

Chapter 1 An overview of auditing

Review questions

1.11 What is an audit?

An auditor is setting out to achieve enhanced credibility of information disclosed to increase reliability for the users of the financial statements. A definition from the Committee on Basic Auditing is as follows:

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

1.12 What does an audit do?

Accounting is a representation of the economic situation of an entity for a period which managers are required to represent to users. These representations by managers are known as **assertions** about the economic actions and events of the entity. The auditor's task is to obtain **evidence** to validate these assertions and ensure economic events are appropriately communicated to users. This is also communicated in part of the audit report as follows:

- An audit shall be described. This includes stating that the auditor has performed procedures to obtain *evidence* about the amounts and disclosures in the financial report. The procedures will vary dependent on the auditor's assessment of the *risks of material misstatement*.
- The auditor's report shall state that the auditor believes that *sufficient and appropriate audit evidence* has been obtained to form an opinion.

1.13 Explain how agency theory results in a demand for auditing?

In an agency relationship, investors (as principals) entrust their resources to managers (as agents). The agent's self-interest is expected to diverge from the principals' interest, giving rise to agency costs. A consequence of this agency problem is that investors will 'price protect' themselves on the assumption that managers are acting for themselves. It is therefore a rational response that there is a demand for a financial statement audit to verify the assertions made by management.

suspicious circumstances exist. Moffit J also addressed the concept of 'reasonable skill and care' and that it calls for changed standards to meet changed business conditions or changed understanding of the dangers.

Case law has provided important guidance on the auditor's role and responsibility over the years. The courts are still the ultimate adjudicator on these issues although the number of decided cases relating to auditors in recent years is few.

1.16 There were a number of major corporate collapses in the early 2000s. What was the main Australian regulatory response to these problems?

The main regulatory response was through the implementation of the Corporate Law Economic Reform Program (CLERP) 9 in 2004. Some main changes of CLERP 9 were to expand the requirements on independence for auditors and also the creation of the Financial Reporting Council, which had a significant effect on the role of the accounting profession in the regulatory landscape. No longer would the accounting profession in Australia be responsible for the setting of auditing standards.

1.17 How have corporate collapses influenced the role of auditing in recent years?

The corporate collapses in the US and Australia have had a fundamental impact on the role of auditing in recent years. Recent events have led to closer public scrutiny on the role of the auditor, audit independence, and the methodology on how an audit is carried out.

Significant changes have been made to emphasise the following:

- A clear objective to enhance and maintain the integrity of the profession;
- Clearly address the auditor interest to the public is as important as to the client, such as safeguarding independence by eliminating complex relationship with audit clients (i.e. limit to audit only);
- Reiterate ethical governance;
- A clear distinction of audit and non-audit engagements carried out by the auditor, this leads to legislation and self regulation being established to a ban on certain non-audit services for audit clients;
- Stronger regulation on auditors and audit firms as well as tougher enforcement on non-compliance;
- Increasing the forensic nature of audit and stronger awareness of corporate fraud;
- Relate audit risks to business risk

1.18 What role does ASIC have in the regulation of auditors?

ASIC has a significant role in the regulation of auditors. ASIC is the statutory administrative body for the enforcement of the Corporations Act 2001 (revised with the CLERP Act). Government regulation is exercised through ASIC's surveillance program which involves the scrutiny of all aspects of the financial statements of listed