



MODERN AUDITING & ASSURANCE SERVICES

6TH EDITION

Leung Coram Cooper Richardson

WILEY

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About the authors

Philomena Leung is Professor and Head of the Department of Accounting and Corporate Governance at Macquarie University, Sydney. She has had extensive teaching experience at tertiary and postgraduate levels for over 30 years, specialising in auditing, ethics and corporate governance. Prior to undertaking the role at Macquarie University, Philomena held senior academic positions at Hong Kong Polytechnic University and in Australia at Victoria University, RMIT University and Deakin University. Her PhD in accounting ethics and her KPMG auditing experience from Hong Kong provide an insight into issues relevant to the accounting and auditing profession. Philomena has written for a number of academic and professional journals in the areas of auditing, corporate governance, ethics, internal auditing and accounting education. She has received a number of research grants and has led and co-authored many research projects in the areas of ethics education, internal auditing and professional issues. Philomena has spoken at many conferences and seminars and is a sought-after speaker for national and international forums and media interviews. She is actively involved in the auditing profession, bridging between academia and practice. Philomena believes in supporting the development and reshaping of the profession in Australia and internationally.

Paul Coram is Professor of Accounting and Head of the School of Accounting and Finance at the University of Adelaide. Paul has a Masters in Accounting from the University of Western Australia and a PhD from the Australian National University. He worked as an auditor and became a Chartered Accountant with one of the Big Four firms in Australia, also gaining work experience as an auditor in London. He is actively involved with the Institute of Chartered Accountants and has been a member for over 20 years. Paul has postgraduate qualifications in education and was the inaugural winner of the Pearson Education Accounting Lecturer of the Year Award in 2001. Paul complements his teaching with research in auditing, and has a particular interest in the areas of audit quality and the value of assurance services. He has presented and published his research in Australia and internationally, and serves on the editorial board of the leading auditing journal, *Auditing: A Journal of Practice and Theory*.

Barry J Cooper is Professor of Accounting and Interim Head of the School of Accounting, Economics and Finance at Deakin University, Melbourne. He has a Bachelor of Commerce and a Master of Education from Melbourne University, a PhD from RMIT University, is a Fellow of CPA Australia and the Association of Chartered Certified Accountants (ACCA), and is a past global president of ACCA. After gaining experience as an auditor, Barry joined RMIT University in 1972 where he taught auditing and financial accounting. In 1987, he joined Hong Kong Polytechnic University and was Head of the Department of Accountancy for 4 years. After returning to Melbourne, he was appointed Head of Accountancy at RMIT University until late 1997, when he took leave and joined CPA Australia as National Director – Member Services. During his time at CPA Australia, Barry was responsible for the operations of the CPA divisions throughout Australia and Asia. After returning to RMIT, Barry later joined Deakin University and is currently Head of the School of Accounting, Economics and Finance at Deakin University. During his academic career, IV Barry has undertaken a number of research projects in the areas of auditing, ethics and accounting education, presented at numerous conferences, published a number of articles in professional and academic journals, and co-authored several books.

Peter D Richardson is a manager with a public sector organisation as well as a teacher of financial reporting and auditing to students preparing for the exams of the ICAA and CPA Australia. He has a Bachelor of Commerce (Hons) and is a member of the Institute of Chartered Accountants in England and Wales. After spending 10 years working for various private accounting firms in the United Kingdom, Peter joined BPP Professional Education, a UK-based public company which, among other things, teaches students strategies for passing their UK professional accounting exams. After 6 years with BPP in the United Kingdom, Peter relocated to Singapore as Managing Director of the local BPP subsidiary, where he was responsible for setting up a BPP school. In 2006 he moved to Australia and joined Deakin University as a lecturer in accounting and auditing.

Preface

Modern Auditing & Assurance Services, 6th edition, is written for courses in auditing and assurance at undergraduate, postgraduate and professional levels. The practice of auditing is explained in the context of auditing theory, concepts and current practice, with appropriate reference to the Australian auditing standards and the respective international standards on auditing.

Auditors play a vital role in the current economic environment, with increasing responsibility for ensuring market integrity. The development of auditing practice reflects how the accounting profession responds to the complex demands of information, competition, corporate failures and technology. Auditing continues to evolve in response to the changing business and regulatory landscape to maintain its relevance and importance. This book is a comprehensive guide to the development and practice of audits of a financial report, with an authoritative insight into the fundamental role of auditors, the influences on audits, and related issues.

Significant changes from the previous edition

This textbook has been further revised with new and contemporary developments since the last edition. The major changes are noted below.

Recent auditing topics embedded within the chapters

- Audit Quality – readers will appreciate that audit quality is a concept that underpins most of this text. The recent exposure draft issued by the International Auditing and Assurance Standards Board (IAASB) in relation to the Audit Quality Framework Paper is a consequence of various debates highlighted within this text. While the topic is being further developed at the time of writing, readers should appreciate that the topic continues to be an issue at the forefront of the profession. Audit quality includes the extent of applying professional judgement and scepticism in undertaking the audit engagement. Audit quality is discussed in chapters 3 and 4 and is referred to throughout the text.
- The role, purpose and the market for the audit profession – this topic is referred to in chapters 1 and 2, as the global audit profession critically re-evaluates the effectiveness of the audit market and its regulation.
- Ethics and corporate governance – professional ethics as defined in detail in APES 110 has reinforced the concept of the public interest. Discussions on professional ethics and the related topic of corporate governance are paramount to auditing and assurance services. The latest ASX corporate governance principles, the overriding principle of the public interest, and the requirements for the auditor to be proactive in dealing with auditing issues by meeting with the audit committee members, are discussed in chapters 1, 3 and 18.
- Scepticism – the importance of the attribute of scepticism to auditors' judgements has increased significantly in recent years. More consideration of this attribute in planning and evaluation of evidence are included in chapters 8 and 10.
- Internal controls – COSO produced a new framework on internal control in 2013 and relevant changes from this new framework have been included in chapters 9 and 11.
- Latest developments in regulatory regimes and audit expectations – this text is deliberate in providing a well-rounded view of what the auditors do, in addition to performing the technical functions. The expectations of the auditors in relation to the aftermath of the global financial crisis, and the latest legal and regulatory changes such as those provided in the competition and consumer laws, are discussed in [chapter 5](#).
- Audit reporting – the auditing profession has more recently re-examined the nature and extent of the audit report, and the language and presentation of the audit report to members. The topic of completing the audit is discussed in [chapter 18](#), with details of means to communicate audit findings to various stakeholders. The key changes in the chapter include the explanation on matters relating to the going concern of the audit client. The IAASB has proposed to significantly reform the content of a standard audit report. This is contained in its 2013 Exposure Draft *Reporting on Audited Financial Statements: Proposed New and Revised International Standards on Auditing*. [Chapter 7](#) on the auditor's report contains an extensive Professional Environment that outlines the main changes that are proposed in the ED. However, as a new standard is not planned to be released until late 2014 (after publication of this text) we could not include these changes in the main body of the chapter.
- Professional environment vignettes have been revised and updated throughout the text. These chapter vignettes present relevant, topical audit issues and/or events that relate the audit processes presented in the chapter to the business world.
- There has been a major revision to the end of chapter materials. In making these changes we have also utilised recent materials from the Institute of Chartered Accountants in Australia and the Association of Chartered Certified Accountants – we thank both of these organisations for their support.

Organisation

How to use this book. This feature helps readers see at a glance how they can make best use of the key features of this text.

Chapter openers. The chapter openers present a summarised account of the main elements in each chapter, the learning outcomes and the relevant professional statements, thus providing readers with a broad contextual base from which to approach each chapter. Each chapter contains an easy-to-read scene setter that provides a lively ‘entrée’ to the topic. Lecturers can use these scene setters to provoke class debate.

Learning objectives. The learning objectives are linked to the relevant section of the text by the restatement of the objective in the margin.

Learning checks. The learning checks are presented in a number of blocks in each chapter, summarising the major points covered. These checks reinforce student learning and provide a basis for revision.

Professional environment vignettes. In each chapter, professional environment vignettes highlight changes and some contextual information in the professional audit environment. These vignettes keep students up to date with recent trends, new developments and changes in technology that affect auditing and assurance services.

Glossary. The key terms, bolded in the text and listed at the end of each chapter, are defined in a glossary at the end of the book. This enables readers to clarify quickly the meaning of technical or unusual terms throughout the text.

XIV Content

Part 1: The auditing and assurance environment

[Part 1](#) provides insight into the major issues affecting the auditing and assurance environment. It takes the reader on a comprehensive journey to appreciate the development of the role of auditors, the legislative and regulatory regimes and current changes to the role of an auditor. This part of the text will give students an understanding of fundamental aspects of the auditing and assurance environment and insight into parts of the auditor's role and function that are directly relevant and of interest to audit partners as well as leaders in business and government.

[Chapter 1](#) ‘An overview of auditing’ sets the scene. It provides answers to fundamental questions about auditing including what an audit is, what auditors provide, why audits exist and their role in the capital markets and society. It also considers the environment within which auditors operate and the standards that they operate under. Finally, the chapter considers the important question of whether audits meet the demands of users.

[Chapter 2](#) 'Governance and the auditor' is a new chapter that introduces the overarching framework of enterprise governance and how auditing contributes to its key aspects of business and corporate governance. The overall objectives of the auditor relating to financial reporting, communication with those charged with governance, and risks and controls are explained with a view to establishing the reader's appreciation of the growing spectrum of assurance and value-adding activities that an auditor undertakes. The auditor needs to appreciate the risks of financial misstatements and the governance processes that safeguard the extent of earnings management. Other governance processes such as internal auditing, operational auditing and performance auditing are discussed. The chapter also covers accountability and governance processes in the public sector, and the role of an audit committee in supporting corporate governance. [Chapter 2](#) combines the previous [chapter 18](#) with details on the public sector, but focuses on governance to provide the broader framework of auditing.

[Chapter 3](#) 'Professional ethics, independence and audit quality' discusses the importance of professional ethics and independence in the role undertaken by the auditor. In particular, the chapter explains the conceptual principles underlying the *Code of Ethics for Professional Accountants* and describes the regulatory and conceptual framework of professional independence and the key guidelines for auditors. Corporate collapses are discussed in the context of the challenges these present to the auditing profession and the consequent regulatory reforms that often result. Finally, the chapter focuses on the issue of audit quality and the processes that the auditor must adopt to ensure that quality standards are met.

[Chapter 4](#) 'Other assurance engagements and quality standards' discusses assurance engagements other than the audit of an annual financial report. It starts by considering what is and what is not an assurance engagement by looking at the criteria that must be met. The chapter then considers a range of assurance services relating to historical and future financial information and other assurance engagements including compliance and performance engagements, sustainability reports and assurance on a greenhouse gas statement, including reference to the NGERs Act. It also highlights the international benchmark of quality standards that many international audit and assurance engagements will be measured against. These benchmarks include the ISO standards and total quality management standards.

xv [Chapter 5](#) 'The auditor's legal liability', discusses the legal environment and the auditor's liability to shareholders and auditees. The question of potential liability to third parties is also considered. As all professionals are covered by competition laws, partnerships, audit companies or sole practitioners and their associations have become subject to the competition provisions of the Trade Practices Act and the competition codes, and the issues that are of relevance to auditors are highlighted. Finally, the global financial crisis and the potential liabilities for auditors are examined.

Part 2: Audit planning

[Part 2](#) examines the crucial evaluations and decisions associated with the audit planning process. Proper planning is important to ensure that the audit is conducted in an effective and efficient manner and to highlight key risk areas early in the audit process.

Chapter 6 'Overview of the audit of financial statements' provides an overview of the appointment of the independent auditor, the responsibilities and duties of auditors, and consideration in more detail of the audit standard setting process. This chapter also explains the important relationships that auditors have with some key stakeholders and the benefits and limitations of an audit.

Chapter 7 'The auditor's report' discusses the latest auditing standards regarding modifications. The chapter provides details on the updated information relating to the standards of reporting, the auditor's communication with management and some other reporting considerations. There is also an extensive Professional Environment that outlines the significant changes to the auditor's report that are currently under consideration by standard setters.

Chapter 8 'Client evaluation and planning the audit' reflects the ethical and legal requirements an auditor should consider before accepting an engagement. It also considers the steps in planning the audit as well as the important requirement of the auditor to understand the entity and its environment as part of the audit-planning process. The enhanced requirements for auditors to consider fraud in planning are also discussed in this chapter.

Chapter 9 'Audit risk assessment' explains how the understanding of the entity and its environment influences the auditor's risk assessment and how risk assessments should be framed in terms of management's financial statement assertions. This chapter also discusses the importance of auditors undertaking a broader business risk assessment of their clients, as well as the nature of internal control and risks related to internal control. Finally, the chapter concludes with a discussion on the nature of audit risk.

Chapter 10 'Materiality and audit evidence' looks at materiality in detail, with explanations of the relevant audit strategies and procedures. The important aspect of ensuring appropriate and sufficient audit evidence is explained. The nature of audit evidence, with the respective assertions, is discussed with a view to providing students with an appreciation of how reliability is assessed. Materiality is a judgement and the method to collect and assess audit evidence is the key technique in arriving at the audit opinion.

Part 3: Audit testing methodology

Chapter 11 'Tests of controls' explains the link between the control risk assessment and audit strategy. It explains how auditors test controls and the importance of communicating control deficiencies found to management. The chapter then considers the types of controls in an information technology environment and how auditors can perform tests of controls in these environments.

Chapter 12 'Designing substantive procedures' discusses the consideration given to assessing the risk of material misstatement before performing appropriate substantive procedures. This includes evaluation of the type, magnitude and likelihood of potential misstatements. Reference is made in the scene setter and the professional environment vignettes to recent corporate events where the quality of auditors' substantive work has been questioned.

Chapter 13 'Audit sampling' looks at sampling from an overall principles approach rather than in-depth detail of statistical techniques, with more details in the appendixes. Research showing why haphazard sampling is bias prone is considered in a professional environment feature.

Part 4: Auditing transactions and balances

Chapter 14 'Auditing sales and receivables' includes issues associated with overstatement of sales by corporations and the need to protect both companies and their customers when using electronic funds transfers.

Chapter 15 'Auditing purchases, payables and payroll' illustrates transactions in computer information systems and how payables can be manipulated to suit corporate goals.

Chapter 16 'Auditing inventories and property, plant and equipment' deals with the audit of inventories and considers the audit of property, plant and equipment.

Chapter 17 'Auditing cash and investments' emphasises the risk of fraud in the main text and in both of the professional environment vignettes. The section on investments reflects current changes in technology, financial instruments and audit standards. For example, it includes a discussion on the audit implications of the Clearing House Electronic Subregister System used to process and record most listed shares.

Part 5: Completing the audit

Chapter 18 'Completing the audit' summarises the responsibilities of the auditor in respect of completing the fieldwork, evaluating the findings and communicating with the client regarding the audit. It incorporates the changes to the accounting standard on events after the end of the reporting period, which categorises these events as 'adjusting' and 'non-adjusting' events. It also reflects ASA 260 *Communication with Those Charged with Governance* (ISA 260), which emphasises that audit communication should be with those charged with governance rather than with executive management. The scene setter highlights the importance of continuing solvency of client companies that might lead to a judgement for a qualified audit report in the Westpoint Group case.

End-of-chapter questions

The end-of-chapter questions have been revised following individual chapter changes. Each chapter contains ten multiple-choice questions to help readers assess their understanding of the concepts. These are followed by review questions. More practical issues are then examined in the professional application questions and case studies. The final question, a research-based exercise, provides opportunities for readers to investigate interesting areas. The end-of-chapter material provides ample opportunities for self-study and can be used for assignments, seminars and in the classroom.

^{xvii} Writing a textbook is a team effort. We would like to thank a number of our colleagues for their input, interest and constructive advice during various editions of the text and we would especially like to thank the excellent editorial, production and management team at John Wiley & Sons Australia, Ltd.

Philomena Leung, Paul Coram, Barry Cooper and Peter Richardson
August 2014

Abbreviations

AAA

American Accounting Association

AARF

Australian Accounting Research Foundation

AASB

Australian Accounting Standards Board

ACCA

Association of Chartered Certified Accountants

AGM

annual general meeting

AGS

auditing guidance statement (Australia)

AICPA

American Institute of Certified Public Accountants

ANAO

Australian National Audit Office

APESB

Accounting Professional and Ethical Standards Board

APS

miscellaneous professional statement (Australian)

ASIC

Australian Securities and Investments Commission

ASX

Australian Securities Exchange

AUASB

Auditing and Assurance Standards Board

CAAT

computer-assisted audit technique

CALDB

Companies Auditors and Liquidators Disciplinary Board

CEO

chief executive officer

CFO

chief financial officer

CIA

certified internal auditor

CIS

computer information system

CJ

Chief Justice

CLERP 9

Corporate Law Economic Reform Program Paper No. 9

CLERP 9 Act

Corporate Law Economic Reform Program Act 2004

COSO

Committee of Sponsoring Organizations (of the Treadway Commission)

CPA

certified practising accountant

CPA Australia

formerly the Australian Society of Certified Practising Accountants

EFT

electronic funds transfer

FRC

Financial Reporting Council

GAAP

generally accepted accounting principles (US)

IAASB

International Auditing and Assurance Standards Board

IAPS

international auditing practice statement

IASB

International Accounting Standards Board

ICAA

Institute of Chartered Accountants in Australia

IFAC

International Federation of Accountants

IIA

Institute of Internal Auditors

ISA

international standard on auditing

ISAE

international standard of assurance engagements

ISO

International Organization for Standardization

JCPAA

Joint Committee of Public Accounts and Audit

LJ

Lord Justice

PY

Professional Year

SCARF

systems control audit review file

SEC

Securities and Exchange Commission

VFM audit

value-for-money audit

[← Preface](#)

[How to use this book →](#)

How to use this book

Modern Auditing & Assurance Services 6th edition has been designed with you – the student – in mind. The design is our attempt to provide you with a book that both communicates the subject matter and facilitates learning. We have tried to accomplish these goals through the following elements.

The **overview** provides a brief summary of the topics, processes and procedures developed within the chapter.

Learning objectives are clearly stated and linked to subsequent discussion in the chapter.

The double-page **chapter opener** displays, at a glance, the chapter content and regulatory framework, expected learning outcomes and chapter scene setter.

The list of **professional statements** identifies the Australian and international regulatory context and the issues discussed in each chapter.

2.1 WHAT IS GOVERNANCE?

Governance is the exercise of executive and administrative authority necessary to manage an entity's affairs. Governance is concerned with the processes by which decisions are made and implemented so that the entity's affairs are conducted properly and in accordance with the laws and other applicable requirements. The Organisation for Economic Co-operation and Development (OECD) refers to governance as (characterised by) participation, transparency, accountability, rule of law, effectiveness, equity... Good governance refers to the management of government (governing body) in a manner that is essentially free of abuse and corruption, and with due regard for the rule of law.

Through the concept of governance is usually linked with the government in general, it is applicable to all companies including corporations, business enterprises and the public sector. In business, the exercise of governance refers to the structure of separation of ownership and management in the agency structure, separation of shareholders of the corporation (only on the management (agents). These agents are the board of directors and managers who conduct the business on behalf of the investors. Shareholders and voters require not only the laws, but also other means to ensure that the management of the corporation act in the best interest of the corporation and its shareholders or voters. Management accepts the accountability measures through which they demonstrate the effectiveness of their performance. This is the origin of corporate governance.

As we have noted above, corporate governance generally refers to the methods through which the corporation is directed and run. However, the OECD has recognised the importance of the interrelationships between the parties who have a role in enhancing the effectiveness of the governance structure. For example, while it is important for the independent auditor to remain impartial so as to provide an objective assessment of the financial affairs of the corporation, the auditor must also maintain a mutual relationship with the management in order to be able to act effectively.

The auditors criticised by a governance body is independent by transparency and accountability. This is the context in which the auditor gives a role. The independent auditor provides an objective assessment to the truth and fairness of an account that is prepared by the management and which represents the way in which the corporation is run. The independent auditor adds to the credibility of the conduct as performed by the agent. This accountability framework is part of the backbone of governance.

According to Becker's 'accountability in engineering' what has been done, what is being done and what is planned. Accountability is also defined by Eric, Olson and Adams' as a group of account, a reporting of that for which one is accountable. Although accountability usually related to workers, this concept was considered by stakeholder theory toward the relationship between owners and managers. In accordance with stakeholder theory managers are not merely the servants for the owners, but are also accountable to employees, customers and society as a whole. The same writer gives an example of the changing expectations of auditors. While auditors provide opinions on the financial performance of companies, business communities have influenced the expectations of their role, especially where there is a high competition amongst audit firms, market complexity and an increasing number of high profile corporate collapses.

chapter 2

Governance and the auditor

OVERVIEW

- 2.1 What is governance?
- 2.2 The auditor and governance
- 2.3 Goals in governance
- 2.4 Internal and operational auditing in the governance process
- 2.5 Enhancing accountability through the audit committee
- 2.6 Governance in the public sector

Summary
Key terms
Multiple-choice questions
Review questions
Professional application questions
Case studies
Research question
Further reading
Notes

LEARNING OBJECTIVES

After studying this chapter, you should be able to:

1. describe the nature of governance;
2. appreciate the role of the auditor in governance;
3. discuss the issues of internal control, risk and earnings management in governance that concern the auditor;
4. appreciate the roles of internal and operational audits in the governance process;
5. consider the significance of the role of the audit committee in governance;
6. describe the nature of governance and the types of audits in the public sector.

PROFESSIONAL STATEMENTS

Australian standards	International standards
ISA 200 Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with Auditing Standards	ISA 200 Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with the International Standards on Auditing
ISA 250 Consideration of Laws and Regulations in an Audit of Financial Reports	ISA 250 Consideration of Laws and Regulations in an Audit of Financial Statements
ISA 260 Communicating with Those Charged with Governance	ISA 260 Communicating with Those Charged with Governance
ISA 300 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management	ISA 300 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management
ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment	ISA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment
ISA 320 The Auditor's Response to Assessed Risks	ISA 320 The Auditor's Response to Assessed Risks
ISA 410 Using the Work of Internal Auditors	ISA 410 Using the Work of Internal Auditors
ISA 600 Performance Engagement	

SCENE SETTER

Auditors need to be less 'separate adviser' and more 'assessing inspectors'

The UK Competition Committee kept auditors should be serving shareholders, but they are increasingly to please company management. In the preliminary findings of a report into the competitiveness of audit suppliers released on 10 July, it said while most auditors are diligent, there were significant barriers to companies switching auditors, and the present system did not encourage independent views to be given to management.

It is clear that there is significant dissatisfaction amongst some institutional investors with the relevance and nature of reporting in audited financial reports, and Laura (Commissioner) of the Public Investigation Group.

There needs to be change so that external audit becomes a more genuinely independent and

(challenging) practice where auditors are less like corporate advisers and more like assessing inspectors.

The Committee said 57 percent of FTSE 100 companies have had the same auditor for more than 20 years and 47 percent for more than 30 years.

It is considering a number of recommendations, including mandatory tendering and rotation of audit firms, expanded external audits frequency of Audit Quality Review teams under the 2012 Financial Reporting Council terms, publication of Big 4 only checks in trust documentation, greater accountability of the external auditor to audit committees, and more stakeholder-auditor engagement.

The double-page **chapter opener** displays, at a glance, the chapter content and regulatory framework, expected learning outcomes and chapter scene setter.

The list of **professional statements** identifies the Australian and international regulatory context and the issues discussed in each chapter.

Professional environment boxes amplify and apply the chapter content and profile current, topical industry issues and developments in Australia and internationally.

MULTIPLE-CHOICE questions

2.1 Which of the following statements is incorrect?

- Enterprise governance can be applied to both corporations and other business entities including the public sector.
- Enterprise governance is a concept of business performance within the organisation with which only the board of directors should comply.
- Enterprise governance encompasses confidence and performance and is an overall concept that includes corporate governance practices.
- Internal control and risk management processes are part of enterprise governance.

2.2 The audit triad concept refers to:

- Governance, management and audit.
- Confidence, performance, assurance.
- Trust, control and better approaches.
- Internal audit, external audit, audit committee.

2.3 The auditor general must report on an enterprise based if:

- Businesses have been made available for inspection.
- Businesses have been assessed for at least 60 years.
- Public accounting records have been kept.
- All the necessary information and explanations were obtained.

2.4 The key benefit to management of an internal audit function is that it:

- Provides assurance to management that fraudulent activities will be detected.
- Reduces internal audit costs.
- Helps management to the areas of risk management, control and governance processes.
- Provides assurance to management that the organisation is complying with its legal requirements.

2.5 The Institute of Internal Auditors states that:

- Internal auditing provides a disciplined approach to evaluating risks, controls and governance processes.
- Internal auditing should concentrate on an advisory and consultancy role to management.
- Internal auditing's role is to support the external audit requirements.
- All internal audit personnel should be certified internal auditors.

2.6 Which of the following statements best describes the appropriate relationship between internal and external auditors?

- The internal auditor often complies with the external auditor for audit engagements.
- The internal auditor's work should supplement the work of the external auditor.
- There should be proper coordination of the work of the internal and external auditors.
- There should be complete independence between the work of the internal and the external auditors.

2.7 The approach that has been suggested for operational audit is the:

- Task based audit approach.
- Value for money audit approach.
- Process audit approach.
- 3R and 3C audit.
- 3R and 3D audit.
- 3R and 3E audit.

Learning checks identify and reinforce the key issues raised, and occur at the end of each main section. Their simple checklist format makes them ideal for reviewing chapter content and revision.

The summary outlines the core issues explored in the chapter and reinforces key points. Where relevant, it also provides links to other chapters.

The Institute of Internal Auditors (IIA) was incorporated in New York in 1941 and is now a worldwide organisation, with local chapters in over 100 countries. It is administered through regional groupings. National territories have also been formed in some countries. In Australia, the first chapter of the IIA was established in Sydney in 1972. It national territory, the Institute of Internal Auditors - Australia, was formed in 1986. It currently has seven chapters and a sub-branch, and is also active in the Asia South Pacific region, which includes New Zealand, Papua New Guinea and the South Pacific Islands. The IIA's membership is for certified internal auditors' examination in 1972.

In 2002, the IIA Board of Regents launched a global research study to define the internal audit skills and abilities required of a global internal auditor in order to develop a common body of knowledge for the certified internal auditor examination. For the first time to measure the IIA internationally performed data on a survey conducted on eight continents. The survey concluded in January 2003 with nearly 2000 responses (80% from North America and 40% from other continents). Nearly two-thirds of respondents listed questions of audit management and advice. Respondents also requested of industries and requested that the IIA membership profile. The latest Corporate Body of Knowledge (CBOK) survey that was published in 2006 and the results of the survey supported the existing syllabus content with modifications. It identified that the key common body of knowledge for internal auditors is in governance, risk and control. The skills of business analysis, information technology and business management required to effectively conduct internal audit engagements are acknowledged. The syllabus has been updated based on the findings. The latest CBOK study in 2010 found that the core competencies of an internal auditor include communication skills, problem identification and solution skills, and keeping up-to-date with industry and regulatory change and professional standards. Understanding the business environment as the most important overall to be used to both the 2006 and 2010 surveys.

To become a certified internal auditor (CIA), a person must pass the examination and have a minimum of 2 years experience as an internal auditor (or equivalent). Auditing experience to public accounting qualifies as work experience in internal auditing. In order for CIA candidates the person must comply with the IIA standards and code of ethics. IIA Australia has recently launched its graduate certificate in internal audit and provides features with a comprehensive set of knowledge and skills for a career in internal auditing. The objective of internal auditing is to help members of an organisation to improve and change their responsibilities. In meeting this objective, internal auditing provides analysis, approach, recommendations, control and information concerning the activities that have been audited. The objectives of internal auditing include risk management and promotion of effective governance and control throughout the organisation at a reasonable cost.

PROFESSIONAL ENVIRONMENT
New guidelines could add teeth to internal audit

Smart companies should benefit from revised internal audit standards. They could make the chief audit executive a subject to more rigorous test. Internal auditors will have a broader scope in their company since January 5, 2013 – that's when new reports to internal auditors standards issued by the Institute of Internal Auditors (IIA) will go into effect.

The IIA standards are technically best practice, since the IIA has no regulatory authority by actually enforcing them.

Source: *Accounting*, New guidelines could add teeth to internal audit, 21/10/12, 10 October 2012.

Multiple-choice questions provide a self-test opportunity to test understanding of the concepts presented in the chapter. Solutions to these are provided at the end of the chapter.

Key terms are bolded in the text at the first major mention in the chapter and defined in a glossary at the end of the book.

Learning Check

Do you know ...

- 2.1.1 Both committees perform an important role in corporate governance. They enhance the auditor's position and the public confidence through the financial reporting and setting format of the organisation.
- 2.1.2 Detailed guidelines of the work of audit committees are contained in the IIA corporate governance principles and all the IIA top 100 companies that have an independent audit committee.
- 2.1.3 The public sector has a broad scope of accountability and governance. When public sector organisations also apply corporate governance principles and the Institute's framework of public sector internal auditors' standards, internal auditing provides assurance for the accountability governance and ensuring certain standards of confidentiality.
- 2.1.4 The auditor general and the Australian National Audit Office work closely together to ensure proper reporting through public financial reports and performance audit control to ensure that only companies that are efficient and effective.

SUMMARY

Governance is a broad concept that applies the authority to govern. Each authority is empowered by transparency and accountability in the way in which such an entity is operated. Enterprise governance encompasses corporate governance and business performance. It promotes significant aspects of governance – confidence and performance – for organisations, and can be applied to business entities, the public sector and not for profit organisations. Auditing plays a vital role in enterprise governance, providing assurance for the accountability governance and ensuring certain standards of confidentiality.

Many auditing and assurance functions are undertaken by internal auditors. Internal auditing, a fast growing profession that assumes a significant role in the current audit sector, is also undergoing rapid development and change. Internal auditing is now referred to as a key function which combines the roles of internal control, risk management and corporate governance. The accountability of internal auditors is largely through an effective audit committee, which monitors and oversees the effectiveness of corporate and business governance through their links with the board, management and the auditors (both internal and external). The accountability of the public sector on the other hand, lies with the auditor general and the work of the Australian National Audit Office. The IIA supports the ACAS standards. The ANAO also publishes detailed work plans and better audit practice guides.

KEY TERMS

governance, p. 72	corporate risk management, p. 70
audit committee, p. 74	governance, p. 87
audit entity, p. 74	internal auditing, p. 80
confidence, p. 86	operational auditing, p. 84
corporate governance, p. 71	performance, p. 86
enterprise governance, p. 86	performance audit, p. 76
	risk management, p. 71



Review questions test your understanding of the material presented in the chapter and encourage considered comment.

Case studies, graded according to difficulty, encourage detailed evaluation of the audit scenario presented. These challenging exercises are ideal for group discussion and build professional communication skills.

Professional application questions reflect 'real world' auditing scenarios and are graded according to difficulty. The questions are designed to develop professional skills in analysing, interpreting, evaluating, communicating and reporting audit information.



The research question takes you beyond the text encouraging you to complete various research-based activities.



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The auditing and assurance environment

[1 An overview of auditing](#)

[2 Governance and the auditor](#)

[3 Professional ethics, independence and audit quality](#)

[4 Other assurance engagements and quality standards](#)

[5 The auditor's legal liability](#)

- ³ Why is auditing important in business? The first part of this book gives you a snapshot of what auditing is about. Auditing has evolved into a dynamic business assurance model in the last few decades and it signifies the credibility of professional accounting.

There are five chapters in part 1. [Chapter 1](#) provides an overview of the nature and scope of auditing and assurance services, with a discussion of how history has impacted upon the development of auditing and assurance. The influence of the demands for quality services through the regulatory framework is also discussed. [Chapter 2](#) examines how auditing and the auditor have become a crucial aspect of business and corporate governance, identifying the concept and practice of risks. [Chapter 3](#) further delves into the way in which auditors work, and how the various expectations of independence, professionalism and ethics are put into practice. [Chapter 4](#) discusses the quality framework to which auditors and assurance service providers are required to adhere. [Chapter 5](#) deals with the external accountability of professional liability to which auditors are subject.

At the end of part 1, students should be able to appreciate the development of the auditing process and the profession, the changing role of auditors and accountants, and the standards of behaviour expected of them.

[« Acknowledgements](#)

[Chapter 1: An overview of auditing »](#)

An overview of auditing

OVERVIEW

[1.1 Auditing fundamentals](#)

[1.2 What is assurance?](#)

[1.3 The auditing environment](#)

[1.4 Auditing standards](#)

[1.5 Does the audit meet the demands of users?](#)

[Summary](#)

[Key terms](#)

[Multiple-choice questions](#)

[Review questions](#)

[Professional application questions](#)

[Case study](#)

[Research question](#)

[Further reading](#)

[Notes](#)

After studying this chapter, you should be able to:

1. explain what an audit is, what it provides, and why it is demanded
2. describe how assurance relates to auditing
3. discuss the importance of the profession, case law and regulation to auditing
4. explain the importance of national and international auditing standards
5. evaluate whether audits meet the demands of users.



PROFESSIONAL STATEMENTS

Australian standards		International standards	
<i>Foreword to AUASB Pronouncements 1</i>		—	
ASA 200	<i>Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards</i>	ISA 200	<i>Overall Objective of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing</i>
ASA 700	<i>Forming an Opinion and Reporting on a Financial Report</i>	ISA 700	<i>Forming an Opinion and Reporting on Financial Statements</i>

SCENE SETTER

ASIC's audit inspection findings

ASIC Chairman Greg Medcraft has described as 'disappointing' the results of ASIC's audit inspection report, which shows a decline in audit quality.

The report for the 18 months to 30 June 2012 covered inspections of 20 Australian audit firms and found 18% of the 602 audit areas reviewed did not perform all of the procedures necessary to obtain reasonable assurance that the audited financial report was not materially misstated. The figure for the previous 18 months was 14%.

While the financial reports audited may not have been materially misstated, the auditor had not obtained reasonable assurance that the financial report as a whole was free of material misstatement.

'Auditors are gatekeepers that play a critical role in ensuring that Australian investors can be confident and informed,' Mr Medcraft said.

'These results are disappointing. Audit firms need to increase their efforts to improve audit quality and the consistency of audit execution.'

ASIC will work with firms and the audit profession more generally on how they can improve audit quality. We will monitor the implementation and execution of any plans to improve audit quality, and their effectiveness.

ASIC has identified three areas needing improvement:

- the sufficiency and appropriateness of audit evidence obtained by the auditor
- the level of professional scepticism exercised by auditors, and
- the extent of reliance that can be placed on the work of other auditors and experts.

The audit areas reviewed included impairment of assets, going concern assessments, and other significant areas involving significant estimates or judgements. ASIC's audit inspection program aims to promote high-quality external audits of financial reports of listed and other public interest entities in Australia. High-quality audits are an important contributor to financial report quality and market confidence.

Audit quality comes down to three key points:

- the likelihood of material misstatement
- the likelihood that the audit detects misstatement, and
- whether the auditor does anything about it.

ASIC publishes its public audit inspection reports every 18 months to inform all audit firms, the investing public, companies, audit committees and other interested stakeholders in the financial reporting chain, of findings and areas of focus.

Source: Australian Securities and Investments Commission, *12-301MR ASIC's audit inspection findings for 2011-12*, 4 December 2012.

- 6 The objective of this chapter is to give you an understanding of some key **auditing** concepts and to introduce topics of importance that will be discussed in more detail later in the text. The chapter starts by addressing what an **audit** actually is, what auditors provide, why audits exist, and the role they fulfil in the capital market and society. These are very important questions and important concepts that anyone studying auditing should understand. These issues frame the exposition of many of the other topics in this book. This is followed by a brief discussion of the broader concept of **assurance**, which is discussed in more detail in [chapter 4](#). The environment within which auditors operate is then considered. There is also consideration of the organisations and laws and **regulations** within which auditors operate. The accounting profession is then discussed as well as a brief examination of the early impact of case law. This is followed by a discussion of the significant crises and changes that occurred in the early 2000s and more recently the global financial crisis (GFC) across many jurisdictions, and some of the effects of these crises are discussed in more detail in [chapter 5](#). The next section provides consideration of the most important regulation that auditors deal with, which is the **auditing standards**. The standards and standard-setting bodies are introduced as well as the interrelationship with international auditing standards, and the Clarity ² project. Finally, we examine how well the audit function performs when examined by the users of these reports. There is evidence that it is useful, but there are also ongoing issues such as the **audit expectation gap** which continues to pose a challenge for the auditing profession.

An overview of auditing

1.1 AUDITING FUNDAMENTALS



Explain what an audit is, what it provides, and why it is demanded.

Across the globe, auditors can be found everywhere business is conducted. However, what do most people know about auditors and the audit function? The answer is probably not that much! This chapter, as an introduction to this book, will provide answers to some fundamental questions such as:

- What is an audit?
- What does an audit provide?
- Why is there a demand for audits?
- Who provides audits?

Core roles of auditors include supporting the stability of capital markets and assisting in ensuring accountability for the government sector. This book will improve your understanding of auditing and assurance in a broad sense, but will also give you a much more detailed understanding about the audit of a financial report which is the most common type of audit. This will help you understand how audits of financial statements are a crucial part of business and **corporate governance**. The focus of the following discussion (and a significant part of the book) therefore will be on the independent financial report audit. It should be noted that many of the principles of auditing in a financial report context also apply to other types of audits and assurance services (discussed in chapters 2 and 4).

1.1.1 What is an audit?

A definition of what the audit provides is in the audit standard ASA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards* (ISA 200), where it states 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 an applicable financial reporting framework. In the case of most general purpose frameworks, that opinion is on whether the financial report is presented fairly, in all material respects, or gives a true and fair view in accordance with the framework. An audit conducted in accordance with Australian auditing standards and relevant ethical requirements enables the auditor to form that opinion (ASA 200.3; ISA 200.3).

⁷ A seminal work by Mautz and Sharaf ³ examined some of the general concepts of auditing such as evidence, due care, disclosure and independence, to develop a theory of auditing. In concluding, based on their review of the history and development of auditing, they stated: