactions involving unauthorised transfers of cash between companies
- reconstructing incomplete accounting records to settle insurance claims over inventory valuation
- proving the commission of money-laundering activities by reconstructing cash transactions
- investigating and documenting embezzlement, and negotiating insurance settlements.

1.15 An internal audit is an appraisal activity within an entity to review financial and business risks and other operations as a service to management. This type of audit is undertaken by a body of audit professionals who are internal to, or employees of, the entity being audited.