ACCOUNTING 312 — AUDITING

CONTENTS:

ACCTG 312 - ASSURANCE AND AUDITING; OVERVIEW

Objectives

- obtain 'reasonable' assurance whether the financial report as a whole is free from 'material misstatement' (whether by fraud or error) thereby enabling the auditor to express an opinion on whether the financial report is prepared in accordance with the applicable financial reporting framework

Assurance

- entities provide reports to users for making decisions
- reports are potentially biased — the report providers have vested interests
- the credibility of the report can be enhanced by having an independent expert report on it
- FS are just one type of report that can be assured (most common however)
- auditors express an opinion that is designed to enhance the confidence of the intended users of the info
- levels of assurance?
  - reasonable assurance (as opposed to absolute assurance) — in audits
  - limited assurance
- types of assurance
  - attest reporting engagement
    - auditor issues an opinion on written assertions made by management
  - direct reporting assurance engagement
    - auditor issues an opinion directly on a subject matter

What Happens in an Audit?

- firstly, a consideration whether to accept the audit
- assess inherent risk; what can go wrong
- assess control risk; will management find and correct errors
- inspect evidence for the assertions in the FSs
- report; FSs true and fair and comply with GAAP

WHY IS THERE DEMAND FOR AUDITING AND ASSURANCE?

- Agency Theory
  - users want assurance
    - e.g. bank manager providing a loan or a share investor
  - users value assurance
    - can borrow at lower rates, as their company is seen as safer
    - people will prefer to invest in your company
  - "price protection"
    - investors are aware of manager's self-interested natures and price their cost of capital accordingly; auditing reduces this, so managers may want auditing

- Information Hypothesis
  - "signalling" — by nature, managers know more than investors do, and so managers can signal to investors that their information is reliable by getting an auditor

- Insurance Hypothesis
  - auditors can be sued if company fails

- Management Control
  - top management also benefit from assurance about information received from lower levels

- Confirmation Hypothesis
  - managers make unaudited announcements
  - market accepts based on later audited results

- Response to Risk
  - auditing as part of portfolio to deal with risk

Cost of Audit Failure?

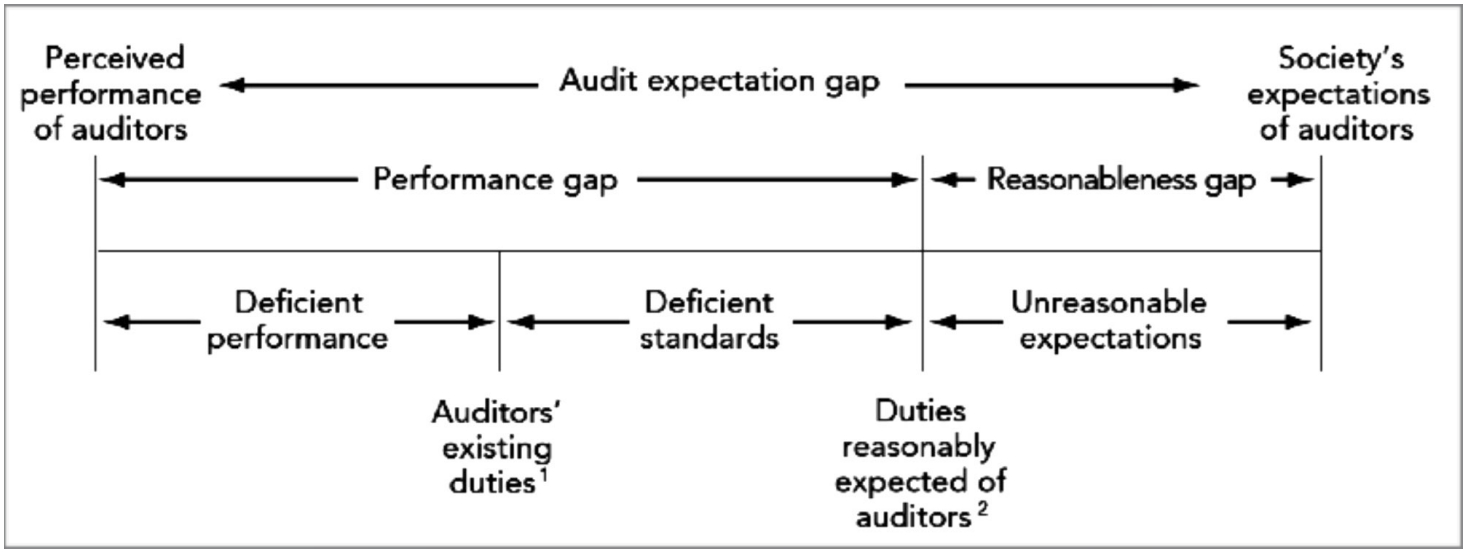
- employees could lose jobs and any investments in their company
- suppliers lose money owed to them
- investors lose their investment
- governments lose unpaid taxes
- management and auditors lose reputation

Social Benefits of Audit?

- investor protection
- protection of other stakeholders
- countries may require companies to be audited

AUDIT EXPECTATION GAP

"the gap between society's expectations of auditors and auditor's performance as perceived by society"



Solutions?

- for deficient performance and standards? BETTER AUDITING
- for unreasonable expectations? PUBLIC EDUCATION

EXPECTATION GAP DUTIES

Fraud

- not always accepted as a major duty by auditors
- ISA 240: "the auditor must consider the risks of material misstatements in the FS due to fraud"
- expected to find MATERIAL fraud

Internal Control

- auditors must find weaknesses in internal control and report on it
- auditors can “assess control risk at the maximum” and rely on other types of testing
- required to report weaknesses that they find to management

Going Concern

- e.g. “where were the auditors?” question when companies collapse
- users expect auditors to predict a company’s collapse, or even prevent it
- actual duty? examine this issue and only report if there are concerns

Liability

- are auditors liable whenever there are misstatements in the FS?
  - need to show that auditor had a duty of care, was negligent, loss was suffered, loss as a result of auditor
- directors and shareholders often subject to this ‘gap’

CONSEQUENCES OF THE EXPECTATION GAP

- developments in auditing standards
- reduced public support for auditors
- increased litigation against auditors

BRIDGING THE EXPECTATION GAP

- engagement letter to clarify responsibilities to management
- audit report now explains directors’ and auditors responsibilities
- expanded duties? going concern and fraud duties
- changes to regulation of NZ auditing

ACCTG 312 - THE AUDITING ENVIRONMENT

Objectives

- obtain 'reasonable' assurance whether the financial report as a whole is free from 'material misstatement' (whether by fraud or error) thereby enabling the auditor to express an opinion on whether the financial report is prepared in accordance with the applicable financial reporting framework

WHO GETS AUDITED AND WHY?

ISSUERS AND REPORTING ENTITIES

- must be audited and disclose accounts on a public file
- why? economic and social accountability
- share issuers are now "reporting entities" under the Financial Markets Conduct Act 2013
  - a "qualified auditor" must perform the audit
  - audits are also now required for large charities and review engagements for medium charities
  - the Act also allows accounting firms to become companies

COMPANIES ACT 1993

- audits required for:
  - "Reporting Entities"
  - "Large Companies" (can opt out if 95% of shareholders agree)
    - (large = assets > $20m OR revenue > $10m)
  - "Public Entities"
  - "Overseas Companies"
  - "Companies with 10 or more shareholders" (can opt out if 95% of shareholders agree)

WHO ELSE?

- Public Sector entities (e.g. universities, government departments)
- Charities
  - audit IF expenditure > $1m
  - review IF expenditure > $500k
- Incorporated Societies (if constitution requires)

WHAT ARE AN AUDITOR'S DUTIES (AND WHO MAKES THEM)?

1. Legislation
   - defines some duties
   - GAAP
   - the Financial Reporting Act

2. Profession
   - CAANZ / NZICA control
     - entry standards
     - ethical standards
     - discipline and inspection (overseen by Financial Markets Authority)

3. Courts
   - case law
     - especially cases on liability

4. Standards
   - set by the XRB
   - enforced by the FMA
     - some functions delegated to professional bodies (CAANZ / NZICA)
   - "co-regulation"

5. Firms
   - international quality control

COURTS AND THE DUTIES OF AN AUDITOR

- Liability under:
  - Contract
  - Tort
    - Negligence
    - Duty of Care

WHEN ARE AUDITORS LIABLE?

1. The audit is negligently performed *(e.g. poorly planned, lack of competence)*
2. The plaintiff has suffered a loss *(e.g. show that damage has taken place)*
3. The loss is a result of he auditor's negligence *(e.g. is there a connection with the damage and work done?)*
4. A duty of care is owed to the plaintiff
   - **in contract to the company (client)**
   - **in tort (negligence) to other parties to whom a duty of care is owed**

DUTY OF CARE OWED UNDER TORT

- owed to 3rd parties
  - "special relationship"
    - such a relationship gives rise to a duty of care

  - "reasonable foreseeability"
    - auditors have a duty to those they can reasonably foresee will need to use the financial statements
    - further cases have said that foreseeability isn't enough; need to show actual reliance
    - focus is on the purpose for which the information is provided
    - there will usually be a clause that prospective investors cannot place reliance on the accounts

  - "liability is to shareholders as a group, not individual shareholders"
    - duty only owed to existing shareholders, not prospective ones or others the auditors doesn't know of

  - "proximity is required"

WHEN ARE AUDITORS LIABLE AND IS THERE AN AUDITOR LIABILITY CRISIS?

LIMITATION OF AUDITOR LIABILITY

- auditors are personally liable for damages arising from failure by themselves or their partners to exercise reasonable skill or care
- costs = litigation and court-awarded damages
- professional indemnity insurance is difficult to obtain and expensive
- in other jurisdictions, there are liability caps for auditors, but not in NZ
  - Arguments for such a cap in NZ?
    - inability of auditors to restrict the scope of their operations
    - fact that auditors are much more likely to be sued than other professions
    - the inability of auditors to rely on representations made by management
  - Arguments against such a cap in NZ?
    - auditors should accept full responsibility for their work
    - auditors are only successfully sued when not performing their duties competently
    - a limit would mean auditor's share of liability passes to public
    - set a precedent for other professions

- what effect does liability have on audit work?
  - selection of clientele
  - quality of work and new approaches
  - qualified and trained staff
  - the following of professional standards
  - understanding of client business
  - engagement letters

WHAT TO STUDY FOR WEEKS 1 & 2?

- the liability issue
- changes to auditing as a result of the audit expectation gap
- components and duties of the expectation gap
- in 1994, the farmer suppliers of Fortex considered legal action against the auditors; what would they need to show in order to succeed?

MANAGEMENT ASSERTIONS

FINANCIAL REPORT ASSERTIONS AND AUDIT OBJECTIVES AND PROCEDURES

- directors and managers make assertions (embodied in the FS)
- auditors use assertions to assess risks by considering potential misstatements and designing audit procedures in response to risks
- there are 3 categories of assertions:

  - **Classes of Events and Transactions**
    - **occurrence** — *transactions and events that have been recorded have occurred and relate to the entity*
    - **completeness** — *all transactions and events that should have been recorded have been recorded*
    - **accuracy** — *amounts and other data relating to recorded transactions and events have been recorded appropriately*
    - **cut-off** — *transactions and events have been recorded in the correct accounting period*
    - **classification** — *transactions and events have been recorded in the proper accounts*

  - **Account Balances**
    - **existence** — A, L, and E interests actually exist
    - **rights and obligations** — the entity holds or controls the rights to As, and Ls are the obligation of the entity
    - **completeness** — all A, L, and E interests that should have been recorded have been recorded
    - **valuations and allocation** — A, L, and E interests are include in the financial report at appropriate amounts and any resulting valuation adjustments are appropriately recorded

  - **Presentation and Disclosure**
    - **occurrence and rights and obligations** — disclosed events, transactions, and other matters have occurred and pertain to the entity
    - **completeness** — all disclosures that should be included in the financial report have been included
    - **classification and understandability** — financial information is appropriately presented and described, and disclosures are clearly expressed
    - **accuracy and valuation** — financial and other information is disclosed fairly and at appropriate amounts

- auditor needs to obtain evidence that supports each of the assertions for every material component of the financial report; component = account balance, group of accounts balance, class of transactions, or disclosure

Assertion and Example Objectives	
Existence	Inventory included in the B/S exists Inventory consists of items held for sale
Completeness	Inventory quantities include all items in stock
Rights and Obligations	Company has legal title to inventory Inventory excludes all items owned by others e.g. customers
Accuracy and Valuation	Inventories are correctly stated at cost (or realisable value if lower) Obsolete inventory items identified

AUDIT PROCEDURES AND EVIDENCE

COMMON AUDIT PROCEDURES

- inspection
- observation
- confirmation
- recalculation
- re-performance
- analytical procedures
- inquiry

AUDIT EVIDENCE

- documents (e.g. invoices, contracts, minutes)
- confirmations (and other written confirmations)
- information from inquiry, observation, and inspection
- business strategy of the entity
- other information developed or obtained by the auditor

- what are some types of evidence an auditor might seek?
  - *select sales transactions and check correctly processed*
  - *ask management about new products being developed*
  - *estimate interest expense based on loans and interest rates and compare to financial statements*
  - *ask about the process for making price changes to the computer file*
  - *write to customers and confirm year end accounts payable*
  - *examine draft financial statements and calculate ratios*

- "sufficient appropriate audit evidence"
  - sufficiency = quantity of audit evidence necessary (determined by reference to sampling)
  - appropriateness = referee to the quality of audit evidence
    - relevance: evidence relates to the financial report assertion of interest
    - reliability: influenced by the source and nature of the evidence
      - *third party information more reliable than information obtained from entity*
      - *information generated internally is more reliable when internal controls are effective*
      - *evidence obtained directly by auditor is more reliable than when obtained by the client*
      - *documentation is more reliable than oral representations*
      - *original documents are more reliable than photocopies/faxes*

Assertion and Example Audit Procedures	
Existence	Select items from inventory records and count them (inspection)
Completeness	Select items in warehouse and check to inventory records
Rights and Obligations	Inspect shipping documents/contracts for terms of sale to ensure ownership recognised correctly
Accuracy and Valuation	Inspect records of subsequent sales to ensure selling price is greater than cost

RISK EVALUATION AND THE AUDIT RISK MODEL

AUDIT RISK

- risk that the auditor will give an *inappropriate* audit opinion when the *financial report is materially misstated*
- before issuing an opinion on the financial report, the auditor needs to *reduce* audit risk to an *acceptable level* to ensure the opinion is reliable
  - reduce by gathering sufficient appropriate evidence for each assertions of each significant transaction class or account balance
  - audit risk model: focus on transactions or balances (and assertions) that are likely to contain material misstatements

COMPONENTS OF AUDIT RISK

- Inherent Risk
  - susceptibility of an assertion to material misstatement given inherent and environmental characteristics, but without regard to prescribed internal control procedures
  - i.e. some companies are just inherently risky, like finance companies

- Control Risk
  - risk that material misstatement might not be prevented or detected by internal control procedures

- Detection Risk
  - risk that auditors' substantive procedures will lead auditor to conclude no material misstatement exists when, in fact, one does
  - this is the ONLY risk that is controlled by the auditor
  - how to reduce? adequate planning, proper assignment of tasks, professional scepticism, appropriate decisions on the nature, timing, and extent of audit procedures, effective performance of the audit procedures and evaluation of results, supervision and review of the audit work performed