

Chapter 1

Auditing, Assurance and the Public Accounting Profession

Reading Reference

Gill, G.S., Cosserrat, G.W., Leung, P., & Coram, P. *Modern Auditing & Assurance Services*, Chapter 1.

A. CHAPTER HIGHLIGHTS

The Evolution of Auditing Practices

1. Auditing has developed from primarily a check of the accounting for stocks and revenues by authorised officers into a sophisticated professional assurance service performed by independent accountants for the interests of their clients and other users of the financial reports.
2. Auditing as we know it today can be linked to the development of joint-stock corporations in the United Kingdom. The Joint-Stock Companies Act (1844) provided for the appointment of auditors to provide an opinion on whether the balance-sheet of the company was properly drawn up to exhibit a true and correct view of the state of the company's affairs.
3. The **objective of early audits** was: the detection of fraud, the detection of technical errors, and the detection of errors of principle.
4. Two major cases in the late 1800s helped to establish the fundamental principles of auditing:
 - (a) In *London and General Bank* (1895) 2 Ch. 673, Lindley, LJ described the auditor's duty as follows, 'An auditor, however, is not bound to do more than exercise reasonable care and skill in making inquiries and investigations'.
 - (b) In *Kingston Cotton Mill Co.* (1896) 2 Ch. D279, Lopes, LJ stated that, 'It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use.'
5. In the United States, audits were in response to non-statutory demands and the general acceptance of the usefulness of an audit. However, following the 1929 stock market crash, the Securities Act of 1933 and 1934 required audits for publicly traded companies.
6. In **Australia**, as in the UK, the formation of professional accounting associations and the legislative requirements of an audit have primarily assisted the development of auditing.
7. Over the past 30 years there has been a growing expectation that auditing as a professional service should not only provide assurance for the **credibility** of the financial report, but also enhance the integrity of financial information and its usefulness in decision-making by management and other users.

The Development of the Assurance Engagement Framework

8. The American Institute of Certified Public Accountants (AICPA) formed a special committee on assurance services – the Elliott Committee. The Elliott Committee recognised the need for the profession to diversify its product potential away from traditional financial report audit and related services.
9. Assurance services to which the framework of Auditing Standards is applicable include:
 - (a) **Audit.** An audit engagement is designed to provide a high but not absolute level of assurance on an accountability matter.
 - (b) **Review.** A review engagement is designed to provide a moderate level of assurance and thus is less extensive in scope than an audit.
 - (c) **Agreed-upon Procedures.** An agreed-upon procedures engagement does not enable the professional accountant to express assurance.

Auditing – A Shifting Paradigm

10. The paradigm of auditing can be argued to be shifting. The major areas of change are:
 - detection of fraud and errors
 - audit approach used
 - audit independence
 - audit liability.

The Accounting Profession and its Associated Organisations

11. **CPA Australia** and **The Institute of Chartered Accountants in Australia** (Institute) provide a broad range of services to their members to assure that they serve the public interest in performing quality professional services. The two accounting bodies cooperate in setting standards, making submissions to government and representing the profession internationally.
12. Public accountancy services are provided through practice entities. **Practice entities** may consist of sole practitioners or partnerships, or may be incorporated as professional organisations. Based on the size and scope of accountancy services provided, these entities can be classified into international (Big 5), national, regional or suburban practices.
13. The **Australian Stock Exchange** (ASX) is a public company operating as the primary national stock exchange for equities, derivatives and fixed interest securities. The ASX also plays a useful role in directing the attention of the accounting profession to important financial reporting issues.
14. The **Australian Accounting Research Foundation** (AARF) is the research arm of the accounting profession. The AARF operates through two functional boards. These are:
 - The **Auditing and Assurance Standards Board** (AuASB) is responsible for the development and maintenance of Statements of Auditing Standards and Auditing Guidance Statements. The work of the AuASB is integrated with that of the International Auditing Practices Committee.
 - The **Legislation Review Board** (LRB) reviews all existing and proposed Commonwealth legislation (other than taxation legislation), official Commonwealth reports and other documents to identify matters which are directly relevant to the accounting profession.

15. The **Financial Reporting Council** (FRC) oversees the setting of Accounting Standards in Australia. Functions of the FRC include:
 - appointing members to the Australian Accounting Standards Board (AASB)
 - directing the AASB on matters of general policy and procedures
 - monitoring the operation of Accounting Standards.
16. Functions and powers of the **Australian Accounting Standards Board** (AASB) include making Accounting Standards and developing a conceptual framework.
17. The **Australian Securities and Investment Commission** (ASIC) is the single national regulator of Australia's companies. The ASIC also has the power to undertake investigations of all perceived serious breaches of Corporations Law.
18. The **Companies Auditors and Liquidators Disciplinary Board** hears applications from the ASIC to determine whether auditors or liquidators have breached Corporations Law. The board has the power to impose penalties if it determines that a registered auditor or liquidator has failed to carry out their duties properly.

Corporate Law Economic Reform Program

19. The Corporate Law Economic Reform Program (CLERP) is an initiative to improve six key areas of Australia's business and company regulation as part of the Commonwealth Government's drive to promote business, economic development and employment. The six proposals are: accounting standards; fundraising; directors' duties and corporate governance; takeovers; electronic commerce; financial markets and investment products.

Services Provided by Public Professional Accountants

20. Services provided by public accounting firms are classified as attest or non-attest services.
21. An **attest service** occurs when a professional accountant issues a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. There are three types of attest services:
 - audit
 - review
 - agreed-upon procedures.
22. A **non-attest service** occurs when a public accountant does not express an opinion or provide a negative assurance, a summary of findings or other form of assurance. Some examples of non-attest services include:
 - accounting
 - tax
 - management consulting
 - insolvency
 - business recovery.

Types of Audit Activity and Auditor

23. Audits are generally classified into different types of activity as follows:
- (a) A **financial report audit** involves obtaining and evaluating evidence about an entity's financial report for the purpose of expressing an opinion as to whether the financial report is prepared in accordance with an identified financial reporting framework.
 - (b) A **compliance audit** involves obtaining and evaluating evidence to determine whether certain financial or operating activities of an entity conform to specified conditions, rules, or regulations.
 - (c) A **performance audit** involves obtaining and evaluating evidence about the efficiency, economy and effectiveness of an entity's operating activities in relation to specified objectives.
 - (d) **Comprehensive auditing** occurs when an auditor undertakes a range of audit and audit-related services within an audit mandate for a client, a scenario that is more common in the public sector.
 - (e) An **environmental audit** is a recent trend, and normally involves a review or an agreed-upon procedures engagement.
 - (f) An **internal audit** refers to any of the above activities carried out by audit professionals who are employees of the entity being audited.
24. Individuals who are engaged to audit economic actions and events can be classified into three groups as follows:
- (a) **Independent auditors** are qualified to perform financial report audits, compliance audits, and performance audits for clients. Two distinguishing characteristics of independent auditors are:
 - they are independent of the entity with respect to the audit and in reporting the results.
 - they are generally registered with the Companies Auditors and Liquidators Disciplinary Board of the Australian Securities and Investment Commission.
 - (b) **Internal auditors** are employees of the entity they audit. They are involved in an independent appraisal activity called internal auditing, which is designed to assist the management of the organisation in the effective discharge of its responsibilities.
 - (c) **Government auditors** are employed by various local, state and federal governmental agencies. They conduct comprehensive audits which combine elements of financial report, compliance and performance auditing.

Regulatory Framework for Ensuring Quality Services

25. The accounting profession and the regulatory agencies have developed a multi-level **regulatory framework** to provide assurance of high quality work. The framework is comprised of:
- (a) **Standard setting.** The private sector establishes standards for accounting, auditing, ethics and quality control to govern the conduct of accountants and practice entities.
 - (b) **Firm regulation.** Each practice entity adopts policies and procedures to assure that professional accountants adhere to professional standards.

- (c) **Self-regulation.** The accounting profession has implemented a comprehensive program of self-regulation including mandatory continuing professional education and a program of quality control and practice reviews.
 - (d) **Government regulation.** Only qualified accountants are licensed to practise and auditor conduct is monitored and regulated by the Australian Securities and Investment Commission and the Courts.
26. To assist practice entities in the pursuit of quality, the Institute and CPA Australia have issued a series of Miscellaneous Professional Statements relating to quality control standards.
 27. Statement of Auditing Standard AUS 206, **Quality Control for Audit Work**, contains policies and procedures which, if adopted by a firm, should provide reasonable assurance that all audits done by the firm are being carried out in accordance with Auditing Standards. The quality control elements included in this statement are:
 - professional independence
 - employment
 - assignment of personnel
 - supervision
 - guidance and assistance
 - client evaluation
 - allocation of administrative and technical responsibilities.

B. TRUE OR FALSE STATEMENTS

State T or F for True or False as appropriate.

1. Independent auditors are expected to be without bias with respect to the client and should appear to be objective to those relying on the audit. _____
2. The focus of early audits was on errors stemming primarily from fraud. _____
3. Initially company audits were performed by shareholders who were not directors or other company officers. _____
4. In the United States, the requirements for audits of publicly traded companies arose primarily as a result of the 1929 stock market crash. _____
5. The scope of work in performing agreed upon procedures is less than in an audit but more than in a review. _____
6. Practice entities are classified as either international, national, regional or suburban. _____
7. Reporting entities must comply with Accounting Standards issued by the AASB. _____
8. The Australian Securities and Investment Commission has the sole authority in regulating companies, securities and futures industries. _____
9. One of the recommendations from the CLERP is a requirement that important accounting standards be pursued irrespective of the cost. _____

6 Study Guide: Modern Auditing & Assurance Services

10. In an attest service, a public accounting firm issues a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. _____
11. Attest services include audit, review and tax. _____
12. In a non-attest engagement, no conclusion about the reliability of another party's written assertion is made. _____
13. An engagement to perform certain agreed-upon procedures is a non-attest engagement. _____
14. An audit designed to determine whether a company supplying parts to the military has followed all regulations of the Department of Defence would be classified as a compliance audit. _____
15. The three types of audits are (a) financial report, (b) compliance, and (c) performance. _____
16. The primary focus of a performance audit is the fairness of financial statements. _____
17. Government auditors are usually associated with comprehensive audits. _____
18. The authority for registering an auditor rests with the Institute and CPA Australia. _____
19. The purpose of practice reviews is to determine whether a practice entity has effectively implemented a system of quality control. _____
20. The primary objective of government regulation is protecting the investing public from substandard practice. _____

C. MULTIPLE CHOICE QUESTIONS

Circle the best answer for each of the following questions.

1. The essence of the audit function is to
 - A detect fraud.
 - B examine individual transactions so that the auditor may certify as to their validity.
 - C determine whether the client's financial report is fairly presented.
 - D ensure the consistent application of correct accounting procedures.
2. The traditional role of auditing could best be described as a process
 - A of ensuring that the company was operating at a profitable level.
 - B to find errors in balance sheet accounts and on stemming the growth of fraud.
 - C allowing directors of companies to ameliorate their responsibilities.
 - D to review the controls within the company to ensure that they are operating in an efficient and effective manner.

3. What best describes the most recent approach taken by auditors?
 - A A conformance role.
 - B A 'watch-dog' role.
 - C To service the needs of management.
 - D A risk-based approach.
4. Which one of the following services is often performed on public companies' interim financial reports?
 - A Accounting.
 - B Review.
 - C Auditing.
 - D Consulting.
5. A statement made by a reviewer that 'nothing has come to our attention that causes us to believe that the financial report of XYZ for the [period] ended does not present fairly the financial position and the results of operations, and its cash flows for the year then ended in accordance with an identified financial reporting framework' is known as
 - A reasonable assurance.
 - B positive assurance.
 - C negative assurance.
 - D necessary ignorance.
6. An auditor would issue a 'summary of findings' in connection with which one of the following types of services?
 - A Auditing.
 - B Review.
 - C Accounting.
 - D Agreed-upon procedures.
7. What organisation is responsible for setting and promulgating auditing standards within Australia?
 - A AASB.
 - B ASIC.
 - C AuASB
 - D The ICAA and ASCPA.
8. What is the main reason for the CLERP initiative?
 - A Clarify directors' duties and increase the role of the auditor in corporate governance.
 - B Improve business and company regulation to promote business, economic development and employment.
 - C To internationalise Australian Accounting Standards.
 - D Take control of the Australian Accounting Standards from the AASB.
9. Which of the following criteria is unique to the auditor's attest function?
 - A General competence.
 - B Familiarity with the particular industry of which the client is a part.
 - C Due professional care.
 - D Independence.

8 *Study Guide: Modern Auditing & Assurance Services*

10. Which of the following is not an attest engagement?
 - A Tax return preparation.
 - B Direct reporting.
 - C Review.
 - D Audit.
11. The auditor's judgment concerning the overall fairness of the presentation of financial position, results of operations, and cash flows is applied within the framework of
 - A quality control.
 - B Australian Auditing Standards which include the concept of materiality.
 - C the auditor's evaluation of the audited company's internal control.
 - D applicable Accounting Standards and Urgent Issues Group Consensus Views.
12. While performing an audit an auditor strives to achieve independence in appearance in order to
 - A reduce risk and liability.
 - B maintain public confidence in the profession.
 - C become independent in fact.
 - D comply with auditing standards.
13. Internal auditing is most appropriately described as
 - A an extension of the accounting process.
 - B an evaluation methodology for the controller.
 - C a management control.
 - D a service to the board of directors.
14. Which of these is not a part of a multi-level regulatory framework to ensure quality services?
 - A Standard setting.
 - B Self-regulation.
 - C Internal firm regulation.
 - D All of these are levels of regulation for quality.
15. A practice entity establishes quality control policies and procedures for deciding whether to accept a new client or continue to perform services for an existing client. The primary purpose for establishing such policies and procedures is to
 - A comply with quality control standards established by regulatory bodies.
 - B reduce the exposure to legal liability resulting from failure to detect irregularities in a client's financial statement.
 - C enable the auditor to attest to the integrity or reliability of a client.
 - D minimise the likelihood of association with clients whose management lacks integrity.

D. REVIEW QUESTIONS

1. Complete the table in relation to the different types of audits.

	Financial Report Audit	Compliance Audit	Performance Audit
Purpose			
Users of report			
Criteria			

2. Briefly describe (a) the changing audit objectives and (b) the evolution of auditing practice over the last century.

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

10 Study Guide: Modern Auditing & Assurance Services

3. Complete the table in relation to the types of attest services provided by public accountants.

Type of service Audit	Level of assurance	Nature of work done	Expression in report
Review			
Agreed upon procedures			

4. Briefly state the purposes of the professional and regulatory organisations that influence the profession.

[illegible]

Suggested Solutions

Section B. True or False Statements

- | | |
|----------|-----------|
| 1. True | 11. False |
| 2. True | 12. True |
| 3. True | 13. False |
| 4. True | 14. True |
| 5. False | 15. True |
| 6. True | 16. False |
| 7. True | 17. True |
| 8. True | 18. False |
| 9. False | 19. True |
| 10. True | 20. True |

Section C. Multiple Choice Questions

- | | |
|------|-------|
| 1. C | 9. D |
| 2. B | 10. A |
| 3. D | 11. D |
| 4. B | 12. C |
| 5. C | 13. C |
| 6. D | 14. D |
| 7. C | 15. D |
| 8. B | |

Section D. Review Questions

1.

	Financial report audit	Compliance audit	Performance audit
Purpose	Express an opinion on the fairness of financial information.	To determine if client is following specified procedures set by higher authority.	To determine the efficiency, economy and effectiveness of an entity's operating activities.
Users of report	Shareholders, creditors, regulatory agencies and general public.	Management of the entity or third parties setting down procedures.	Governing body, or management of the entity or third parties.
Criteria	Identified financial reporting framework.	Specified conditions, rules or regulations.	Performance measures or indicators as determined by the auditor.

12 Study Guide: Modern Auditing & Assurance Services

2. (a) Up to the beginning of the twentieth century, audits primarily focussed on the detection and prevention of fraud and detection and prevention of errors. Subsequently the detection of fraud and error became secondary to the determination of the fairness of the reported financial position of the entity. This de-emphasis of the detection of fraud and error as an audit objective has become a subject of controversy and it is in the process of being revised to meet the continuing public expectations that auditors will detect fraud.
- (b) From ancient times to the middle of the nineteenth century, auditing involved a detailed verification of accounts. Some testing of accounts was introduced by the second half of the nineteenth century but detailed verification was still in practice. However by the 1940s there was a shift from detailed verification of accounts to sampling, and the development of the practice of linking the testing to be done to the auditor's evaluation of the company's internal controls. Since then, substantial emphasis has been placed on systems-based auditing. However since the 1980s audit practice has begun to favour a risk-based approach.

3. Type of service	Level of assurance	Nature of work done	Expression in report
Audit	High/reasonable	Unlimited scope	Positive assurance
Review	Moderate or limited	Inquiry and analytical procedures	Negative assurance
Agreed-upon procedures	Derived or non-expressed	As agreed with client	Factual findings

4. The purposes of the professional and regulatory organisations that influence the profession are as follows:

The Institute of Chartered Accountants in Australia and CPA Australia. These organisations determine the entry qualifications into the profession and subsequently regulate the members' practice. The professional accounting bodies set the standards and code of ethics for observance by the members. The ICAA and CPA Australia provide a broad range of services to their members to assure that they serve the public interest in performing quality professional services.

The Australian Stock Exchange organises a national market for company securities. It establishes listing rules and helps to maintain an informed market.

The Australian Accounting Research Foundation (AARF) acts as the principal research organisation for the Accounting Bodies in Australia. The research activity is undertaken through the functional boards: Auditing & Assurance Standards Board; Legislation Review Board.

The public sector organisations that directly influence the profession are the Financial Reporting Council (FRC) which oversees the setting of Accounting Standards in Australia; the Australian Accounting Standards Board (AASB) whose functions include making Accounting Standards and developing a conceptual framework; and the Australian Securities and Investment Commission, which is the single national regulator of Australia's companies and has the power to undertake investigations of all perceived serious breaches of Corporations Law.