

MODULE 1

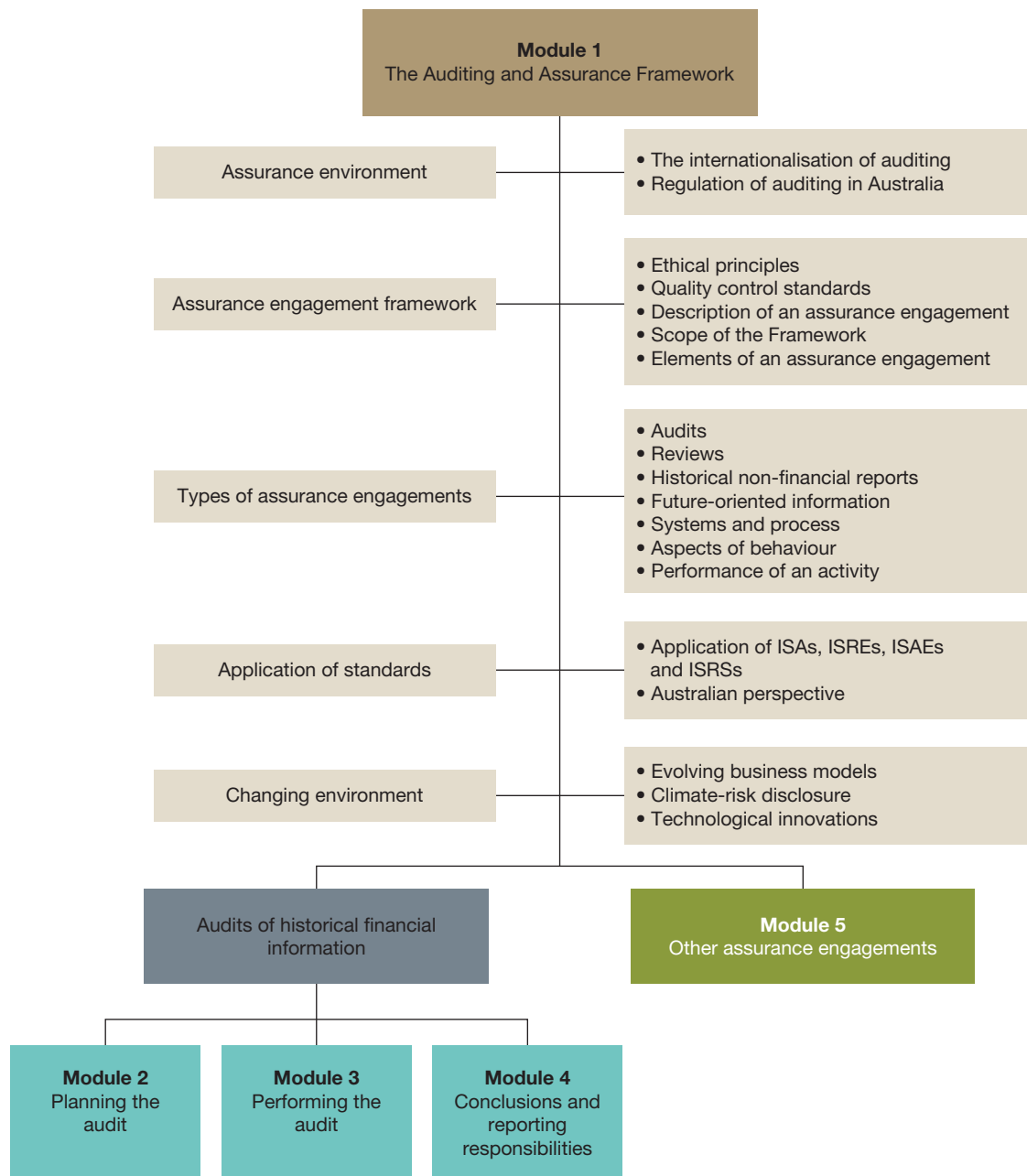
THE AUDITING AND ASSURANCE FRAMEWORK

LEARNING OBJECTIVES

After completing this module, you should be able to:

- 1.1** apply the *International Framework for Assurance Engagements* (the Framework) and the related standards and other guidance to assurance engagements
- 1.2** apply the *Code of Ethics for Professional Accountants* to assurance engagements.

RELEVANT STANDARDS AND GUIDANCE MATERIALS



International standards	Australian standards
<i>IESBA International Code of Ethics for Professional Accountants (including International Independence Standards)</i>	<i>APES 110 Code of Ethics for Professional Accountants (including Independence Standards)</i>
<i>International Framework for Assurance Engagements</i>	<i>Framework for Assurance Engagements</i>
n/a	<i>ASA 101 Preamble to Australian Auditing Standards</i>
n/a	<i>ASA 102 Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements</i>
<i>ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing</i>	<i>ASA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards (Compiled)</i>
<i>ISA 220 Quality Control for an Audit of Financial Statements</i>	<i>ASA 220 Quality Control for an Audit of a Financial Report and Other Historical Financial Information (Compiled)</i>
<i>ISA 230 Audit Documentation</i>	<i>ASA 230 Audit Documentation (Compiled)</i>
<i>ISA 300 Planning an Audit of Financial Statements</i>	<i>ASA 300 Planning an Audit of a Financial Report (Compiled)</i>
<i>ISA 315 (Revised) Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment</i>	<i>ASA 315 Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment (Compiled)</i>
<i>ISA 402 Audit Considerations Relating to an Entity Using a Service Organization</i>	<i>ASA 402 Audit Considerations Relating to an Entity Using a Service Organisation (Compiled)</i>
<i>ISA 510 Initial Audit Engagements — Opening Balances</i>	<i>ASA 510 Initial Audit Engagements — Opening Balances (Compiled)</i>
<i>ISA 540 (Revised) Auditing Accounting Estimates, and Related Disclosures</i>	<i>ASA 540 Auditing Accounting Estimates and Related Disclosures</i>
<i>ISA 600 Special Considerations — Audits of Group Financial Statements (including the Work of Component Auditors)</i>	<i>ASA 600 Special Considerations — Audits of a Group Financial Report (Compiled)</i>
<i>ISA 610 (Revised) Using the Work of Internal Auditors</i>	<i>ASA 610 Using the Work of Internal Auditors</i>
<i>ISA 800 (Revised) Special Considerations—Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks</i>	<i>ASA 800 Special Considerations — Audits of Financial Reports Prepared in Accordance with Special Purpose Frameworks (Compiled)</i>
<i>ISA 805 (Revised) Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement</i>	<i>ASA 805 Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement (Compiled)</i>
<i>ISA 810 (Revised) Engagements to Report on Summary Financial Statements</i>	<i>ASA 810 Engagements to Report on Summary Financial Statements</i>
<i>ISQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements</i>	<i>ASQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Reports and Other Financial Information, Other Assurance Engagements and Related Services Engagements</i>

ISRE 2400 (Revised) <i>Engagements to Review Historical Financial Statements</i>	ASRE 2400 <i>Review of a Financial Report Performed by an Assurance Practitioner Who is Not the Auditor of the Entity</i>
ISRE 2410 <i>Review of Interim Financial Information Performed by the Independent Auditor of the Entity</i>	ASRE 2410 <i>Review of a Financial Report Performed by the Independent Auditor of the Entity (Compiled)</i>
n/a	ASRE 2415 <i>Review of a Financial Report: Company Limited by Guarantee or an Entity Reporting under the ACNC Act or Other Applicable Legislation or Regulation (Compiled)</i>
ISAE 3000 (Revised) <i>Assurance Engagements Other than Audits or Reviews of Historical Financial Information</i>	ASAE 3000 <i>Assurance Engagements Other than Audits or Reviews of Historical Financial Information</i>
n/a	ASAE 3100 <i>Compliance Engagements</i>
n/a	ASAE 3150 <i>Assurance Engagements on Controls</i>
ISAE 3400 <i>The Examination of Prospective Financial Information</i>	n/a
ISAE 3402 <i>Assurance Reports on Controls at a Service Organization</i>	ASAE 3402 <i>Assurance Reports on Controls at a Service Organisation</i>
ISAE 3410 <i>Assurance Engagements on Greenhouse Gas Statements</i>	ASAE 3410 <i>Assurance Engagements on Greenhouse Gas Statements</i>
ISAE 3420 <i>Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus</i>	ASAE 3420 <i>Assurance Engagements to Report on the Compilation Of Pro Forma Financial Information Included in a Prospectus</i>
n/a	ASAE 3450 <i>Assurance Engagements involving Corporate Fundraisings and/or Prospective Financial Information</i>
n/a	ASAE 3500 <i>Performance Engagements</i>
n/a	ASAE 3610/AWAS 2 <i>Assurance Engagements on General Purpose Water Accounting Reports</i>
ISRS 4400 <i>Engagements to Perform Agreed-Upon Procedures Regarding Financial Information</i>	ASRS 4400 <i>Agreed-Upon Procedures Engagements to Report Factual Findings</i>
ISRS 4410 (Revised) <i>Compilation Engagements</i>	n/a
n/a	ASRS 4450 <i>Comfort Letter Engagements</i>
n/a	APES 310 <i>Client Monies</i>

PREVIEW

This module begins by describing the assurance environment. The institutions behind the development of the *International Framework for Assurance Engagements* (the Framework), which shapes auditing and other assurance engagements, are introduced. The regulation of auditing in Australia is also outlined. Next, the following key requirements of the assurance engagement framework are discussed:

- ethical principles
- quality control standards
- description of assurance engagements
- attestation and direct engagements
- reasonable and limited assurance engagements
- scope of the Framework
- elements of an assurance engagement.

The audit profession has ~~developed its reputation~~, methodology and expertise through financial statement audits and reviews and, in the public sector, on performance engagements. More recently, the profession has expanded its range of assurance services to cover numerous situations where there is a desire to have the credibility of a report enhanced for users.

Some of the common types of assurance engagements are discussed, including:

- audits and reviews of historical financial information
- other assurance engagements
 - non-financial information (e.g. sustainability or business performance reports)
 - future-oriented information (e.g. prospectuses)
 - systems and processes (e.g. internal control)
 - aspects of behaviour (e.g. compliance with regulations)
 - performance of an activity.

Next, the module discusses the application of the standards, including:

- auditing standards that **are applied to audits of historical financial information** (i.e. audits of financial statements)
- review engagement standards
- other assurance engagement standards
- related services engagement standards.

Lastly, this module introduces material to be covered in subsequent modules, discusses how the business and regulatory environment is evolving and highlights potential impacts on the auditing profession largely due to technological innovations.

1.1 ASSURANCE ENVIRONMENT

Assurance services are independent professional services that aim to improve the quality, relevance and reliability of information necessary for decision making. The terms ‘auditing’ and ‘assurance’ are sometimes confused. An audit is a specific type of assurance engagement that focuses on historical financial information. That is, an audit is a subset of assurance engagements. As shown in table 1.1, assurance services are divided between:

- audits of historical financial information
- reviews of historical financial information
- assurance engagements other than audits and reviews of historical financial information.

Further information on the **structure and hierarchy of assurance** standards is provided later in this module.

The *International Framework for Assurance Engagements* (para. 7) defines assurance engagements as:

an engagement in which a practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria.

This definition provides five essential elements of an assurance engagement.

For an audit of financial statements, an auditor evaluates the presentation of the financial statements against criteria (e.g. accounting standards) and expresses a conclusion (audit report) based on their findings. The audit is designed to provide users (such as shareholders) with a reasonable level of confidence about the truth and fairness of the financial statements.

TABLE 1.1 Population of assurance services

	Types of information		
	Historical financial information	All other information	
Level of assurance provided	Reasonable	Limited	Reasonable or limited
Examples	Audit of financial statements	Review of financial statements	<ul style="list-style-type: none"> • Corporate social responsibility (CSR) reports • Greenhouse gas statements (GHG) • Sustainability reports • Water accounting reports • Business performance measurement • Integrated reports • Future-oriented information • Systems and processes • Aspects of behaviour • Performance of an activity
International standards	ISAs 100–999 International Standards on Auditing	ISREs 2000–2699 International Standards on Review Engagements	ISAEs 3000–3699 International Standards on Assurance Engagements

Source: CPA Australia 2019.

Auditing and assurance are governed by two separate but closely related sets of standards: auditing standards that are concerned with audits of historical financial information; and assurance standards that are concerned with all other types of assurance engagements. Both the International Standards on Auditing and International Standards on Review Engagements continually evolve to keep pace with changes in business and social expectations.

The demand for assurance services continues to grow and so does the range of assurance services offered by public accountants. As a result, the role of regulators and regulation in maintaining the quality of the assurance services is pivotal. Assurance engagement providers operate in a complex environment that is subject to a number of important influences, such as the internationalisation of auditing and regulation. This section will explain these influences on the provision of assurance services.

THE INTERNATIONALISATION OF AUDITING

Auditing has become an international market with a large increase in the number of multinational corporations as audit clients. The auditing profession, the auditing standard-setting process and the regulatory process have also become internationalised. This internationalisation has led to the promulgation of international assurance pronouncements to harmonise auditing practices across jurisdictions.

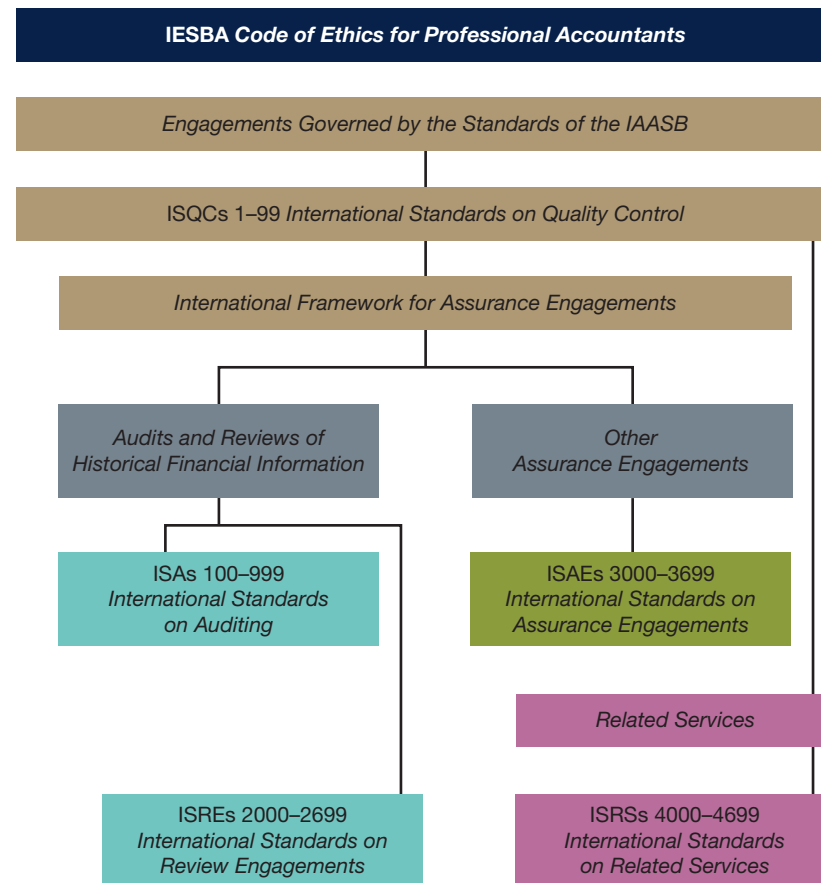
Figure 1.1 shows the structure and hierarchy of the international pronouncements, including the International Standards on Quality Control and the International Framework for Assurance Engagements. The Framework and Standards on Quality Control will be discussed in section 1.2. The types of assurance engagements will be discussed in section 1.3, and the application of the standards will be discussed in section 1.4.

The pronouncements shown in figure 1.1 govern assurance engagements conducted in accordance with International Standards. However, they do not override the local laws and regulations that govern historical financial statement audits or assurance engagements on other information that are required to be followed in a particular country.

Regulatory agencies implement and enforce laws and regulations. Globally, regulators want greater consistency in the delivery of quality audit services (Deloitte 2019). This includes increasing coordination through the International Forum of Independent Audit Regulators (IFIAR) by ‘sharing knowledge, collaborating and promoting consistency in the way auditing is regulated’ (Deloitte 2019). The main regulatory agencies that have an impact on auditing and assurance engagements in a global setting include:

- International Federation of Accountants (IFAC)
- International Forum of Independent Audit Regulators (IFIAR)
- International Ethics Standards Board for Accountants (IESBA)
- International Auditing and Assurance Standards Board (IAASB).

FIGURE 1.1 Pronouncements issued by the IAASB



Source: International Auditing and Assurance Standards Board (IAASB) 2018, *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, 2018 ed., vol. 1, p. 4, accessed July 2019, <https://www.ifac.org/publications-resources/2018-handbook-international-quality-control-auditing-review-other-assurance>

International Federation of Accountants (IFAC)

The International Federation of Accountants (IFAC) is the global organisation for the accountancy profession dedicated to serving the public interest by strengthening the profession. With headquarters in New York, IFAC’s members are the associations of professional accountants from around the world. CPA Australia, for example, is a member of IFAC. The IFAC council comprises one representative of each member body. In 2019, IFAC had over 175 members from 130 countries and jurisdictions (IFAC 2019).

International Forum of Independent Audit Regulators (IFIAR)

There has been increased oversight of the auditing profession by independent audit regulatory authorities, resulting in the formation in 2006 of the International Forum of Independent Audit Regulators (IFIAR), which in 2018 had a membership of 55 independent public oversight bodies (such as the Australian Securities and Investments Commission (ASIC) in Australia) from different countries (IFIAR 2019).

International Ethics Standards Board for Accountants (IESBA)

The International Ethics Standards Board for Accountants (IESBA’s) restructured code of ethics, the *International Code of Ethics for Professional Accountants (including International Independence Standards)* (the Code), which was issued in April 2018, is the fundamental pronouncement for assurance practitioners. The Code was developed with a view to enhancing ease of navigation, use and enforcement.

The Code states that ‘a professional accountant shall comply with the code’ (the Code, para. R100.3) except for parts where laws and regulations in a specific jurisdiction preclude compliance. All other standards and related guidance issued by the IAASB shall be applied in the context of the ethical framework presented in the Code. Similarly, all standards other than the Code shall be applied in the context of the *International Standards on Quality Control* (i.e. ISQC 1). It is not possible for a practitioner to comply with the standards without first complying with the Code.

You should look through the Code now to familiarise yourself with its content. The Code is available online at https://www.ifac.org/system/files/publications/files/Final-Pronouncement-The-Restructured-Code_0.pdf. However, it will be discussed further in section 1.2.

International Auditing and Assurance Standards Board (IAASB)

The International Auditing and Assurance Standards Board (IAASB) is:

an independent standard-setting body that serves the public interest by setting high-quality international standards for auditing, quality control, review, other assurance, and related services, and by facilitating the convergence of international and national standards (IAASB 2019).

The convergence of international and national standards enhances the quality and consistency of practice throughout the world and strengthens the public’s confidence in the global auditing and assurance profession.

The IAASB develops and issues standards for three types of assurance engagements: audits, review engagements and other assurance engagements.

1. *International Standards on Auditing (ISAs)* — to be applied to the *audit of historical financial information*.

2. *International Standards on Review Engagements (ISREs)* — to be applied to the *review of historical financial information*.

3. *International Standards on Assurance Engagements (ISAEs)* — to be applied in assurance engagements dealing with information *other than historical financial information* (e.g. prospectuses, sustainability reports). Information that is ‘other than historical financial’ may be future oriented and/or non-financial.

The application of these standards will be discussed later in this module. As shown in figure 1.1, the IAASB also issues International Standards on Related Services (ISRSs), which are not assurance engagements (in that they are not designed to offer a degree of assurance), but which do utilise assurance-type, evidence-gathering procedures (e.g. agreed procedures engagements to report factual findings). This will be discussed in more detail in module 5.

In addition, the IAASB issue other pronouncements such as the International Framework for Assurance Engagements and A Framework for Audit Quality. Both of these frameworks are discussed in section 1.2.

REGULATION OF AUDITING IN AUSTRALIA

This section describes Australian institutional arrangements surrounding the Australian auditing pronouncements, which are based on the international pronouncements.

There are a number of regulators and institutions that have an impact on the audit process, either directly or indirectly. They include the:

- Financial Reporting Council (FRC)
- Australian Securities and Investments Commission (ASIC)
- Accounting Professional and Ethical Standards Board (APESB)
- Auditing and Assurance Standards Board (AUASB)
- Companies Auditors and Liquidators Disciplinary Board (CALDB)
- Australian Securities Exchange (ASX)
- professional accounting bodies:
 - CPA Australia
 - Chartered Accountants Australia and New Zealand (CAANZ)
 - Institute of Public Accountants (IPA).

Financial Reporting Council (FRC)

The Financial Reporting Council (FRC) is an independent statutory agency that was established in 1999 to oversee the accounting standards-setting process. Its duties were expanded in 2005 to include the oversight of the auditing standard-setting process and the monitoring of auditor independence. Its responsibilities include appointing the members of the AUASB.

Australian Securities and Investments Commission (ASIC)

The Australian Securities and Investments Commission (ASIC) is an independent Commonwealth body that was set up under the *Australian Securities and Investments Commission Act 2001* (Cwlth) (ASIC Act). ASIC carries out most of its work under the *Corporations Act 2001* (Cwlth) (Corporations Act).

ASIC regulates the corporate markets and financial services sectors in Australia by overseeing activities to protect investors. Their aim is to ensure investors have access to adequate information, are treated fairly

and have adequate avenues for redress. Of particular interest to auditors is the expanded role of ASIC in recent years to include responsibility for reviewing the quality of audit work performed (Leung et al. 2019).

Its responsibilities with regard to the oversight of the auditing profession include registration of auditors, enforcement of rules regarding auditor independence and use of auditing standards, and inspection of audit firms.

Accounting Professional and Ethical Standards Board (APESB)

The Accounting Professional and Ethical Standards Board (APESB) is responsible for setting ethical standards in Australia. It is funded by the professional accounting bodies in Australia (however, its members are independent). It is responsible for setting standards on quality control, ethical conduct and compliance with auditing and assurance standards.

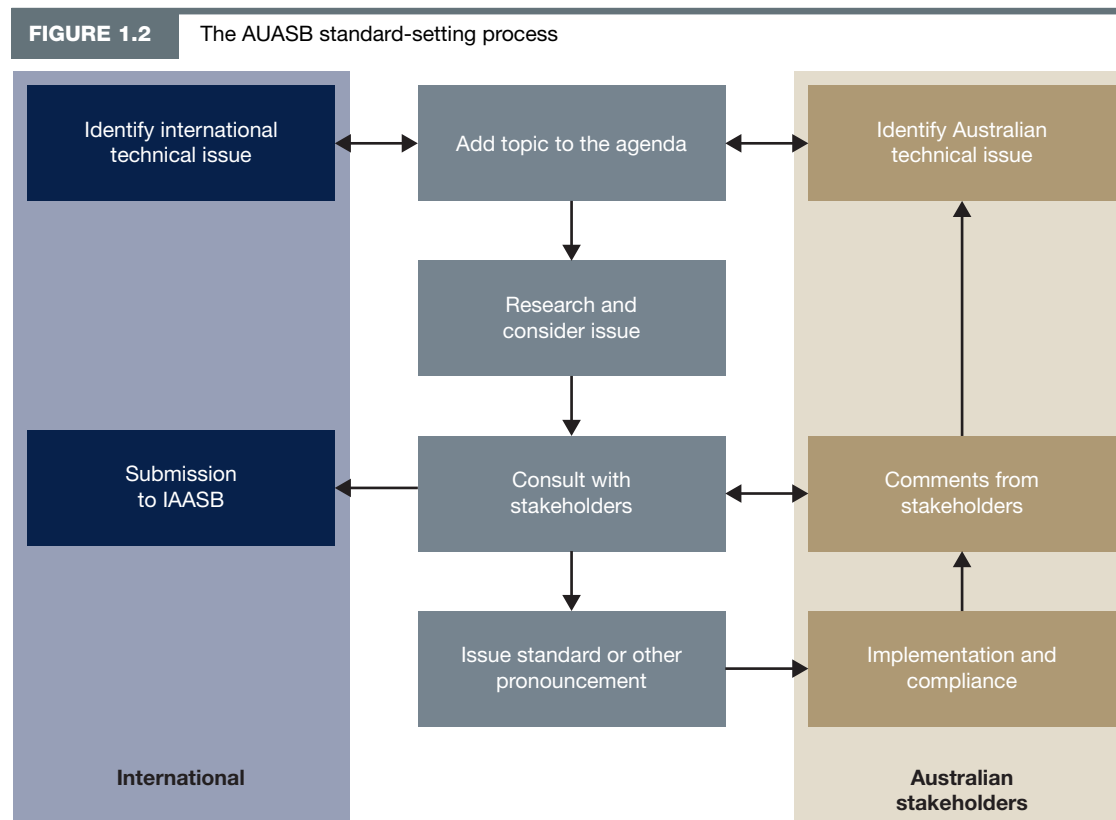
Australian Auditing and Assurance Standards Board (AUASB)

The Australian Auditing and Assurance Standards Board (AUASB) was established in Australia as an independent statutory agency under the ASIC Act. The AUASB’s mandate requires it to consider revisions and improvements to the pronouncements initiated by the IAASB.

The *Australian Framework for Assurance Engagements* (Australian Framework) conforms with the *International Framework for Assurance Engagements* (the Framework) with only minor differences.

Pronouncements are issued in Australia by the AUASB and are, in general, the same as the pronouncements of the IAASB. However, they are *not identical* to the international pronouncements and differences mainly arise to accommodate the requirements of Australian legislation. Differences also arise because the *Australian Auditing Standards* (ASAs) include a small number of paragraphs that are not found in the ISAs. These paragraphs are labelled Aus (e.g. Aus 14), and in most cases, Aus paragraphs impose requirements on Australian auditors that are additional to those found in the international standards.

Figure 1.2 illustrates the AUASB standard-setting process and identifies the procedures followed when International or Australian technical issues are identified and research and consultation with stakeholders are undertaken prior to issuing a standard or other pronouncement.



Source: AUASB 2019, The Standard-Setting Process’, accessed August 2019, <https://www.auasb.gov.au/About-the-AUASB/The-standard-setting-process.aspx>

Table 1.2 shows the equivalent Australian pronouncements to the International pronouncements covering various aspects of audit and assurance engagements.

TABLE 1.2 Equivalent Australian pronouncements	
IAASB (International) pronouncements	AUASB (Australian) pronouncements
ISQC	ASQC
ISA	ASA
ISRE	ASRE
ISAE	ASAE

Source: CPA Australia 2019.

The Companies Auditors Disciplinary Board (CADB)

The CADB is a statutory body initially established as the Companies Auditors and Liquidators Disciplinary Board (CALDB) in 1990. It hears applications from ASIC to determine whether auditors or liquidators have breached the Corporations Act. It also has the power to impose a penalty if it determines that a registered auditor or liquidator has failed to carry out duties properly or is not a fit and proper person to be registered. Penalties include the cancellation or suspension of registration, an imposition of restrictions on conduct, or an admonition (Leung et al. 2019).

CADB members are appointed by the Treasurer based on the requirements of the ASIC Act and have a breadth of knowledge and experience encompassing the law, accounting and business (Leung et al. 2019).

The Australian Securities Exchange (ASX)

The ASX is also an important participant in the market, but it is not a regulator. The ASX became a public company in 1998 and operates as the main national securities exchange for equities, derivatives and fixed-interest securities. It facilitates capital raisings and trading for listed companies, settlement and capital matching, and provides comprehensive market data and information to a range of users. The ASX describes itself as ‘an integrated exchange’ offering ‘listings, trading, technology, data and post-trade services for a wide range of asset classes, including equities, fixed income, commodities and energy’ (ASX 2018).

To list a company on the ASX, there are a number of Listing Rules designed to protect investors. The Listing Rules are enforceable against listed entities under the requirements of the Corporations Act. Listing Rules create obligations that are additional and complementary to the statutory obligations under the Corporations Act. One particular example of the enhanced requirements under the Listing Rules is Listing Rule 4.10.3, which requires an entity to make a statement of the extent to which their corporate governance practices have followed the best practice recommendations of the ASX Corporate Governance Council and disclose reasons for any non-conformity. Another example of enhanced requirements is in relation to continuous disclosure, where Listing Rule 3.1 requires that once a company becomes aware of any information that a reasonable person would expect to have a material effect on the price or value of its securities, it should inform the market. The ASX has a role in maintaining the integrity of the capital market.

Professional Accounting Bodies

Professional accounting bodies represent the interests of their members by lobbying governments and provide the framework for self-regulation, where permitted by statute. Professional bodies also administer training and examinations for students and members. There are three professional accounting bodies in Australia. They are:

- CPA Australia
- Chartered Accountants Australia New Zealand
- Institute of Public Accountants (IPA).

CPA Australia

CPA Australia is a professional body with more than 164 000 members working as finance, accounting and business professionals, academics, and public servants in Australia and around the world. CPA Australia’s core services to their members include education, training, technical support and advocacy. To become a CPA it is necessary to undertake the CPA Program and have three years of work experience mentored by a member of CPA Australia.

Chartered Accountants Australia and New Zealand (CAANZ)

CAANZ is a professional body with more than 120 000 members working in public practice (including the Big-4 and mid-tier chartered accounting firms), industry, academia and government. Its members work in Australia, New Zealand and more than 100 other countries. To become a chartered accountant it is necessary to undertake the Chartered Accountants (CA) Program, which combines study and mentored work experience.

Institute of Public Accountants (IPA)

The IPA is a professional body with more than 35 000 members working in industry, commerce, government, academia and public practice. To become an IPA member it is necessary to meet eligible accounting qualifications equivalent to the IPA Program Stage 1 and industry experience equivalent to the Mentored Experience Program. An alternative path is available for those who have a current membership with an IFAC Member level body.

QUESTION 1.1

Several private and public sector organisations are associated with the public accounting profession. The following are functions pertaining to these organisations.

1. Hear applications from ASIC to determine whether auditors have breached the Corporations Act.
2. Oversee the accounting standards-setting process.
3. Formulate auditing standards and audit guidance statements.
4. Regulate the distribution and trading of securities offered for public sale.
5. Establish a code of professional ethics.
6. Oversee the Australian Auditing and Assurance Standards Board.
7. Issue auditing standards.
8. Take punitive action against an independent auditor.
9. Establish quality control standards for audit work.
10. Undertake investigation of perceived breaches of the Corporations Act.

Indicate the organisation associated with each activity.

REGULATION OF AUDITING IN NEW ZEALAND

In the previous two sections we have described the regulation of auditors and institutional arrangements around auditing pronouncements in the international setting and then some specific Australian differences. Here we consider the New Zealand environment.

The External Reporting Board (XRB) is an independent Crown entity established under the *Financial Reporting Act 1993* with the following functions:

1. developing and implementing an overall strategy for financial reporting standards and auditing and assurance standards (including developing and implementing tiers of financial reporting and assurance);
2. preparing and issuing accounting standards;
3. preparing and issuing auditing and assurance standards, including the professional and ethical standards that will govern the professional conduct of auditors; and
4. liaising with national and international organisations that exercise functions that correspond with, or are similar to, those conferred on the XRB (XRB 2019a).

The XRB consists of the New Zealand Accounting Standards Board (NZASB) and the New Zealand Auditing and Assurance Standards Board (NZAuASB). The auditing and assurance standards issued by the NZAuASB consist of four suites of standards:

1. Professional and Ethical Standards: these are the professional and ethical standards applying to assurance practitioners issued by the XRB Board/NZAuASB.
2. International Standards on Auditing (NZ): apply to the conduct of audit engagements (reasonable assurance) undertaken by assurance practitioners.
3. Review Engagement Standards: apply to the conduct of review engagements (limited assurance) undertaken by assurance practitioners (XRB 2019c).
4. Other Assurance Engagement Standards: apply to the conduct of assurance engagements (other than on historical financial information) undertaken by assurance practitioners.

The XRB Board has set key strategic objectives for the NZAuASB related to harmonisation as follows:

1. the adoption of international auditing and assurance standards as applying in New Zealand unless there are compelling reasons not to; and
2. working with the Australian Auditing and Assurance Standards Board (AUASB) towards the establishment of harmonised standards based on international standards (XRB 2019b).

The equivalent of the Australian regulator (ASIC) in New Zealand is the Financial Markets Authority (FMA), which is an independent Crown authority responsible for ensuring public confidence in New Zealand financial markets. Its responsibilities include:

- the licensing of New Zealand and overseas auditors and audit firms
- monitoring the audit firm performance
- performing quality reviews of New Zealand audit firms and auditors
- overseeing and monitoring accredited bodies to make sure they carry out their statutory duties.

Further details of the FMA’s role can be obtained from the Auditor Regulation and Oversight Plan 2019–2022 (FMA 2019).

The key points covered in this part, and the learning objectives they align to, are below.

KEY POINTS

1.1 Apply the *International Framework for Assurance Engagements* (the Framework) and the related standards and other guidance to assurance engagements.

- The *International Framework for Assurance Engagements* distinguishes assurance engagements from other engagements and provides a hierarchy of standards applicable to different engagements.

1.2 Apply the *Code of Ethics for Professional Accountants* to assurance engagements.

- All professional accountants have to comply with the fundamental ethical principles set out in the Code.

1.2 ASSURANCE ENGAGEMENT FRAMEWORK

The *International Framework for Assurance Engagements* (the Framework) issued by the IAASB applies to all assurance engagements. It helps in understanding the engagements to which ISAs, ISREs and ISAEs apply. Engagements for non-assurance and related services including consulting engagements are outside the scope of this Framework, but accountants undertaking such engagements must also adhere to the IESBA *Code of Ethics for Professional Accountants* (the Code). The Framework is not a standard and does not include any requirements for performance. The Framework refers to the applicable assurance standards and the Code where requirements are prescribed. As such, this section will outline information contained in the Framework as well as requirements of the Code and applicable standards. Matters contained in the Framework that will be discussed in this section include:

- ethical principles
- quality control standards
- description of assurance engagements
- attestation and direct engagements
- reasonable and limited assurance engagements
- scope of the Framework
- elements of an assurance engagement:
 - three-party relationship
 - underlying subject matter
 - criteria
 - evidence
 - assurance report.

ETHICAL PRINCIPLES

The Framework specifies that firms that perform assurance engagements must comply with the fundamental ethical principles outlined in IESBA’s Code. The Code’s conceptual framework (the Code, s. 120) outlines circumstances in which threats to compliance with the fundamental principles may occur.

The Code’s conceptual framework also specifies how accountants may identify, evaluate and address the threats by eliminating them or reducing them to an acceptable level.

The Code

IFAC established the IESBA to develop ethical principles for accountants. IESBA’s Code is the central standard. The *Ethics and Governance* subject of the CPA Program examines the Code in depth. The aspects of the Code that are of particular interest to assurance practitioners are discussed next. The Code is divided into four parts.

- Part 1 introduces and describes the fundamental principles and conceptual framework.
- Part 2 applies to professional accountants in business.
- Part 3 applies to professional accountants in public practice.
- Part 4 covers independence standards for:
 - 4A audits and review engagements
 - 4B other assurance and non-assurance engagements.

After providing an overview of the fundamental principles included in Part 1 of the Code, this section will focus on Part 3 ‘Professional accountants in public practice’, which includes professional accountants in the auditing and assurance profession. Part 3 is extensive and describes many of the circumstances and relationships that could be encountered by an assurance practitioner and the associated threats to compliance with the fundamental ethical principles. This will be followed by a review of the independence requirements outlined in Part 4 of the Code.

Part 2 is outside the scope of this study guide as it concentrates on the Code that relates to professional accountants in business.

Fundamental Principles

The Code begins by establishing the fundamental principles of professional conduct and outlining the requirements and application of the conceptual framework to identify, evaluate and address the threats to compliance with the fundamental principles set out in the Code. The following topics are discussed next.

- Fundamental principles (the Code, s. 110):
 - integrity
 - objectivity
 - professional competence and due care
 - confidentiality
 - professional behaviour.
- Conceptual framework (the Code, s. 120):
 - threats and safeguards.

Integrity

The principle of **integrity** imposes an obligation on professional accountants to be straightforward and honest (the Code, para. R111.1).

Objectivity

Accountants, and in particular auditors, may be exposed to numerous situations that could reduce **objectivity** in their professional judgments. Therefore, they have a duty to avoid relationships or situations that allow prejudice, bias, conflict of interest or the undue influence of others, which might compromise their professional and business judgments (the Code, para. R112.1).

Professional Competence and Due Care

The principle of **professional competence and due care** (the Code, para. R113.1) is an obligation that has two distinct parts:

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- (a) Attaining and maintaining professional knowledge and skills necessary to provide competent professional service to the client.
- (b) To act ‘diligently and in accordance with applicable technical and professional standards’ (the Code, para. R113.1(b)).

This obligation requires continuing awareness of relevant technical, professional and business developments, which can be obtained through continuing professional development (the Code, para. 113.1 A2). The Code explains that ‘diligence encompasses the responsibility to act in accordance with the requirements

of an assignment, carefully, thoroughly and on a timely basis’ (the Code, para. 113.1 A3). Professional accountants are required to decline a job unless they possess the necessary skills to perform it properly.

QUESTION 1.2

Brenda Jones is a newly qualified accountant who is carrying out her first audit as the in-charge auditor for a construction company client that is engaged in a range of long-term contracts. Brenda has little experience of these types of clients and the accounting requirements in relation to long-term contracts. John Bull is the CFO of the client — he is a busy man and has a notorious reputation for being unfriendly to auditors. It has become apparent that Brenda has not fully understood the accounting issues involved and has avoided asking the necessary questions of John Bull to gain an understanding of the company’s transactions and the necessary audit work required to obtain evidence on the long-term contract transactions.

As Brenda’s supervisor, how would you explain to her the importance of professionalism, using the *International Code of Ethics for Professional Accountants (including International Independence Standards)* and particularly referring to its guidance on competence? What advice would you give as to how she should proceed?

Confidentiality

A professional accountant must respect the **confidentiality** of information acquired as a result of professional and business relationships. They must not:

- use the information for the personal advantage of themselves or third parties
- disclose any such information to third parties without proper and specific authority, unless there are responsibilities under law, regulation or relevant ethical requirements to disclose (the Code, para. R114.1).

Circumstances where disclosure of confidential information may be required or appropriate (the Code, para. 114.1 A1) include:

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- (a) Disclosure is required by law, for example:
 - (i) Production of documents or other provision of evidence in the course of legal proceedings; or
 - (ii) Disclosure to the appropriate public authorities of infringements of the law that come to light;
- (b) Disclosure is permitted by law and is authorized by the client or the employing organization;
- (c) There is a professional duty or right to disclose, when not prohibited by law:
 - (i) To comply with the quality review of a professional body;
 - (ii) To respond to an inquiry or investigation by a professional or regulatory body;
 - (iii) To protect the professional interests of a professional accountant in legal proceedings;

or

 - (iv) To comply with technical and professional standards, including ethics requirements (the Code, para. 114.1 A1).

Professional Behaviour

An accountant must demonstrate **professional behaviour** by complying with relevant laws and regulations and avoid any conduct that discredits the profession (the Code, para. R115.1). They must act in a way that promotes the good reputation of the profession.

Threats and Safeguards

Using the conceptual framework approach recommended by the Code, members must identify any threats to compliance with the fundamental principles, evaluate those threats and address threats to compliance with the fundamental principles in section 110 of the Code. Where the threats are significant, members must apply safeguards to eliminate them or reduce them to an acceptable level (i.e. so that compliance with the fundamental principles is no longer compromised). If members cannot implement appropriate safeguards, they must either decline or discontinue the specific professional service, or consider resigning from the client or employer.

Compliance with the fundamental ethical principles can be jeopardised by a range of threats.

- **Self-interest threat** may occur as a result of the financial or other interests of a professional accountant.
- **Self-review threat** may occur when the assurance team needs to form an opinion on their work or work performed by others in their firm.
- **Advocacy** may occur when an auditor is asked to promote or represent their client in some particular way. This could happen when a client asks the auditor to promote their shares on the stock exchange, argue their client’s position on a proposed accounting disclosure or represent them in a court case. The auditor’s objectivity may be impaired. Further, the auditor’s independence of mind and in appearance could be compromised.
- **Familiarity** may occur when, because of a long or close relationship with a client, a professional accountant becomes too sympathetic to their interests or too accepting of their work.
- **Intimidation** may occur when a professional accountant is deterred from acting objectively because of actual or perceived threats (the Code, para. 120.6 A3).

Many of the safeguards that eliminate or reduce threats are discussed in the Code. Safeguards may be created by the following.

- The profession, legislation or regulation — for example:
 - the issue of quality standards, member education, establishment of a code of ethics, and the enactment of legislation such as the Corporations Act and the ASIC Act.
- In the work environment of the assurance client — for example:
 - when the client’s management appoints the auditor, people other than management ratifying or approving the appointment
 - the client having competent employees to make managerial decisions
 - policies and procedures emphasising the client’s commitment to fair financial reporting
 - internal procedures ensuring objective choices in commissioning non-audit work
 - strong corporate governance, including an effective audit committee.
- In the work environment of the audit firm — for example:
 - systems and procedures to ensure compliance with ethical standards (e.g. rules on share ownership, relationship with clients, client acceptance procedures)
 - partner rotation policies to enhance audit partner independence
 - peer review policies to provide other partners with feedback.

In exercising judgment on the significance of threats and safeguards, accountants must consider what a **reasonable and informed third party** would likely conclude on whether compliance with the fundamental principles has been compromised.

You should now read paragraphs 200.1–200.8 of Part 2 of the Code, ‘Professional accountants in business’, which provide guidance on identifying, evaluating and addressing threats.

Professional Accountants in Public Practice

Part 3 of the Code, ‘Professional accountants in public practice’, provides guidance on applying the conceptual framework from Part 1. In this section, we consider specific issues relevant to public practitioners, including:

- conflicts of interest
- professional appointments
- second opinions
- fees and other types of remuneration
- inducements (including gifts and hospitality)
- custody of client assets
- responding to non-compliance with laws and regulations.

You should now read paragraphs 300.6–310.13 of Part 3 of the Code, ‘Professional accountants in public practice’, which provide many examples of the various threats and safeguards for professional accountants in public practice.

Conflicts of Interest

A professional accountant should not allow a conflict of interest to compromise their professional judgment. ‘A conflict of interest creates threats to compliance with the principle of objectivity and might create threats to compliance with other fundamental principles’ (the Code, para. 310.2). Such threats may be created, for example, when the interests of the client and the professional accountant conflict or when a professional accountant in public practice performs services for two or more clients whose interests are in conflict. In these circumstances, it is the responsibility of the

professional accountant to notify the relevant parties that they are acting for two or more parties whose respective interests are in conflict and obtain their consent to so act.

Safeguards to address threats created by a conflict of interest include:

1. Having separate engagement teams who are provided with clear policies and procedures on maintaining confidentiality.
2. Having an appropriate reviewer, who is not involved in providing the service or otherwise affected by the conflict, review the work performed to assess whether the key judgments and conclusions are appropriate (the Code, para. 310.8 A3).

Professional Appointments

Before accepting a new client, a professional accountant in public practice must determine whether acceptance would create any threats to compliance with the fundamental principles.

- A threat to integrity or professional behaviour may be created from behaviours of the ‘client (its owners, management or activities)’, such as ‘illegal activities, dishonesty, questionable financial reporting practices or unethical behaviour’ (the Code, para. 320.3 A1). The professional accountant can safeguard against this threat by obtaining knowledge and understanding of the client or securing the client’s commitment to address the questionable behaviours.
- A threat to professional competence and due care arises if the engagement team does not possess the competencies necessary to properly carry out the engagement. In these circumstances, an obvious safeguard would be for the practitioner to acquire knowledge of the relevant industry and its regulatory requirements.

In Australia, there are additional requirements that apply to the appointment of auditors. If the auditor has been an officer or audit-critical employee of the proposed client within the 12 months immediately before the proposed audit period, accepting an appointment is not permitted (Corporations Act, s. 324).

In respect of a change of auditor, an accountant who is asked to replace an existing auditor will generally need to obtain the prospective client’s permission to communicate with the existing auditor. On receipt of permission, they should request the necessary information to enable a decision to be made as to whether the audit engagement should be accepted. If permission is not granted, the accountant must carefully consider if the appointment should be declined. In this situation, the accountant must take reasonable steps to obtain information by other means about the circumstances of the change of appointment and any possible threats. These steps include enquiries of third parties or background investigations of senior management or those charged with governance of the prospective client (the Code, paras 320.4–320.5 A1).

Second Opinions

In accounting, an intimidation threat arises when a client succeeds in obtaining a second opinion favourable to their position — for example, an opinion on the use of particular accounting policies — and uses this to apply pressure on the existing accountant. The fundamental principle threatened is objectivity. Safeguards include the accountant who is asked to provide the second opinion seeking client permission to contact the existing accountant, as well as providing the existing accountant with a copy of the second opinion (the Code, para. 321.3 A3).

Fees and Other Types of Remuneration

Even though auditors, may quote whatever fee they consider as appropriate, quoting fees that are too low may make it difficult for the auditor to perform the assurance engagement in accordance with the applicable technical and professional standards. This is likely to impact on the principle of professional competence and due care. Safeguards to address this type of self-interest threat include:

- adjusting the level of fees or the scope of the engagement
- having an appropriate reviewer review the work performed (the Code, para. 330.3 A4).

Additionally, contingent fees may create a threat to compliance with the principle of objectivity. Having an appropriate reviewer review the work performed or obtaining a written agreement with the client on the basis of remuneration prior to commencement of work may address such self-interest risks (the Code, para. 330.4 A3).

A self-interest threat ‘with the principles of objectivity and professional competence and due care is created if a professional accountant pays or receives a referral fee or commission relating to a client’ (the Code, para. 330.5 A1). Such self-interest threats can be addressed by having the client outline commission arrangements prior to commencing

work or ‘disclosing to clients any referral fees or commission arrangements’ with other professional accountants (the Code, para. 330.5 A2).

Inducements — Gifts and Hospitality

Professional accountants may find themselves in situations where they, or their immediate or close family members, are offered **inducements** to influence their behaviour, such as:

- gifts
- hospitality
- entertainment
- political or charitable donations
- appeals to friendship and loyalty
- employment or other commercial opportunities
- preferential treatment, rights or privileges (the Code, para. 340.4 A1).

Offers of inducements may create self-interest, familiarity or intimidation threats to the principles of integrity, objectivity or professional behaviour (the Code, para. 340.2). Professional accountants need to understand and comply with the relevant laws and regulations as offering or accepting inducements are prohibited in many jurisdictions.

Custody of Client Assets

A professional accountant should not take ‘custody of client money or other assets unless permitted to do so by law’ because doing so may create a self-interest threat to the principles of professional behaviour and objectivity (the Code, para. R350.3). Before taking custody, a professional accountant should make enquiries about the source of the assets as they may be derived from illegal activities such as money laundering. After taking custody of client money or other assets, a professional accountant must comply with the relevant laws and regulations, keep the assets separate from personal or firm assets, use them only for the intended purpose and be ready to account for them at all times (the Code, para. R350.5).

Responding to Non-Compliance with Laws and Regulations

The Code incorporates the IESBA’s standard, *Responding to Non-Compliance with Laws and Regulations* (NOCLAR), which became effective in July 2017. The Code sets out an approach to guide professional accountants who encounter or become aware of a potential NOCLAR committed by a client (the Code, s. 360).

Section 360 of the Code outlines provisions relevant to professionals in public practice, which are also reflected in auditing standards, as explained in module 2.

While providing professional services to a client, a professional accountant may encounter or be made aware of non-compliance or suspected non-compliance with laws and regulations. Regardless of the nature of the client, including whether or not it is a public-interest entity, the accountant has a responsibility to act in the public interest. If they encounter, or are made aware of NOCLAR, their objectives are:

- identify!
- (a) To comply with the principles of integrity and professional behavior;
 - (b) By alerting management or, where appropriate, those charged with governance of the client, to seek to:
 - (i) Enable them to rectify, remediate or mitigate the consequences of identified or suspected non-compliance; or
 - (ii) Deter the commission of the non-compliance where it has not yet occurred; and
 - (c) To take such further action as appropriate in the public interest (the Code, para. 360.4).

QUESTION 1.3

The following circumstances raise questions about an auditor's ethical conduct.

- An auditor accepts an engagement knowing that they do not have the specialist knowledge required.
 - An auditor discloses confidential information about a client to a successor auditor.
 - A public accountant pays a commission to a solicitor to obtain a client.
 - A public accountant agrees to be the committee chairperson for a local fundraising activity.
 - An auditor accepts a Christmas gift from a client.
 - An auditor accepts a commission from an insurance company for recommending the company to one of its audit clients.
 - An auditor has a bank loan with a bank that is an audit client.
 - An auditor retains a client's records as a means of enforcing payment of an overdue audit fee.
1. Discuss the fundamental principles of the *International Code of Ethics for Professional Accountants (including International Independence Standards)* in relation to each of the above.
 2. Indicate, in each of the above circumstances, whether the effect on professional ethics is (i) a violation, (ii) not a violation or (iii) indeterminate, and explain.

Independence

Independence is generally considered to be the cornerstone of the auditing and assurance profession. The definition of independence in the Code stresses that the accountant must be independent both of mind and in appearance (refer also Glossary, APES 110). Accordingly, the accountant must act with integrity, and exercise objectivity, professional judgment and professional scepticism.

In addition, the accountant must remain alert for new information, changes in facts and circumstances and avoid circumstances that a reasonable and informed third party might think indicate that a member's integrity, objectivity or professional scepticism has been compromised. The reasonable person must perceive that the accountant is impartial and free of bias. When fraudulent practices and large business failures occur without apparent warning, the independence of the profession is questioned. As a result, the Code establishes a conceptual framework that requires a member to identify, evaluate and address threats to compliance with the fundamental principles (the Code, para. 120.2).

The Code provides extensive application material in Part 4A describing numerous circumstances of threats to independence and safeguards to reduce these threats. One of the major features of the Code is the independence requirements in relation to long association of personnel with an audit client, in particular the audit partner rotation requirements (the Code, s. 540). Audit partner rotation and independence requirements in relation to the conduct of an audit are discussed further in module 2.

Under the Corporations Act, ASIC has responsibility for the surveillance, investigation and enforcement of auditor independence.

EXAMPLE 1.1

Principles of Professional Conduct

Identify the fundamental principles of professional conduct outlined in the Code that are under threat for each of the situations below.

- (a) You become aware that one of your clients is involved in illegal activities.
- (b) Your largest client (and the related fees) is growing at a much quicker rate than the rest of your business. The client's fees have increased from 10% to 16% of your firm's total fees.
- (c) You are the auditor of a client whose CEO is your long-time next-door neighbour.
- (d) In the past, you have not carried out audits of credit unions. Most of your clients are clubs and small local businesses. You decide to take on a credit union as a new client and hope there is a professional development

program available to update your staff on specialised issues for this industry.

- (e) The audit assistant is asked to randomly select ten items from a stock list, then sight and count the relevant inventory. The assistant selects the ten items, finds nine, and is told the tenth item is in the loft. The assistant is wearing new clothes and, knowing how dusty the loft is, instead randomly selects and locates another item.
 - (f) A partner received a loan from an audit client that is an Australian credit union.
 - (g) A member of your assurance team is considering resigning to take up a job offer with the assurance client during the year.
 - (h) A prospective client asks for an audit to be completed within a month to meet bank requirements. It offers a fixed fee plus a bonus for completing the audit on time.
 - (i) A current client, for whom you have provided consulting services that involved hiring financial accounting staff and designing an information system, asks for an audit to be completed within a month to meet bank requirements. It offers a fixed fee for completing the audit on time but there is no bonus attached.
 - (j) An audit manager is concerned that their client is not investing their funds wisely by having large amounts of cash in the bank. To help the client without offending the bank manager, the audit manager explains this issue to a friend who is a qualified financial adviser, who then sends the relevant information to the client.
 - (k) The audit firm places an advertisement stating they have had fewer legal suits than any other firm of accountants in Australia or Asia.
- Check your response against the suggested answer at the end of the book.

EXAMPLE 1.2

Independence Policies and Procedures

Audit firms are required to comply with independence requirements.

For each of the three listed audit firm requirements, describe practical policies and procedures a firm could implement to ensure compliance.

1. Audit firms must have policies and procedures to provide reasonable assurance that the firm and its personnel maintain independence.
2. Audit firms must communicate with and educate partners and professional staff, including non-audit personnel, to ensure they understand the independence policies that relate to their activities.
3. Audit firms must maintain adequate records to identify, communicate and monitor compliance with specific independence requirements (e.g. prohibited investment lists).

Check your response against the suggested answer at the end of the book.

Australian Perspective

Note that in Australia, the APESB issued APES 110 *Code of Ethics for Professional Accountants (including Independence Standards)* in November 2018, which is based on the Code in both structure and content. The updated APES 110 code is effective from 1 January 2020.

You should now read the Preface section of APES 110 Code of Ethics for Professional Accountants (including Independence Standards) on the application of APES 110 to members of CPA Australia and auditors who conduct audits in Australia.

ASA 102 *Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements* states that the auditor, assurance practitioner, engagement quality control reviewer, and firm shall comply with the Code.

ASA 102 was designed to suit Australian law so there is no equivalent ISA. It allows references to ethical requirements in other AUASB standards to remain current. Whenever APES 110 is amended, the AUASB amends ASA 102, thereby eliminating the need to amend other AUASB standards.

QUALITY CONTROL STANDARDS

The Framework specifies that ethical principles, independence requirements and quality control (QC) within firms are widely recognised as being in the public interest and are an integral part of high-quality assurance engagements. The Framework outlines that professional accountants performing assurance engagements are subject to ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*.

An auditing standard ISA 220 *Quality Control for an Audit of Financial Statements* discusses specific engagement matters. Much of the content of ISQC 1 is repeated in ISA 220, but as indicated, the difference is that ISA 220 relates to the specific engagement while ISQC 1 is broader and relates to the audit firm as a whole. In February 2019, the IAASB issued a suite of proposed international standards on quality management. The proposals change the way professional accounting firms will be expected to manage quality for audits, reviews and other assurance and related services engagements. Quality management is being addressed to:

- more proactively manage quality to address stakeholder expectations and concerns
- improve the scalability of the standards
- modernise the standards and keep them fit for purpose.

For more details of these proposals, see <https://www.iaasb.org/quality-management>.

ISQC 1 establishes basic principles and essential procedures for firms to establish and maintain a system of QC for assurance engagements. Each of the elements of quality control will be discussed, followed by an overview of the Framework for Quality Control.

Elements of Quality Control

There are six areas where firms should have QC policies in place:

1. leadership responsibilities for quality within the firm
2. relevant ethical requirements
3. acceptance and continuance of client relationships and specific engagements
4. human resources
5. engagement performance:
 - (a) engagement support materials
 - (b) supervision and review
 - (c) consultation
 - (d) an engagement QC review
6. monitoring (ISQC 1, para. 16).

Leadership Responsibility

Leadership culture underpins all other elements of QC, so it is important for a firm to have a strong QC culture established by the leadership of the firm and the examples it sets. Operational responsibility for the firm's QC system must rest with a person with appropriate experience and ability, as well as the necessary authority. In all likelihood, this will be one of the most senior partners.

An assurance firm should develop, document and implement appropriate QC procedures and a formal code of conduct. Perhaps most challengingly, its leadership should demonstrate the firm's overriding commitment to quality above commercial considerations. This means that the work done in an assurance engagement cannot be limited by the budget or by the fee, but must be determined by the assessed risk and the procedures thought necessary to address that risk.

Read ISQC 1, paragraphs 18–19 and A4–A6 for discussions on these responsibilities.

Ethical Requirements

The assurance firm should develop, document and implement policies and procedures to guide and reinforce ethical behaviour. These include independence policies describing permitted and prohibited behaviour reflecting the advice in the Code, and independence consultations that allow staff and partners to refer independence threats to relevant partners so that timely action can be taken. Systems that support ethical behaviour include databases to match staff disclosures with a prohibited securities list, and (in Australia) tracking the firm’s management of the auditor rotation requirements of the Corporations Act.

Read ISQC 1, paragraphs 20–25 for discussions on these responsibilities.

ISA 220 explains the ethical requirements, including independence, of the engagement team in relation to audit engagements. In particular, the engagement partner shall consider whether members of the engagement team have complied with relevant ethical requirements relating to audit engagements. The **engagement partner** must remain alert for evidence of non-compliance with the ethical requirements relating to the audit engagement. With respect to independence, it is mandatory that the engagement partner:

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- (a) obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;
- (b) evaluate information on identified breaches, if any, of the firm’s independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and
- (c) take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards ... The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action (ISA 220, para. 11).

Non-compliance can be at the firm level (e.g. the control system to monitor employee ownership of shares in listed companies is not adequate) or at the individual client level (e.g. the audit manager and the CFO are related). In most firms, senior personnel (e.g. risk management partners) will be assigned to look after these issues at the firm level. However, individual partners are responsible at the engagement level.

ASIC’s 2019 audit inspection report discusses compliance with these independence requirements. It states that most firms have established policies and processes to facilitate compliance with the auditor independence requirements of the Corporations Act and professional standards. However, there were some instances of non-compliance.

- Three larger firms provided non-audit services to audit clients that compromised the appearance of independence.
- One small firm failed to send partners and staff an annual independence questionnaire to confirm compliance with independence (ASIC 2019, p. 40).

Examples such as these can undermine actual or apparent independence of auditors.

Acceptance and Continuance of Client Relationships

An assurance firm must:

- consider the integrity of each client, including potential issues associated with the client (e.g. client involvement in illegal activity, questionable financial reporting practices or unethical behaviour)
- determine that it is competent to perform the engagement
- determine that it can comply with the Code, including, in particular, those matters related to independence.

One approach taken by practitioners to assess the integrity of a client is a risk checklist. The client’s risk score is used to determine whether the audit engagement should be accepted or continued. The risk assessment can affect:

- the choice of an appropriate engagement team
- the extent of consultation required
- the audit approach
- the calculation of an appropriate audit fee.

The acceptance and continuance decisions should focus on independence considerations, possible conflicts of interest and the ability to provide requisite skills to conduct the audit (e.g. whether the firm has staff with the required expertise to do this audit).

For each engagement, the engagement partner is required to make the acceptance or continuance decision prior to commencing the audit, and this decision needs to be documented. Prior to accepting the engagement, the auditor may be required by law, regulations or relevant ethical requirements to request the predecessor auditor to provide known information regarding any facts or circumstances that, in the predecessor auditor’s judgment, the auditor needs to be aware of before deciding whether to accept the engagement (ISA 220, para. A9).

Thereafter, if the engagement partner obtains information that would have caused the firm to decline the audit engagement (had that information been available earlier), this information needs to be promptly communicated to the firm so that ‘necessary action’ can be taken (ISA 220, para. 13). The auditing standard is not clear on what this appropriate action should be, but it is likely to depend on what stage of the audit has been reached. During the audit, it is unlikely that the firm would withdraw from the audit, although this could happen.

Read ISQC 1, paragraphs 26–28 and A18–A23 for discussions on these responsibilities.

QUESTION 1.4

List four factors that may indicate additional client evaluation procedures are necessary when evaluating the continuance of an audit client.

Human Resources

An assurance firm’s human resource policies must apply at both the staff and partner levels. Important personnel issues include:

1. recruitment
2. performance evaluation
3. capabilities, including time to perform assignments
4. competence
5. career development
6. promotion
7. compensation
8. the estimation of personnel needs (ISQC 1, para. A24).

‘Effective recruitment processes and procedures help the firm select individuals of integrity who have the capacity to ... perform competently’ (ISQC 1, para. A24). Human resources policies should demonstrate that adherence to QC policies and ethical principles are criteria for promotion and remuneration decisions. Non-compliance should result in disciplinary action (including financial penalties) and other follow-up procedures such as training. For audit firms, it is also important that partner evaluations and promotions are documented and that the documentation covers quality controls and independence.

Assignment of Engagement Teams

A firm should establish policies and procedures to assign appropriate personnel with the necessary competence and capabilities to an engagement (ISQC 1, para. 31). The firm should have systems in place to monitor the workload and availability of engagement partners. This will ensure that engagement partners assigned to an engagement ‘have sufficient time to adequately discharge their responsibilities’ (ISQC 1, para. A30).

ISA 220 requires an engagement partner to be satisfied that the engagement team collectively has the appropriate capabilities and competence to perform the audit engagement (ISA 220, para. 14). Note that these requirements apply

to the engagement team as a whole. Therefore, it is possible to put a staff member on an audit without all of the required capabilities and competencies, provided there is adequate supervision and review. In most firms these issues will be handled through staff training and on-the-job training. Knowledge of relevant industries can sometimes provide additional challenges and require using resources from outside the firm. If the auditor becomes particularly aware of specific risk areas or areas requiring specialist skills, the engagement partner may include more senior staff and specialists on the audit and carry out additional reviews of the work done.

Engagement Performance

Engagement performance means completing assurance engagements in accordance with professional standards, and legal and regulatory requirements.

Important policies and procedures that relate to engagement performance are:

- consistency in the quality of engagement performance
- supervision and review of work
- consultation
- engagement quality control review.

Consistency in the Quality of Engagement Performance

Most audit firms promote consistency in the quality of engagement performance through written or electronic manuals, software tools or other forms of documentation and materials.

Supervision and Review

The engagement review process has long been accepted as a critical QC process within auditing firms. A hierarchy of review is established within the audit team. Seniors review the work of juniors, managers review seniors, and partners review managers. These reviews are ongoing throughout the engagement. They ensure that sufficient evidence has been collected, the conclusions reached are consistent with the results of the work performed, and documentation is appropriate. Additionally, the review process provides training for all members of the audit team.

Read ISQC 1, paragraphs A34 and A35 for further details of the supervision and review processes.

The engagement partner takes responsibility for the direction, supervision and performance of the audit engagement (ISA 220, para. 15). Direction to other members of the audit engagement team would normally include informing them of:

- their responsibilities
- risk-related issues
- problems that may arise
- the detailed approach to the performance of the engagement.

Supervision of members of the engagement team is also an important aspect of engagement performance. ISA 220, paragraph A16, provides the following examples of supervision:

- tracking the progress of the audit engagement
- considering the capabilities, competence, time availability and understanding of instructions of team members, and whether the work is being carried out consistent with the planned audit approach
- addressing significant issues that arise during the audit and modifying the planned approach where appropriate
- identifying matters for consultation with more experienced engagement members.

An important part of the supervision responsibility includes the review process, where more experienced team members review work performed by less experienced team members. Reviewers will consider whether, for example:

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- (a) the work has been performed in accordance with professional standards and applicable legal and regulatory requirements;
- (b) significant matters have been raised for further consideration;

- (c) appropriate consultations have taken place and the resulting conclusions have been documented and implemented;
- (d) there is a need to revise the nature, timing and extent of work performed;
- (e) the work performed supports the conclusions reached and is appropriately documented;
- (f) the evidence obtained is sufficient and appropriate to support the auditor’s report; and
- (g) the objectives of the engagement procedures have been achieved (ISQC 1, para. A35; ISA 220, para. A18).

Consultation

Consultation is an important responsibility of the engagement partner. This includes the requirements to:

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- (a) take responsibility for the engagement team undertaking appropriate consultation on difficult or contentious matters;
- (b) be satisfied that members of the engagement team have undertaken appropriate consultation during the course of the engagement, both within the engagement team and between the engagement team and others at the appropriate level within or outside the firm;
- (c) be satisfied that the nature and scope of, and conclusions resulting from, such consultations are agreed with the party consulted; and
- (d) determine that conclusions resulting from such consultations have been implemented (ISQC 1, para. 34; ISA 220, para. 18).

In most assurance firms, specialist partners are available for consultation on technical or complex aspects of auditing and accounting issues, tax, systems and legal matters. Often, a technical query database is compiled and firms designate partners to consult on conflict of interest and independence issues. In addition, many firms have a mentoring scheme in place where audit staff are assigned to a mentor who is a more senior auditor. The mentor provides the staff member with career planning and can be another source of consultation when needed.

It is common for the larger firms to emphasise their culture of consultation. For example, Ernst and Young states that their:

consultation policies are built upon a culture of collaboration, whereby audit professionals are encouraged to share perspectives on complex accounting, auditing and reporting issues. Consultation requirements and related policies are designed to involve the right resources so that audit teams reach appropriate conclusions (Ernst & Young Australia 2018, p. 11).

Read ISQC 1, paragraphs 34 and A36–A40 for further details of the consultation processes.

Engagement Quality Control Review

On completion of the audit of listed entities and other public interest entities, assurance firms must perform an engagement quality control review (EQCR). The EQCR provides an objective and independent evaluation of the significant judgments made and the conclusions reached by the audit team and the audit partner. The EQCR is in addition to the ongoing ‘review of audit working papers’ (see module 4) performed by the engagement team and the engagement partner, discussed in the previous section, ‘Supervision and review’.

EQCR reviewers are experienced audit partners who are not otherwise involved in the audit engagement. They carry out a second (or concurring) independent review of the engagement, including the quality of the work performed and the appropriateness of the auditor’s opinion.

An EQCR policy should identify:

- the nature, timing and extent of an EQCR
- criteria for eligibility of an EQCR reviewer
- documentation required of an EQCR
- how differences of opinion are to be resolved.

Read ISQC 1, paragraphs 35–42 for further details on engagement quality control reviews.

QUESTION 1.5

What are the main attributes of an effective audit quality review program (i.e. quality review processes within audit firms) in an audit engagement?

Monitoring

‘Monitoring’ refers to the ongoing examination of QC systems and procedures to ensure that they are appropriate and are carried out consistently and properly. Monitoring systems should ensure that any identified problems are communicated to the partner responsible for the firm’s QC and that appropriate responses to problems are implemented. These responses might include additional training, counselling or disciplinary action for individuals, or a revision of the firm’s QC policy.

ASIC (2019) continues to emphasise that effective firm quality review processes are important for improving audit quality. Such monitoring of audit quality involves regular reviews within firms of a sample of completed audits. These reviews are usually carried out by senior staff from a different location (e.g. interstate).

ASIC also released Information Sheet 222 ‘Improving and maintaining audit quality’ (INFO 222) in June 2017 to outline considerations for auditors to improve and maintain audit quality. Some of the considerations raised in INFO 222 for effective audit firm quality reviews include:

- suitability of reviewers
- review coverage
- review and reporting
- remedial action.

For more details, read INFO 222 at <https://asic.gov.au/regulatory-resources/financial-reporting-and-audit/auditors/improving-and-maintaining-audit-quality>.

You can also refer to ISQC 1, paragraphs 48–56 for further details on monitoring.

As mentioned previously, in addition to an audit firm’s internal monitoring process, external monitoring also takes place. In Australia, for example, in order to review compliance with audit quality and auditor independence requirements, ASIC started an audit firm inspection program in 2004. The purpose of the inspection program is to focus on audit quality and promote compliance with the requirements of the Corporations Act, auditing standards, and professional and ethical standards. The audit firms to be inspected are selected based on a number of criteria, but there is an emphasis on audit firms that audit publicly listed or public interest entities. With auditing moving beyond national borders, there is a need for effective global auditor oversight. ASIC, through its membership of IFIAR, has sought arrangements with other international audit oversight bodies with the intention of conducting work either jointly or on their behalf.

ASIC regularly releases a report of its inspection program. At the time of writing, the most recent report released was in January 2019 for ASIC’s audit inspection program in the 18 months to 30 June 2018 (ASIC 2019). ASIC continued to find deficiencies in quality control systems and the audit evidence obtained. It concluded:

In our view, in 20% of the key audit areas that we reviewed, auditors did not obtain reasonable assurance that the financial report as a whole was free of material misstatement. This compares to 23% in the previous 18-month period ended 31 December 2016 and represents a welcome reduction in the level of findings for the largest six firms. (ASIC 2019, p. 4).

ASIC stated that its findings did not necessarily mean the financial reports audited were materially misstated, but rather that the auditor did not have a sufficient basis to support its opinion on the financial report. It also noted that the level and nature of the findings were consistent with those found by inspectors in other countries.

As further evidence of monitoring, in 2013, Australia mandated the preparation and release of transparency reports by the larger audit firms of significant entities, with a focus on the disclosure of their internal governance systems. Under section 322 of the Corporations Act, all audit firms must publish a transparency report on their website if they have conducted audits under the Corporations Act of ten or more significant entities. Just over 20 audit firms in Australia are required to publish such reports. The information to be published includes:

- a description of the firm or company’s legal structure and ownership
- a description of the auditor’s governance structure and internal quality control system
- a statement by the management body on the effectiveness of the functioning of the internal quality control system
- information concerning the basis for remuneration of the audit firm’s partners or the authorised audit company’s directors.

The KPMG Auditor Transparency Report 2018 can be viewed at <https://home.kpmg/au/en/home/insights/2018/10/transparency-report.html>.

QUESTION 1.6

Outline procedures that a firm could implement to demonstrate its commitment to quality above commercial considerations.

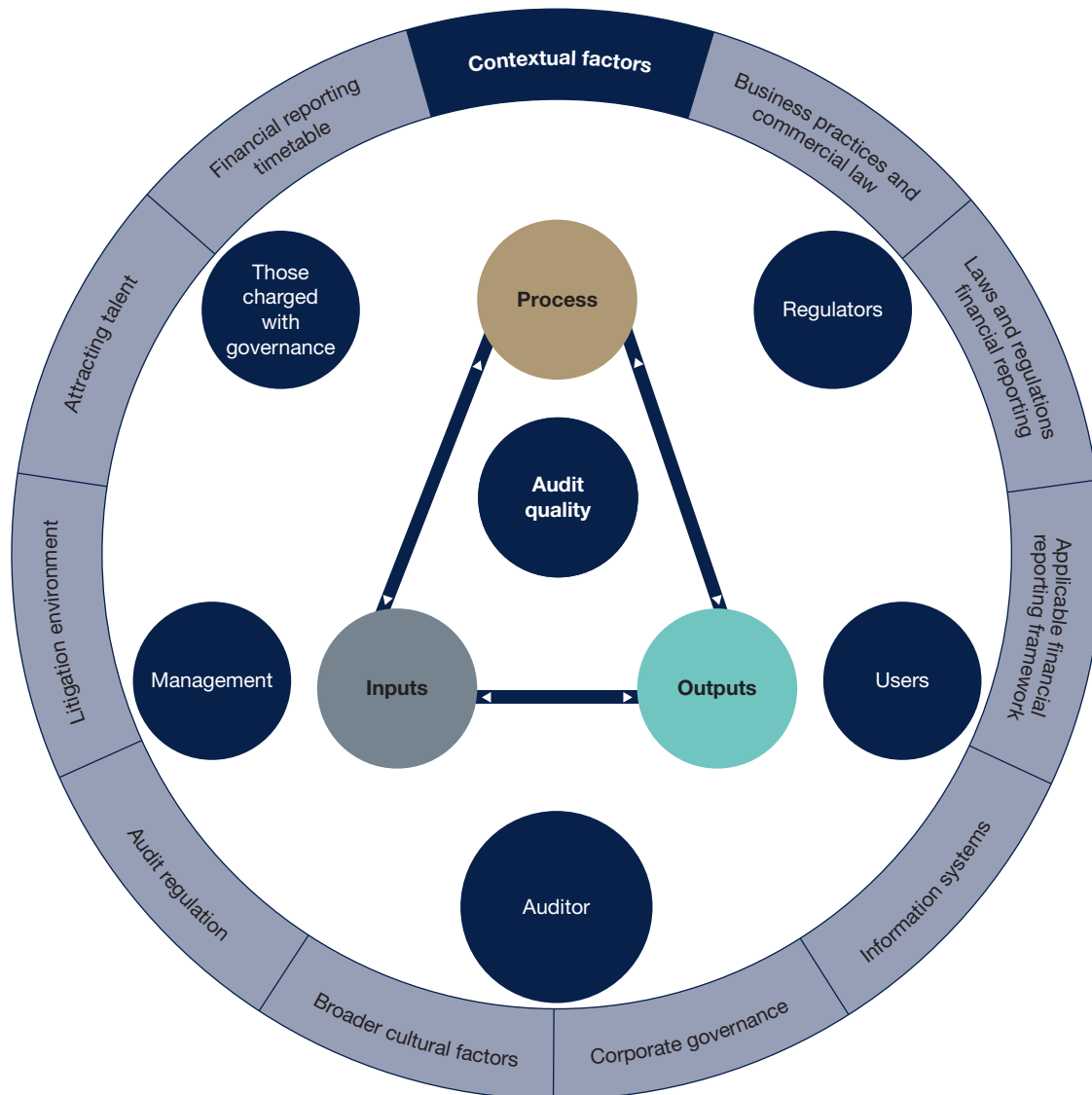
A Framework for Audit Quality

Identifying the drivers of high-quality audits has been the subject of extensive discussion. In 2014, the IAASB published *A Framework for Audit Quality: Key Elements that Create an Environment for Audit Quality* (2014a), which describes, in a holistic manner, the different elements that create the environment for audit quality at the engagement, firm and national levels, as well as relevant interactions and contextual factors.

There are three parts to the audit quality framework. As outlined diagrammatically in figure 1.3, these are the input, process and output stages of the audit, with each of these capable of being identified at the engagement, firm and national level.

Figure 1.3 illustrates the main contextual factors impacting on audit quality as identified in *A Framework for Audit Quality* (IAASB 2014a).

FIGURE 1.3 A framework for audit quality



Source: International Auditing and Assurance Standards Board (IAASB) 2014, A Framework for Audit Quality: Key Elements That Create an Environment for Audit Quality, in *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*, 2018 ed., vol. 3, p. 6, accessed August 2019, available from: <https://www.ifac.org/publications-resources/2018-handbook-international-quality-control-auditing-review-other-assurance>

The inputs to quality audits include auditors:

- exhibiting appropriate values, ethics and attitudes
- being sufficiently knowledgeable, skilled and experienced, and having sufficient time allocated to them to perform the audit work.

A quality audit process involves auditors applying a rigorous audit process and appropriate quality control procedures that comply with laws, regulations and applicable firm and national standards.

Quality audit outputs are those that are useful and timely to the report users and include outputs from the auditor, the audit firm, the entity and audit regulators. These include the independent auditor’s report at the individual engagement level or the audit firm’s transparency report at the national level, which in Australia are both publicly available. The outputs also include those that arise from the auditing process but that are generally not available to those outside the audited organisation, including the management letter provided by the auditor to the audit committee at completion of the audit.

The second part of the audit quality framework covers the interactions between the various participants in the financial reporting supply chain. The participants identified in the audit quality framework include management, those charged with governance, regulators, users and auditors. While the primary responsibility for performing quality audits rests with auditors, audit quality is best achieved in an environment where there is support from the other participants. The way the stakeholders interact may affect audit quality, and increased interaction is promoted in the audit quality framework. Recently there has been much greater emphasis on communication between the auditors and the audit committee.

The third level outlines the contextual factors, as shown in the circle around the audit quality framework (see figure 1.3). The ten contextual factors identified in the audit quality framework are:

1. business practices and commercial law
2. laws and regulations relating to financial reporting
3. the applicable financial reporting framework
4. information systems
5. corporate governance
6. broader cultural factors
7. audit regulation
8. litigation environment
9. attracting talent
10. financial reporting timetable.

Collectively, the contextual factors have the potential to affect the nature and quality of financial reporting and, directly or indirectly, audit quality. Where appropriate, auditors respond to these factors when determining how best to obtain sufficient appropriate audit evidence.

Notwithstanding the publication of *A Framework for Audit Quality* (IAASB 2014a), it is recognised that the concept of audit quality is elusive, because it is only when financial statements are restated or companies fail that a misstatement in the financial statements is discovered, and this is often long after the period under audit.

DESCRIPTION OF ASSURANCE ENGAGEMENTS

Assurance engagements are described in the *Framework for Assurance Engagements* (para. 10) as an engagement in which a practitioner obtains sufficient appropriate evidence in order to express a conclusion aimed at enhancing the degree of confidence the intended users will have about the evaluation of the underlying subject matter against criteria. The outcome of the measurement or evaluation is ‘the subject matter information about which the practitioner gathers sufficient appropriate evidence as the basis’ for their conclusion (Framework, para. 11). Examples of assurance engagements are provided in table 1.3 and will be discussed further later in this module and again in module 5.

TABLE 1.3 Examples of assurance engagements		
Underlying subject matter	Criteria	Outcome
Financial position, financial performance and cash flows	Financial reporting framework	Financial statements
Entity’s internal control process	Relevant criteria	Internal control effectiveness
Various aspects of performance	Relevant measurement methodologies	Entity-specific performance measures
Entity’s greenhouse emissions	Recognition, measurement and presentation protocols	Greenhouse gas statement
Entity’s compliance	Law and regulation	Compliance statement

Source: The Framework, para. 11.

ATTESTATION AND DIRECT ENGAGEMENTS

Assurance engagements include the following.

- **Attestation engagements** (where attest means affirm, verify or corroborate the work of others), where a party other than the assurance

practitioner (normally management) measures or evaluates the underlying subject matter against the criteria (i.e. prepares the financial statements in accordance with the accounting standards) (Framework, para. 12). For this type of engagement, the preparers of the subject matter assert in the report that it is in accordance with a stated framework. The auditor's role is to attest to whether (in their opinion) that is the case.

- **Direct engagements** where the assurance practitioner directly ‘measures or evaluates the underlying subject matter against the criteria’ (Framework, para. 13). In this type of engagement, as there are no such assertions made regarding the subject matter, the auditors must directly test the content themselves.

There is no overlap between attestation and direct engagements: an assurance engagement is either an attestation engagement or a direct engagement. The key distinction is *who* measures or evaluates the underlying subject matter against the criteria. In the Framework definition, ‘measure or evaluates the underlying subject matter’ essentially means ‘prepares a report’. In an attestation engagement, management prepares the report and the practitioner examines that report to provide assurance to readers. In a direct engagement, the report and the assurance on that report are both provided by the practitioner.

Audits and reviews of financial statements are structured as attestation engagements (i.e. financial statements are prepared by management in accordance with the accounting standards and relevant legislation). Auditors and reviewers are not permitted to prepare the financial statements that they audit.

In contrast, an assurance engagement examining the efficiency of an internal control system (the underlying subject matter) against, for example, COSO (2013) (the criteria) could be carried out as either an attestation engagement or a direct engagement.

- It is an attestation engagement if management evaluates the internal control system against the criteria and the assurers attest to the credibility of their report.
- It is a direct engagement if the assurers undertake the evaluation of the internal control system against the criteria and report on this.

The main advantage of a direct engagement is that an independent assurer undertakes the measurement and prepares the information. This approach reduces the appearance of any bias or measurement error that management can, either deliberately or not, incorporate in the report. Direct engagements can, in this sense, offer an additional level of assurance to users.

QUESTION 1.7

For a report on internal controls, select whether the following are attestation or direct engagements.

- Management provides an assessment of the effectiveness of the internal control system and the practitioner provides a conclusion on that assertion.**
- The practitioner evaluates and measures the internal control system and reports their findings to the intended users of the assurance report.**

REASONABLE AND LIMITED ASSURANCE ENGAGEMENTS

The Framework sets out the distinction between reasonable and limited assurance engagements. An audit is an example of a **reasonable assurance engagement**, and a review is an example of a limited assurance engagement. The following descriptions of the two types of engagements are derived from the Framework.

Reasonable Assurance Engagements

In a reasonable assurance engagement, the practitioner reduces engagement risk to an acceptably low level in the circumstances of the engagement as the basis for their conclusion. The practitioner’s conclusion is expressed in a form that conveys their opinion on the outcome of the measurement or evaluation of the underlying subject matter against criteria (Framework, para. 14).

The term ‘reasonable assurance’ is a high level of assurance but not an absolute level of assurance. The latter is not feasible because of the inherent limitations of an audit, where most of the evidence obtained by the auditor is persuasive rather than conclusive. The auditor needs to obtain reasonable assurance about whether the financial statements, as a whole, are free of material misstatement. Reasonable assurance arises when the auditor obtains sufficient appropriate audit evidence to reduce audit risk to an acceptably low level (ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, para. 5).

Sufficient appropriate audit evidence includes:

- obtaining an understanding of the engagement circumstances
- assessing risks
- responding to these risks
- performing further procedures, including substantive procedures
- evaluating the evidence obtained.

The entire audit process is geared towards an expression of opinion on the financial statements. The assurance report for a reasonable assurance engagement conveys the practitioner’s opinion on the outcome of the assessment of the subject matter information against the criteria. For an audit of the financial statements, the following opinion is commonly used: ‘In our opinion, the financial statements are fairly presented ...’

Examples of conclusions provided in ISAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*, paragraph A179 are:

‘In our opinion, the entity has complied, in all material respects, with XYZ law.’

‘In our opinion, the forecast of the entity’s financial performance is properly prepared, in all material respects, based on XYZ criteria.’ or

‘In our opinion, the [appropriate party’s] statement that the entity has complied with XYZ law is, in all material respects, fairly stated’.

Limited Assurance Engagements

A **limited assurance engagement** provides less confidence to users than a reasonable assurance engagement as the **engagement risk** is greater. The Framework (para. 16) suggests that the assurance offered by a limited assurance engagement should be ‘meaningful’, and that meaningful is ‘clearly more than inconsequential’. Other than that, any judgment about the meaning of the terms ‘limited’ and ‘reasonable’ is left up to the practitioner’s judgment.

For a limited assurance engagement, sufficient appropriate evidence includes obtaining an understanding of the subject matter information and other engagement circumstances, but the procedures are deliberately limited in comparison to a reasonable assurance engagement.

The limited assurance engagement expresses a conclusion that conveys whether, based on procedures performed and evidence obtained, anything has come to the auditor’s attention to lead them to believe that the information has been materially misstated. For a review of the financial statements, the following conclusion is commonly reached: ‘Nothing has come to our attention that would lead us to believe that the financial statements are not fairly presented ...’

Examples of conclusions provided in ISAE 3000 (Revised), paragraph A181 are:

‘Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe that [the entity] has not complied, in all material respects, with XYZ law.’

‘Based on the procedures performed and evidence obtained, we are not aware of any material amendments that need to be made to the assessment of key performance indicators for them to be in accordance with XYZ criteria.’

‘Based on the procedures performed and evidence obtained, nothing has come to our attention that causes us to believe that the [appropriate party’s] statement that [the entity] has complied with XYZ law, is not, in all material respects, fairly stated’.

QUESTION 1.8

Explain in detail the extent to which reasonable and limited assurance engagements differ from one another.

QUESTION 1.9

Can auditors provide absolute assurance? Discuss.

SCOPE OF THE FRAMEWORK

Practitioners perform engagements other than assurance engagements that are not covered by the Framework as mentioned earlier in this module. These engagements include:

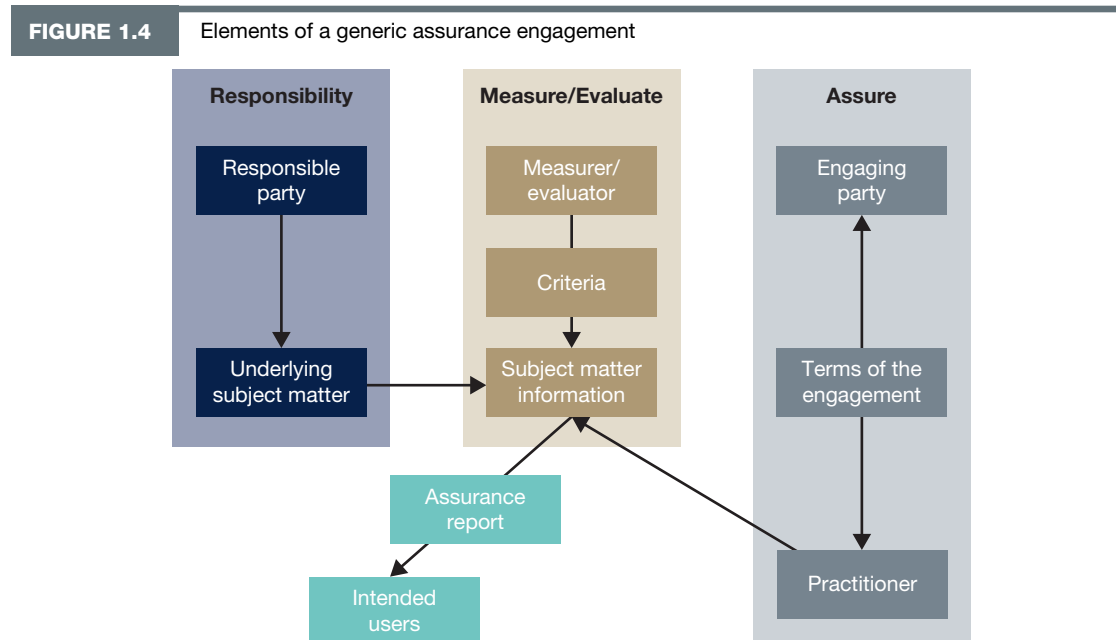
- engagements performed that are covered by ISRSs (e.g. agreed-upon procedures and compilation engagements)
- the preparation of tax returns where no assurance conclusion is expressed
- consulting or advisory engagements (e.g. management and tax consulting) (the Framework, para. 17)

- engagements to testify in legal proceedings regarding accounting, auditing, taxation or other matters
- engagements that include professional opinions if certain conditions apply (see the Framework, para. 19).

When an assurance engagement is part of a larger engagement that includes consulting or advisory work, the Framework is only relevant to the assurance portion of the engagement.

ELEMENTS OF AN ASSURANCE ENGAGEMENT

Figure 1.4 illustrates the elements of a generic assurance engagement and the relationships between these elements.



Source: International Auditing and Assurance Standards Board (IAASB) 2018, ISAE 3000 (Revised) Assurance Engagements Other than Audits or Reviews of Historical Financial Information, in Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, 2018 ed, vol. 2, p. 204, accessed July 2019, available from: <https://www.ifac.org/publications-resources/2018-handbook-international-quality-control-auditing-review-other-assurance>

The difference between the elements illustrated in figure 1.4 for a generic assurance engagement and a financial statement audit are depicted in table 1.4.

The final aspect of the Framework to be discussed is the elements of an assurance engagement, as listed:

- a three-party relationship involving:
 - practitioner (the assurance practitioner)
 - responsible party (responsible for the underlying subject matter and the preparation of the subject matter information)
 - intended users (of the assurance report)
- an appropriate underlying subject matter (e.g. a government department; a program; a system or a business) (note that ‘subject matter information’ means the outcome of an evaluation or measurement of a subject matter)
- criteria (rules governing the preparation of the subject matter information)
- sufficient appropriate evidence (providing the basis for the assurance report)
- a written assurance report (Framework, para. 26).

TABLE 1.4 Comparison of the elements of a generic assurance engagement and a financial statement audit

Generic assurance engagement	Financial statement audit
Responsible party	Board of directors
Measurer/evaluator	Company accountant
Engaging party	Company audit committee
Underlying subject matter	The business
Criteria	Accounting standards
Subject matter information	Financial statements
Terms of the engagement	Auditing standards
Practitioner	Auditor
Assurance report	Auditor's opinion
Intended users	Shareholders/investors

Source: CPA Australia 2019.

Refer to figure 1.4 as you go through these five elements in the following sections.

Three-Party Relationship

The **three-party relationship** involves the practitioner (professional accountant), the responsible party (the person(s) responsible for the underlying subject matter) and the intended users of the report.

Practitioner

The practitioner is the assurance practitioner. For example, the auditor is the practitioner in a financial statement audit. The practitioner is responsible for determining the nature, timing and extent of procedures, and must judge the fair presentation of the subject matter information.

Responsible Party

The responsible party is the party responsible for the underlying subject matter. For example, for a financial statement audit, the responsible party is normally the board of directors as they are responsible for the conduct of the business — the underlying subject matter. Their responsibility for the financial statements is evidenced by their signature on the Directors' Statement. Employees who prepare the financial statements (the subject matter information) are usually headed by the company accountant/chief financial officer. The engaging party is usually the audit committee, which is a subcommittee of the board of directors.

The responsible party may or may not be the party who engages the practitioner. For example, parliament may engage the Auditor-General to carry out a performance audit of a government program. In this case, the management of the public sector organisation responsible for the program is the responsible party, and the program is the underlying subject matter.

Intended Users

The intended users are the people or groups expected to read the assurance report. The aim of the assurance report is to increase users' confidence in the subject matter information. Of course, the users of the report are also the users of the subject matter information. Table 1.5 provides examples of different types of engagements and their intended users.

Sometimes, an assurance engagement is performed for a specific purpose and there is only one user. For example:

- a purchaser of a motorway may be interested in assurance regarding the number of cars that use the motorway each day
- a bank may be interested in assurance on the cash budgets of a creditor

TABLE 1.5 **Examples of intended users**

Engagement	Examples of intended users
Financial statement audit	Suppliers of capital, such as existing shareholders, potential shareholders, creditors and financiers
Assurance engagement that evaluates internal controls	Management and the board of directors, audit committees
Sustainability assurance engagement	May include a broad range of intended users. For example, a local community may be interested in water usage, or a local conservation group may be interested in impacts on animal habitats.

Source: CPA Australia 2019.

- a board of directors may want assurance on the information provided to them by management.

In such cases, the practitioner might include a restriction in the assurance report that limits its use to a specific user and for a specific purpose.

QUESTION 1.10

Determine the responsible party and the intended users for each of the following engagements.

- 1. A financial statement audit.**
- 2. An assurance report on the internal controls over sales required by the board of directors.**
- 3. An assurance report on controls at a company that provides cloud-based accounting services to customers.**

Underlying Subject Matter

The level of assurance does not impact on the appropriateness of an underlying subject matter. ‘An **appropriate underlying subject matter** is identifiable and capable of consistent measurement or evaluation against the identified criteria such that the resulting subject matter information can be subjected to procedures for obtaining sufficient appropriate evidence to support a reasonable assurance or limited assurance conclusion, as appropriate’ (The Framework, para. 41).

Appropriate underlying subject matter is information, which may include:

- data (e.g. historical or prospective financial information, CSR information, statistical information provided to boards, performance indicators)
- reports on systems and processes (e.g. internal controls, information systems)
- reports on behaviours (e.g. corporate governance, compliance with regulations, human resource practices).

Non-financial information is often a mix of qualitative and quantitative data. Established measurement conventions for financial information (e.g. the accounting standards) are not normally available. The subject matter information may be of a subjective nature (particularly for qualitative information).

Table 1.6 shows how the underlying subject matter of an assurance engagement can take many forms.

TABLE 1.6 Subject matter of an assurance engagement

Underlying subject matter	Example	Subject matter information
Financial performance of a business	Profitability of a bank	Statement of comprehensive income
A government program	A public transport system	Report on efficiency and effectiveness (e.g. percentage of late trains; customer satisfaction)
Sustainability	Greenhouse gas emissions	Emissions report
Systems	An internal control system*	An assertion about the effectiveness of internal controls
Behaviour	Compliance with debt covenants	Statement of compliance

* This type of assurance has become particularly important. Since 2002, US companies and their international subsidiaries have been required to have their internal control systems audited.
Source: CPA Australia 2019.

Criteria

Criteria are the standards, rules or benchmarks used to prepare and evaluate the subject matter information of an assurance engagement.

Criteria can be formal, for example in the preparation of financial statements, the criteria may be International Financial Reporting Standards or International Public Sector Accounting Standards; when reporting on the operating effectiveness of internal controls, the criteria may be based on an established internal control framework or individual control objectives specifically designed for the purpose; and when reporting on compliance, the criteria may be the applicable law, regulation or contract. Examples of less formal criteria are an internally developed code of conduct or an agreed level of performance (such as the number of times a particular committee is expected to meet in a year) (IAASB Framework, para. 42).

The Framework suggests (but does not require) that the auditor considers a number of criteria in deciding what is reasonable or meaningful. These include:

- the underlying subject matter (e.g. historical financial information, an internal control system, key indicators of the effectiveness of a process)
- the criteria (e.g. International Financial Reporting Standards)
- the needs of users (e.g. investors considering buying shares)
- the responsible party and its environment (e.g. management and the economic conditions)
- other matters, events, transactions, conditions and practices that may have a significant effect on the engagement.

In some cases, specific criteria will be developed within an organisation by the responsible party. Alternatively, practitioners may develop suitable criteria to carry out an assurance engagement. A range of criteria can be drawn upon for assurance engagements. Figure 1.5 illustrates three criteria specifically developed for a report on customer satisfaction.



Source: Adapted from International Auditing and Assurance Standards Board (IAASB) 2018 *International Framework for Assurance Engagements*, para. 43, in Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, 2018–19 ed., vol. 3, pp. 79-80, accessed July 2019, <https://www.ifac.org/publications-resources/2018-handbook-international-quality-control-auditing-review-other-assurance>

Table 1.7 explains the characteristics of suitable criteria and provides an example for each.

Characteristics of suitable criteria		
TABLE 1.7		
Characteristic	Description	Example
Relevance	Relevant criteria help intended users make decisions.	For a performance audit on a state rail corporation, relevant criteria could include the on-time running of trains. Intended users are more likely to be concerned with the number of trains more than five minutes late rather than one minute late.
Completeness	Criteria are sufficiently complete when all significant and relevant factors that could affect the conclusions of users are present.	For the rail network, including on-time running but omitting the number of times trains miss their station would result in criteria that are incomplete. People want to know that the trains arrive on time and stop at their intended stations.
Reliability	Reliable criteria allow reasonably consistent evaluation or measurement of the subject matter.	Measuring the number of trains that run late every day gives a more reliable measure than taking a sample of one day every three months.

(continued)

TABLE 1.7 (continued)

Characteristic	Description	Example
Neutrality	Neutral criteria help draw conclusions that are free from bias.	In many cases, management has an incentive to overstate performance because improved performance may lead to rewards (e.g. bonuses or promotion). Evidence provided by independent parties is more likely to be neutral than information provided by management.
Understandability	Understandable criteria help draw conclusions that are clear and not subject to significantly different interpretations.	Criteria must be available to the intended users to allow them to understand how the subject matter has been evaluated or measured.

Source: Adapted from International Auditing and Assurance Standards Board (IAASB) 2018, *International Framework for Assurance Engagements*, para. 44, in Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements, 2018–19 ed., vol. 3, p. 80, accessed July 2019, <https://www.ifac.org/publications-resources/2018-handbook-international-quality-control-auditing-review-other-assurance>

Many standard-setting organisations have created frameworks to guide preparers and assurers of reports, which may form suitable criteria for an assurance engagement. For example, there are frameworks for financial reporting, sustainability reporting, internal control system design and water accounting. However, for some data, especially qualitative data, suitable criteria may be difficult to identify. It may also be difficult for all three parties to agree on criteria, and this becomes even more difficult where the range and identity of potential users is unclear.

Table 1.8 lists some types of engagement with examples of suitable criteria.

TABLE 1.8 Examples of criteria

Engagement	Examples of criteria
Financial statement audit	International financial reporting standards; international public sector accounting standards
Assurance report on internal control	<i>Internal Control — Integrated Framework</i> (COSO 2013); this document is an accepted standard for the design of an internal control system
Risk management	<i>Enterprise Risk Management — Integrated Framework</i> (COSO 2004); this document is an accepted standard for the design of a risk management system
Compliance	Applicable laws, regulations, policies or clauses in contracts
Sustainability report	Global Reporting Initiative (GRI) standards

Source: CPA Australia 2019.

Evidence

The practitioner has to gather evidence that is both sufficient and appropriate to form an opinion about the subject matter’s compliance with the relevant criteria. ‘**Sufficiency**’ refers to the quantity of evidence and ‘**appropriateness**’ to its quality. High-quality evidence is both relevant and reliable. In situations of high risk, the practitioner is expected to gather a greater amount of evidence and to seek out evidence that is highly relevant and reliable.

For example, in an examination of a year-end cash balance, statements obtained directly from the bank are considered more reliable than bank statements provided by management (which may have been altered). Similarly, a bank statement covering the year-end is more relevant than one for a previous month.

Sufficient appropriate evidence for subject matter information can sometimes be difficult to obtain. For example, information can be proprietary and hence may not be shared by third parties with the practitioner. Sometimes, lack of market data makes it difficult to corroborate information. Internal controls over the preparation of non-financial information are generally not as strong as those for financial information preparation.

According to the Framework, an assurance practitioner has to exercise professional scepticism in obtaining sufficient appropriate evidence before reaching conclusions on the assurance engagement against the criteria. In addition, the practitioner needs to exercise professional judgment ‘in considering materiality, engagement risk, and the quantity and quality of available evidence when ... determining the nature, timing and extent of procedures’ (the Framework, para. 50).

Professional Scepticism

The Framework describes **professional scepticism** as an attribute that includes being alert to such issues as:

- inconsistent evidence
- information that indicates the need to question the reliability of documents and management responses to enquiries
- the need to collect additional evidence beyond what is specified in the audit standards
- conditions indicating likely misstatements (Framework, para. 51).

According to Nolder and Kadous (2018), professional scepticism comprises a sceptical mindset and a sceptical attitude. The mindset component of professional scepticism captures the critical thinking and objective decision making reflected in the auditor’s judgments. However, the attitude component of professional scepticism captures the auditor’s feelings and beliefs about the evidence gathered, thereby informing their evaluations.

As a result, a practitioner must make an assessment, with a questioning mind, of the validity of evidence obtained and is especially alert to evidence that contradicts or brings into question the reliability of documents or representations by the responsible party. An attitude of professional scepticism is necessary throughout the engagement process for the practitioner to reduce the risk of overlooking suspicious circumstances, of over-generalising when drawing conclusions from observations, and of using faulty assumptions in determining the nature, timing and extent of evidence-gathering procedures and evaluating the results.

Professional scepticism means that the practitioner needs to make critical assessments with a questioning mind about the validity of evidence obtained and is also alert to evidence that contradicts the reliability of documents or representations by the responsible party (ISA 200, para. A21–A23). For example, if the auditor knows there is increasing competition in an industry, yet the client’s total sales and gross margins are increasing, professional scepticism would suggest the importance of further enquiry. Similarly, a long or close relationship with a client may pose a familiarity threat to professional scepticism because the practitioner may become too sympathetic to the client’s interests or too accepting of their work (the Code, para. 120.6 A3(d)).

The importance of professional scepticism is also emphasised by regulatory bodies around the world. For example, in its latest audit inspection report, ASIC (2019) outlines that professional scepticism will continue to remain an area of focus for audit firms and ASIC’s future inspections. ASIC states that it will continue to focus on:

Whether an appropriate level of professional scepticism is exercised by auditors, focusing on significant judgements about audit evidence, accounting estimates, going concern assumptions and accounting treatments (ASIC 2019, p. 25).

In its 2019 ASIC inspection report, ASIC notes that, ‘auditors should deliver professional, high quality audits through a strong internal culture focused on quality audits and professional scepticism’ (ASIC 2019, p. 17). ASIC emphasises that it is important for firms to focus on professional scepticism, along with the sufficiency and appropriateness of audit evidence obtained and the appropriate use of the work of experts and other auditors (ASIC 2019, p. 10).

Example 1.3 demonstrates the importance of professional scepticism in collecting and evaluating evidence. Review this example now.

EXAMPLE 1.3

Toe Ltd

Toe Ltd is a long-term audit client. The auditor has the highest regard for management integrity and honesty. Management has a long history of open commu-



nication with the auditor and willingness to accept all audit adjustments.

In auditing the financial statements of Toe Ltd, the auditor has sent confirmation letters to debtors as part of the tests of existence for trade debtors. Most responses are mailed back and many have small changes noted on the invoices, which are all immaterial. However, three responses are handed to the auditor by the client. The auditor is informed that the responses had been faxed back directly to the client. None of these three responses had any corrections on them.

What impact could these facts have for the audit of Toe Ltd?

Check your response against the suggested answer at the end of the book.

Various bodies have provided descriptions and information to clarify and define what is meant by professional scepticism and how it should be applied in practice. For example, the Center for Audit Quality (CAQ) (2010) suggests that exercising professional scepticism includes:

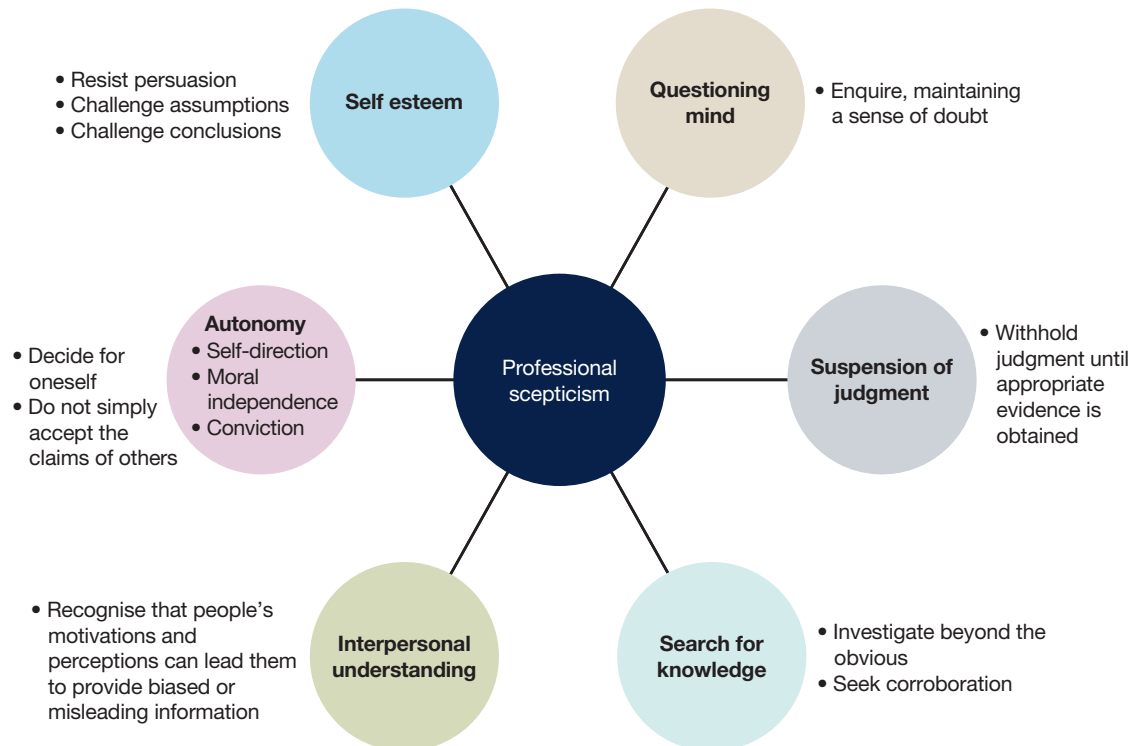
- evaluating and challenging audit evidence
- remaining alert for information that suggests a material misstatement
- considering the risk that management may override internal controls.

Figure 1.6 describes six characteristics of scepticism as outlined by the CAQ (2010), Hurtt (2010) and IAASB 2015.

In 2015, the IAASB released an invitation to comment around enhancing audit quality in the public interest with a focus on professional scepticism, quality control and group audits (IAASB 2015). It lists seven key issues, with the first two focused on scepticism:

1. Fostering an appropriately independent and challenging skeptical mindset of the auditor — professional skepticism is a fundamental concept and core to audit quality. Can we better articulate how we and others expect auditors, especially engagement partners, to appropriately apply professional skepticism? Can the concept be reinforced more within the ISAs, or through other activities by us or others?
2. Enhancing documentation of the auditor's judgments — how might an audit file more appropriately demonstrate the auditor's decision-making processes, essential interactions and communications, in order

FIGURE 1.6 The characteristics, attitudes and behaviours of scepticism



to support the auditor's judgments and the audit opinion overall? How can the application of professional skepticism be better evidenced? (IAASB 2015, p. 7).

Technology

Professional scepticism is affected by a range of contextual factors, which IAASB outlines in its *Framework for Audit Quality* (IAASB 2014a). One important contextual factor affecting the auditor's scepticism is information technology changes. IAASB (2015) states:

Technological change is occurring at a rapid pace, ushering in the capability to capture and communicate data digitally, on an unprecedented scale and on almost instantaneous timescales. This has resulted in increasing focus on 'big data,' whether structured or unstructured. Comprehensive and powerful digital information systems are increasingly capable of handling, analyzing, communicating and responding to these data related changes. Businesses are rapidly changing their business models in innovative ways in response to these developments. These changes are feeding into the information systems for financial and broader corporate reporting, and therefore have implications for audits. Audits are also increasingly being conducted using advanced

technologies, including the evolving use of audit data analytics (IAASB 2015, p. 9).

With these changes in technology, the auditor is continually facing new challenges as well as being provided with new tools. It is, therefore, necessary that auditors adjust how they apply professional scepticism to the changing environment.

QUESTION 1.11

How does the use of digital information by companies and the ‘feeding into the information systems for financial and broader corporate reporting’ (IAASB 2015, p. 9) affect an auditor’s professional scepticism?

QUESTION 1.12

How could audit firms play an important role in cultivating a sceptical mindset in auditors?

Professional Judgment

Professional judgment involves the assurance practitioner applying their training, knowledge and experience to make appropriate decisions and reach conclusions. The Framework (para. 56) explains that ‘professional judgment is essential to the proper conduct of an assurance engagement’. Professional judgment is needed to interpret ethical requirements and relevant Assurance Standards in order to make informed decisions throughout the engagement.

Professional judgment is required to be exercised throughout an assurance engagement but must not be used to justify decisions unless it is ‘supported by the facts and circumstances of the engagement or sufficient appropriate evidence’ (the Framework, para. 60).

International auditing standards are replete with the term ‘judgment’. The need for the auditor to make professional judgments is paramount. The audit manuals of large audit firms note that the single most important element in applying firm procedures in an audit is the exercise of informed judgment. A report by KPMG emphasises this point:

[Judgment] can be consequential to the continued viability of organizations, the livelihoods of the people employed by them, and the investors who rely on them not to mention the effectiveness and efficiency of our capital markets. Audit judgments both big and small matter (KPMG 2011, p. ii).

ASIC’s latest review of 98 audit files undertaken in 18 months to 30 June 2018 continues to reveal instances when auditors did not obtain sufficient appropriate audit evidence, adequately question management’s basis for valuation or challenge the work of experts, particularly in areas of impairment testing and investments and financial instruments (ASIC 2019). ASIC further notes that audit firms should continue to focus on ‘the audit of asset values ... especially challenging the reasonableness of any forecasts, key assumptions, and the basis of the valuation’ (ASIC 2019, p. 10). These shortcomings indicate the auditors’ professional judgment is inadequate.

Experience in financial statement auditing informs assurance engagements on non-financial information (e.g. assessing materiality, understanding the business, obtaining sufficient appropriate evidence, and making informed judgments). However, ISAE 3000 (Revised), paragraph 52, requires appropriate specialist knowledge to be applied in an assurance engagement, where considered necessary.

Table 1.9 identifies many circumstances where professional judgment is required.

TABLE 1.9	Examples of audit judgments
Understanding the entity and its environment	<ul style="list-style-type: none"> • What environmental factors to examine • Which risk assessment procedures to use • Which members of the audit team should be involved in discussions of potential fraud • Assessing the appropriateness of suitable criteria for a greenhouse gases (GHG) emissions assurance engagement
Assessing the risk of material misstatement	<ul style="list-style-type: none"> • Assessing inherent risk • Determining high risk audit areas • Assessing the probability of company failure • Assessing the percentage of debtors that will be recoverable • Assessing directors' best estimate assumptions in the preparation of forecast financial information • Assessing whether the preparer has applied appropriate criteria (e.g. GRI reporting standards)
Internal controls	<ul style="list-style-type: none"> • Assessing control risk • Extent of auditor reliance on internal controls
Consideration of fraud and error	<ul style="list-style-type: none"> • Which fraud risk factors are present • Determining which trends and relationships indicate the risk of fraud • The extent to which matters are documented • Whether a sales overstatement is material • Whether an item of non-compliance is material in a compliance audit • Determining the level of pollution that is material in an environmental assurance engagement
Communication	<ul style="list-style-type: none"> • The appropriate person(s) to communicate with • Matters to be communicated • The level of detail to be communicated
Policies	<ul style="list-style-type: none"> • The appropriateness of accounting policies used • Whether policies used are consistent with prior years
Audit evidence	<ul style="list-style-type: none"> • Nature, timing and extent of evidence • Whether to rely on audit evidence from previous audits • Sufficiency and appropriateness of audit evidence • Conclusions on results of specific audit procedure • Use of an independent expert
Analytical procedures	<ul style="list-style-type: none"> • Audit strategy • Which techniques to use • Development of expectations • Identification of significant fluctuations • Assessing the appropriateness of data used by management in developing an environmental report
Audit sampling	<ul style="list-style-type: none"> • Whether or not to use statistical sampling • Determining sample size • Selection of items to test
Audit reporting	<ul style="list-style-type: none"> • Whether a modified audit report is appropriate, and if so, which one • Whether an emphasis of matter paragraph is appropriate • Qualified, disclaimer, adverse opinions • What key audit matters (KAMs) to include in the audit report, if any • Whether a going concern basis is appropriate • The wording of other assurance reports

Source: CPA Australia 2019.

QUESTION 1.13

Both professional scepticism and professional judgment are essential to the proper conduct of an assurance engagement. Explain how auditors use professional scepticism and professional judgment in the context of an assurance engagement.

Materiality

As mentioned earlier, judgments pertaining to evidence collection and evaluation are made within the context of **materiality**. In respect of accounting information, an omission, misstatement or non-disclosure is material if it could adversely affect user’s decisions based on the financial statements. Materiality is relevant when the practitioner:

- plans the engagement
- determines their procedures for gathering evidence
- assesses whether the subject matter information is free of misstatement.

Materiality judgments must take into account both quantitative (numerical and measurable) and qualitative (other than numerical; subjective) factors. Materiality is discussed in more detail in module 2.

Engagement Risk

The subject matter presented to the assurance practitioner may fail to meet the requirements of the relevant criteria and, hence, may be materially misstated. **Assurance engagement risk** is the risk that the practitioner reports that the subject matter information is fairly presented when, in fact, it is materially misstated. In other words, it is the risk that the practitioner’s conclusion is wrong. When an audit is undertaken, this is referred to as **audit risk**.

A key requirement of a quality assurance engagement is to keep the engagement risk at an acceptably low level (some firms don’t use the ‘low’ category e.g. use numbers instead). Consequently, an assurance provider assesses the engagement risk during the planning stage of the engagement by assessing three components.

1. **Inherent risk** is defined as the susceptibility of the subject matter information to a material misstatement and is therefore determined by the underlying subject matter. For example, in the case of a financial statement audit of a business, inherent risk is determined by the riskiness of both the business and the economic environment. Normally, it would be expected that higher inherent risk exists for small as opposed to large businesses, and during periods of recession as opposed to periods of economic growth. Many considerations affect the assessment of inherent risk.
2. **Control risk** is defined as the risk that a material misstatement will not be prevented, or detected and corrected, by the internal control system. A well-designed and implemented control system can reduce control risk, but some level of control risk always exists because of the limitations of control systems. For example, an important control over cash is the bank reconciliation, so if a bank reconciliation is not performed, control risk increases. That is, the risk that

the bank account will be misstated, and that the control system will fail to prevent the error, or fail to detect and correct the error, is increased.

3. **Detection risk** is the risk that the assurance practitioner’s evidence-gathering procedures will not detect a material misstatement. Detection risk is affected by the quantity, reliability and relevance of evidence. For example, assume that to determine the existence of the inventory, an auditor counts ten items of inventory. Detection risk would be reduced if the practitioner were to increase the sample size for testing to 20 items.

Inherent risk and control risk are commonly combined and are referred to as the risks of material misstatement. In the Glossary of Terms provided by IAASB, audit risk is described as ‘a function of the risks of material misstatement and detection risk’.

The degree to which the practitioner considers each of the components of audit risk is affected by the engagement circumstances and whether a reasonable assurance or a limited assurance engagement is being performed.

Example 1.4 illustrates the use of professional judgment in planning the audit for Galaxy Ltd. Review this example now.

EXAMPLE 1.4

Galaxy Ltd

Galaxy Ltd (Galaxy) is a large, well-established computer-parts manufacturer that sells parts to computer stores. Changing technology makes the industry very competitive, and Galaxy has made only small profits for the last couple of years. Its bank loan depends on it continuing to earn a profit.

Because of the competitive pressures, Galaxy recently relocated the manufacture of some of its computer parts from Perth, in Australia, and Hong Kong to southern China. This has reduced manufacturing costs, but occasional quality problems have resulted in some lost orders.

Sales staff have previously been paid a fixed salary based on the number of years they have been with the company. However, a new commission scheme is being introduced this year by which staff will be paid a lower fixed salary but will receive a 4% commission if their individual sales targets are met or exceeded.

Galaxy plans to upgrade its general ledger reporting with a new software package. The conversion is planned for just before year-end so that it will be ready for next year. The new computer system will provide detailed information on sales, gross margins and inventory levels by product line.

What factors will affect the planning of the audit for Galaxy?

Check your response against the suggested answer at the end of the book.

QUESTION 1.14

- (a) What is professional scepticism?
- (b) How is it linked to engagement risk?

Nature, Timing and Extent of Procedures

Based on the assessment of materiality and combined risk of misstatement, an assurance practitioner will use a combination of procedures to collect sufficient and appropriate evidence. The exact nature, timing and extent of these procedures will vary from engagement to engagement (the Framework, para. 76).

Nature refers to the purpose of the test (e.g. to test controls, transactions or account balances) and the procedure used (e.g. inspection, observation, enquiry, confirmation, recalculation, re-performance or analytical procedures). For example, in auditing inventory, the auditor could perform the following procedures:

- ask warehouse personnel about obsolete inventory (enquiry)
- watch warehouse personnel count the inventory (observation)
- test count the inventory (re-performance)
- sight shipping documents and receiving reports (inspection).

The nature of an audit procedure will also depend upon the assertion being tested. The higher the risk of material misstatement, the more reliance placed on substantive procedures, the greater the use of audit procedures that access the most persuasive audit evidence (Moroney et al. 2017).

Timing refers to when the evidence is collected (e.g. interim period or year-end). Evidence collected at year-end, or close to the date of the subject matter information, is the most reliable. This is largely due to year-end testing focusing more on substantive tests of balances rather than transactions.

Extent refers to the quantity of information collected and tested. It is equivalent to sufficiency. More evidence is better than less, but this is highly dependent on its quality.

Planning for the nature, timing and extent of evidence collection is informed by the:

- assessment of inherent risk
- intention to use selective testing and sampling
- limitations of internal control systems
- assessed control risk
- fact that much of the evidence available to the practitioner is persuasive rather than conclusive
- use of judgment in gathering evidence and evaluating and forming conclusions based on that evidence.

Assurance Report

A practitioner provides a **written assurance report** containing a clearly expressed conclusion about the subject matter information. The determination of the level of assurance that can be provided involves consideration of the relationships between the underlying subject matter, the criteria and the quantity and quality of evidence. Basic elements for assurance reports are established by Assurance Standards (Framework, para. 83).

In providing the assurance report, there are important considerations related to the wording. There is a much greater variety in assurance reports that do not relate to historical financial information. Reporting timetables may also be shorter and sometimes less predictable (e.g. when an entity decides to issue a report on an environmental issue in response to a current event and requires assurance on that report within a particular timeframe).

As discussed earlier, in a reasonable assurance engagement, the practitioner expresses the conclusion in a positive form — for example, ‘In our opinion the internal control system is effective’.

In a limited assurance engagement, the practitioner expresses the conclusion in a form that aligns to the limited scope of the assurance engagement — for example, ‘Nothing has come to our attention that causes us to believe that internal control is not effective’.

Review paragraphs 83–92 of the Framework to become familiar with the contents of these types of assurance reports.

QUESTION 1.15

Does an engagement to perform an audit of financial statements include the provision of assurance on internal controls?

The key points covered in this part, and the learning objectives they align to, are below.

KEY POINTS

1.1 Apply the *International Framework for Assurance Engagements* (the Framework) and the related standards and other guidance to assurance engagements.

- The Framework is not a standard. It provides a frame of reference for assurance practitioners and others involved in assurance engagements.
- The Framework distinguishes direct engagements from attestation engagements and reasonable assurance engagements from limited assurance engagements.
- The Framework sets out preconditions for an assurance practitioner to accept an assurance engagement.
- The Framework identifies five elements that assurance engagements exhibit and how they vary in different assurance engagements.
- The Framework discusses assurance practitioner’s responsibilities towards the use of professional scepticism and the application of professional judgment in obtaining sufficient appropriate evidence to support the assurance practitioner’s conclusion.

1.2



1.3 Apply the *Code of Ethics for Professional Accountants* to assurance engagements.

- The Code sets out fundamental principles of ethics for all professional accountants. These principles establish the standard of behaviour expected of a professional accountant.
- The Code provides a conceptual framework that members are required to apply in order to identify, evaluate and address threats to compliance with fundamental principles.
- The Code also sets independence standards for audits and other assurance engagements.

1.3 TYPES OF ASSURANCE ENGAGEMENTS

In addition to historical and prospective financial information, entities report a large amount of non-financial information, such as:

- additional disclosures relating to wider operating data, internal controls, corporate governance, and risk management practices and outcomes
- corporate social responsibility (CSR) reporting on economic, social and environmental issues (including carbon emissions)
- reporting to regulators regarding such issues as compliance with regulatory requirements.

The types and amount of these reporting requirements are generally growing and, while there may be differences in emphasis across some countries, it is certainly a worldwide trend.

In this section, we provide an overview of the different types of assurance services that an assurance practitioner can provide. These types of engagements are introduced here and will be examined in more detail in the remaining modules. The most common types of assurance engagements are:

- audits of financial statements
- audits of specialised areas
- review engagements
- assurance of historical non-financial information
- assurance on future-oriented information
- assurance on systems and processes
- assurance on aspects of behaviour
- assurance of performance of an activity.

Each type of assurance engagement will now be explained in turn.

AUDITS OF FINANCIAL STATEMENTS

According to ISA 200, the objectives of the auditor are to obtain reasonable assurance that the **financial statements** are free from material misstatement and ‘to express an opinion about whether the financial statements are prepared in all material respects in accordance with a financial reporting framework’ (ISA 200, para. 11).

Within an Australian context, this means that the financial report has been prepared in accordance with Australian Accounting Standards and interpretations and any relevant legislation, such as the Corporations Act (ASA 200). Where a fair presentation framework is applicable for financial reports, the opinion required by the Australian Auditing Standards is on whether the financial report is presented fairly, in all material respects, or gives a true and fair view (ASA 200, para. A13; ISA 200, para. A13).

The entity’s reporting requirements are specified in the Corporations Act. Both a financial report and a directors’ report must be prepared annually by disclosing entities, public companies, large proprietary companies and registered schemes (s. 292 of the Corporations Act). Under sections 295(4)(c) and 295A of the Corporations Act, directors of the reporting entity must declare whether the reporting entity will be able to pay its debts as and when they become due, whether the financial records have been properly maintained, whether the financial report and notes comply with Australian Accounting Standards including interpretations, and whether the financial report and notes give a **true and fair view**. A true and fair view refers to the consistent and faithful application of accounting standards in accordance with the financial reporting framework when preparing the financial report (ASA 200, para. 13; ISA 200, para. 13). Australian companies must prepare their financial report in compliance with accounting standards (s. 296 of the Corporations Act). If compliance with accounting standards does not give a true and fair view, a company should provide additional information in the notes to the financial report (s. 295(3)(c) of the Corporations Act). Regulatory Guide 230 (ASIC, 2011) provides information for company directors and financial report preparers regarding the disclosure of information other than in accordance with accounting standards. Section 301 of the Corporations Act requires that the financial report be audited. In fulfilling their role, the auditor must be independent of the company they audit, exercise due professional care, and comply with Auditing and Assurance Standards (APES 210).

Limitations of an Audit

A financial statements audit is conducted to enhance the reliability and credibility of the information included in a financial report. Yet it is not a guarantee that the financial report is free from error or fraud. The limitations of an audit stem from the nature of financial reporting, the nature of audit procedures and the need for the audit to be conducted within a reasonable period of time and at a reasonable cost (ISA 200).

The nature of financial reporting refers to the use of judgment when preparing financial reports due to the subjectivity required when arriving at accounting estimates. Judgment is also required when selecting and applying accounting methods.

The nature of audit procedures refers to the reliance on evidence provided by the client and its management. If an auditor does not have access to all the information relevant to the audit, there is a limitation in the scope of their audit. If the auditor is unaware of this situation, they may arrive at an inappropriate conclusion based on incomplete facts. Evidence may be withheld or modified by perpetrators of fraud. It can be difficult for an auditor to determine whether a fraud has occurred and documents altered as those committing a fraud generally hide evidence. Sampling is used when testing transactions and account balances. If a sample is not representative of all items available for testing, an auditor may arrive at an invalid conclusion.

The timeliness and cost of a financial report audit refers to the pressure an auditor faces to complete their audit within a certain time frame at a reasonable cost. While it is important that an auditor does not omit procedures in an effort to meet time and cost constraints, they may be under some pressure to do so. This pressure will come from clients wanting to issue their financial reports by a certain date, from clients refusing to pay additional fees for additional audit effort, and from within the audit firm where there are pressures to complete all audits on a timely basis to avoid incurring costs that may not be recovered. By taking the time to plan the audit properly (covered in module 2), an auditor can ensure that adequate time is spent where the risks of a significant error or fraud are greatest.

AUDITS OF SPECIALISED AREAS

Audits of specialised areas cover audits of historical financial information other than general purpose financial statements. This includes audits of:

- special purpose financial statements
- single financial statements or components thereof
- summary financial statements including concise financial reports.

REVIEW ENGAGEMENTS

An assurance practitioner may be engaged to perform a review of a financial report rather than an audit, and this review may be conducted by a practitioner who has no other dealings with the company or may be conducted by the company’s independent auditor. Specific requirements exist for reviews of financial statements which are distinct from those requirements that relate to the reviews of other historical financial information.

A review of interim financial statements enables the auditor to express a conclusion whether, on the basis of the review, anything has come to light to cause the auditor to believe that the interim financial report is not prepared in accordance with an applicable financial reporting framework. A review differs significantly from an audit in that it does not provide a basis for an opinion to be formed regarding whether the financial report gives a true and fair view, or is presented fairly, in all material aspects, in accordance with the applicable financial reporting framework. A review is not designed to obtain reasonable assurance that the interim financial report is free from material misstatement.

Reviews of historical financial information that are other than a complete financial report include reviews of specific components, elements, accounts or items of a financial report, other information or schedules that can be derived from financial records, or financial statements that are prepared in accordance with a financial reporting framework that is not designed to achieve fair presentation, such as condensed financial statements and an entity’s internal management accounts.

QUESTION 1.16

You have been approached by a prospective client, who is unsure about the applicability of the financial reporting requirements. They are unclear about the difference between an audit and a review. Prepare notes for a meeting to help the prospective client understand the differences between an audit and a review, including differences in the level of assurance, form of the opinion and types of procedures that could be performed.

HISTORICAL NON-FINANCIAL REPORTS ASSURANCE

ISAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* is an umbrella standard for ‘other’ assurance engagements. Other assurance engagements under ISAE 3000 (Revised) may be either ‘reasonable’ or ‘limited’ (para. 10), and the conditions for accepting or continuing them are set out in ISAE 3000 (Revised), paragraph 22. These conditions include the general requirements that the practitioner (signing partner) believes that the engagement team satisfies relevant ethical requirements, including independence. The practitioner should also be satisfied that the engagement team, collectively, has the appropriate competence and capabilities. Further, the practitioner should be satisfied that the preconditions of an assurance engagement, as discussed in ISAE 3000 (Revised), paragraph 24, are present.

Assurance of non-financial information includes assurance on:

- corporate social responsibility (CSR) reports
- greenhouse gas statements (GHG)
- sustainability reports
- water accounting reports
- business performance measurement
- integrated reports.

FUTURE-ORIENTED INFORMATION ASSURANCE

Assurance engagements covering future-orientated information include prospective financial information about future events which are not certain. This information includes:

- forecasts based on best-estimate assumptions based on expectations
- projections based on hypothetical assumptions
- pro forma financial statements for a prospectus.

Given the inherent uncertainties surrounding financial information based on future predictions, assurance engagements in relation to this information only ever give limited assurance. An example of circumstances where this kind of information would need assurance attached to it is where an organisation has prepared forecast information in support of an application for a bank loan and the assurance provided by the auditor would enhance the credibility of these forecasts.

It is not within the scope of the engagement to express an opinion on the truth, fairness or other characteristics of the information. The auditor will express a negative form opinion on the suitability of the assumptions and then give a further opinion about whether the information has been prepared in accordance with those assumptions and an appropriate financial reporting framework. An additional statement will be included, which highlights that actual results are likely to be different to the forecast where events do not occur as expected.

ASSURANCE ON SYSTEMS AND PROCESSES

‘Systems and processes’ is one of the categorisations of underlying subject matter for other assurance services (*International Framework for Assurance Engagements*, Appendix 4). The most common other assurance services relate to internal control.

Following the enactment of the *Sarbanes–Oxley Act 2002* (US), there are now requirements for management reports on internal controls and subsequent requirements for these assessments to be audited. Given that these requirements are seen by many regulators as best practice, they are likely to lead to greater reporting and assurance on internal controls in other jurisdictions as well. The IAASB issued ISAE 3402 *Assurance Reports on Controls at a Service Organisation* for auditors performing assurance engagements on controls at a service organisation.

You can access ISAE 3402 at <https://www.ifac.org/system/files/publications/files/IAASB-2018-HB-Vol-2.pdf>.

In Australia, the AUASB issued a new Standard, ASAE 3150 *Assurance Engagements on Controls*, in 2015. This standard sets out mandatory requirements for assurance practitioners to apply, in conjunction with the requirements in ASAE 3000, when accepting, planning, performing and reporting on controls. Providing a report on internal controls enables management to discharge its accountability obligation to establish an effective internal control structure. The investing public has a legitimate interest in the state of an entity’s internal controls. Also, a requirement for management to report on the adequacy of internal controls may cause them to be more effective in maintaining internal control systems.

Assurance on systems and processes include:

- internal audits
- internal controls audit
- continuous auditing.

Internal Audits

Internal audits are conducted to provide assurance about various aspects of an organisation’s activities. The internal audit function is typically conducted by employees of the organisation being audited but can be outsourced to an external audit firm. As such, the function of internal audit is determined by those charged with governance and management within the organisation. While the functions of internal audits vary widely from one organisation to another, they are often concerned with evaluating and improving risk management, internal control procedures and elements of the governance process. The internal audit function often conducts performance audits, compliance audits, internal control assessments and reviews.

Internal Controls Audit

Engagements in relation to control procedures aim to provide a level of assurance in relation to the design and operating effectiveness of internal control procedures. These engagements may be direct reporting engagements, where the auditor gives an opinion directly on the internal controls themselves, or an assertion-based engagement, where management has made assertions (usually in the form of a written report) about the effectiveness of their control procedures and the auditor is providing an opinion on those assertions. Engagements of this nature may give rise to either reasonable assurance or limited assurance.

Continuous Auditing

The electronic revolution has created a demand for more timely assurance on a broader range of information than that provided by the annual audit of historical financial statements. Companies now release information via their websites to interested parties over a short time frame, and continuous auditing allows auditors' reports on that information to be provided almost immediately. A continuous audit is a process or method that enables independent auditors to provide written assurance on subject matter using a series of auditors' reports issued simultaneously with, or a short time after, the occurrence of events underlying the subject matter. It is conducted on continuous financial and non-financial information made available to users in formats defined by management.

Auditors could be asked to continuously audit and report on:

- financial statements available on demand via a website
- specific financial information in conjunction with a debt covenant agreement
- compliance with published policies and practices regarding e-commerce transactions (e.g. reliance on secure encrypted systems for credit card processing)
- the effectiveness of controls operating in key systems or processes.

A continuous audit presents a number of auditing issues. There is little time for the auditor to gather audit evidence for verifying and substantiating the subject matter concerned. The auditor cannot rely on normal audit procedures, such as obtaining independent confirmations and checking material misstatements, so a reliable and well-controlled application system is vital. The auditor must use fully automated audit software such as IDEA or ACL to read, manipulate and generate the information required. Other conditions necessary for ensuring a successful continuous audit are:

- effective communication and technology between the client and the auditor
- agreement as to the form, content and scope of the audit
- a sound knowledge by the auditor of the systems used by the client.

Continuous auditing is more relevant in an online environment where strategies and business processes are used to provide value-added performance information to interested parties.

ASSURANCE ON ASPECTS OF BEHAVIOUR

Assurance on aspects of behaviour include:

- compliance engagements
- corporate governance assurance.

Compliance Engagements

Organisations may have obligations to follow requirements imposed by law or regulation, by contract or internally imposed through accounting policies and procedures. Compliance engagements provide assurance that regulations, contractual obligations or other requirements have been complied with. An example of this is reporting on whether an entity has complied with certain aspects of a bank loan agreement relating to interest payments and maintenance of predetermined financial ratios.

The level of work that the auditor needs to carry out will be dependent upon whether the engagement is a reasonable assurance engagement or limited assurance engagement, and specific procedures need to be designed accordingly. Given the variety of possible engagements that could arise, it is important that the auditor ensures that the overall aspects of compliance relate to matters within their scope of professional competence. One of the most significant issues in these engagements is ensuring the suitability of the criteria against which the outcome is to be measured. This may be simple with legislation or contractual provisions where the criteria are clearly stated; in other circumstances, such as compliance with organisational policies and procedures, the suitability of the criteria will need to be carefully considered. The report prepared by the auditor should clearly identify the criteria, the time period covered and state whether, in the auditor's opinion, the entity has complied with its obligations.

Corporate Governance Assurance

The major corporate collapses in the early 2000s (including Enron, WorldCom, HIH Insurance and Le Nature’s Inc.) prompted an increase in the regulation of corporate governance. This included the introduction of the Sarbanes–Oxley Act in the United States and the CLERP 9 reforms in Australia. Corporate governance has thus assumed new levels of importance in today’s business world. The Big Four accounting firms all provide assurance services related to corporate governance requirements and best practice board reporting (refer to the websites of any of the Big Four accounting firms).

PERFORMANCE OF AN ACTIVITY

Performance engagements are concerned with the economy, efficiency and effectiveness of an organisation’s activities (ASAE 3500 *Performance Engagements*, para. 7). Economy refers to the cost of inputs, including wages and materials. Efficiency refers to the relationship between inputs and outputs. Specifically, efficiency refers to the use of the minimum amount of inputs to achieve a given output. Finally, effectiveness refers to the achievement of certain goals or the production of a certain level of outputs. From an organisation’s perspective it is important to perform well across all three dimensions and not allow one to dominate. For example, if buying cheap inputs results in an inefficient production process, efficiency may be seen to be sacrificed to achieve economic goals.

QUESTION 1.17

A firm provides the following service for its clients.

- 1. Preparation of a report advising a client on the introduction of a new system of internal controls.**
- 2. A report providing an opinion on a school’s responses to a questionnaire required by the auditor-general.**
- 3. Preparation of the company’s tax returns.**
- 4. A report to management about the success of a marketing campaign.**
- 5. A report to directors in relation to half-year financial report for a listed company.**
- 6. An audit of a management report into the effectiveness of a company’s internal control system.**
- 7. A statement of findings to management in relation to the completeness and accuracy of its trade creditors balance.**

For each of the above, identify whether assurance services are being provided and justify your answer. For each assurance service, identify what level of assurance will be provided and what form the opinion will take.

The key points covered in this part, and the learning objectives they align to, are below.

KEY POINTS

1.1 Apply the *International Framework for Assurance Engagements (the Framework)* and the related standards and other guidance to assurance engagements.

- Standards on Assurance Engagements establish requirements and provide application and other explanatory material for a range of assurance engagements other than audit or review of financial information.
- ASAEs on a specific subject matter are read and applied in conjunction with ASAE 3000.
- According to ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, the objective of a financial statements audit is for the auditor ‘to express an opinion about whether the financial report is prepared in all material respects in accordance with a financial reporting framework’.
- ISAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* is an umbrella standard for ‘other’ assurance engagements.
- ISAE 3402 *Assurance Reports on Controls at a Service Organisation* provides guidance for auditors performing assurance engagements on controls at a service organisation.
- ASAE 3500 *Performance Engagements* are concerned with the economy, efficiency and effectiveness of an organisation’s activities.

1.4 APPLICATION OF STANDARDS

The *Preface to the International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements* issued by the IAASB facilitates understanding of the scope and authority of the IAASB’s pronouncements. The IAASB pronouncements govern audit, review, other assurance and related services engagements that are conducted in accordance with International Standards.

As discussed earlier:

- International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information

- International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information
- International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements other than audits or reviews of historical financial information
- International Standards on Related Services (ISRSs) are to be applied to compilation engagements, agreed upon procedures and other related service engagements.

ISAs, ASREs, ISAEs and ISRSs are collectively referred to as the IAASB’s Engagement Standards. As mentioned previously, these pronouncements do not override the local laws or regulations in a particular country.

APPLICATION OF ISAs

The ISAs are developed by the International Auditing and Assurance Standards Board (IAASB). The following points are noteworthy.

- The ISAs are written in the context of an audit of historical financial statements.
- The ISAs apply to all members of the accounting profession and are applicable to both the private and public sectors.
- The ISAs apply to audits of all sizes and complexity. The argument is that it is in the public interest that users of audited financial statements have confidence that the audits have been performed at a high standard. This applies regardless of whether the entities are large or small, complex or simple (IAASB 2009).

Figure 1.7 provides an overview of the categories of auditing standards, as well as the ISA number sequence used for each category, and shows the number of standards in each category. As can be seen from figure 1.7, the standards provide a guide that takes the auditor through the whole audit process. Not surprisingly, many standards are in the category of ‘audit evidence’ because obtaining evidence to support an opinion is crucial to the auditor’s work. The standards are designed to be applicable to the whole audit process. Specific standards are not written for particular classes of transactions or balances.

These ISAs cover the following.

- Audits of annual general purpose financial statements (covered by ISA series 200 to 700)
 - covered in modules 2–4
- Other audits of historical financial information (covered by ISA series 800) and discussed in module 5 includes:
 - financial statements prepared in accordance with special purpose frameworks
 - single financial statements and specific elements, accounts or items of a financial statement
 - summary financial information.

The authority of ISAs is set out in ISA 200. ISA 200:

- creates an obligation for auditors to comply with ethical requirements and the ISAs
- sets out the overall objectives of the independent auditor
- explains the nature and scope of an audit that will enable the independent auditor to meet these objectives



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SME Perspective

Applying ISAs Proportionately with the Size and Complexity of an Entity (IAASB 2009) provides questions and answers relating to the audits of small and medium-sized entities (SMEs). So while the requirements of all relevant ISAs apply to SMEs and the auditor’s objectives are the same regardless of size or complexity, some important issues are raised in IAASB (2009) as to the conduct of an audit of an SME compared to a larger entity. Not all audits are planned and performed in the same way. Specific audit procedures to comply with ISAs may vary considerably depending on the size and complexity of the entity.

The work effort for the audit of an SME may differ from that in a larger audit because it will generally involve much simpler transactions and, therefore, be more straightforward. For example, the requirement to understand the entity and its environment (ISA 315 (Revised) *Identifying and Assessing the Risks of Material Misstatement through*

Understanding the Entity and Its Environment) will be much easier to carry out for an SME. Similarly, internal controls in an SME are usually simpler; while the auditor is still required to obtain an understanding of internal control, the auditor can usually obtain and document that understanding more quickly.

ISAs often have a special section entitled ‘Considerations Specific to Smaller Entities’. Examples of considerations from these sections include:

1. Standard audit programs or check-lists ... drawn up on the assumption of few relevant control activities ... may be used provided that they are tailored to the circumstances of the engagement, including the auditor’s risk assessments (ISA 300 *Planning an Audit of Financial Statements*, para. A21).
2. Some smaller entities may not have interim or monthly financial information that can be used for purposes of analytical procedures. In these circumstances ... the auditor may need to plan to perform analytical procedures to identify and assess the risks of material misstatement when an early draft of the entity’s financial statements is available (ISA 315 (Revised), para. A17).
3. Audit evidence for elements of the control environment in smaller entities may not be available in documentary form ... Consequently, the attitudes, awareness, and actions of management or the owner-manager are of particular importance to the auditor’s understanding of a smaller entity’s control environment (ISA 315 (Revised), paras A86–A87).

While an auditor of an SME must comply with all relevant ISAs (ISA 200, paras 18–20), a number of ISAs are likely to be less relevant to an SME. Examples include:

- ISA 300 *Planning an Audit of Financial Statements* — if a one-person audit team is used, the requirements related to the direction, supervision and review of team members is not relevant
- ISA 402 *Audit Considerations Relating to an Entity Using a Service Organization* — if the SME does not use a service organisation
- ISA 510 *Initial Audit Engagements — Opening Balances* — if the SME audit is a continuing engagement and not an initial engagement
- ISA 600 *Special Considerations — Audits of Group Financial Statements (Including the Work of Component Auditors)* — if the SME audit engagement is not a group audit
- ISA 610 (Revised) *Using the Work of Internal Auditors* — if the SME has no internal audit function
- ISA 800 (Revised) *Special Considerations — Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks*, ISA 805 (Revised) *Special Considerations — Audits of Single Financial Statements and Specific Elements, Accounts or Items of a*

*Financial Statement and ISA 810 (Revised)
Engagements to Report on Summary Financial
Statements* — if the SME audit engagement is to
report on general purpose financial statements.

Even when an ISA is relevant to an SME, not all requirements of every ISA will be relevant when performing an audit of an SME (ISA 300, para. A17). Similarly, the form, content and extent of documentation can vary with the size and complexity of the entity (ISA 230 *Audit Documentation*, para. A2). Also, documentation for an SME is generally less extensive than for a large entity (ISA 230, para. A16), and it may be helpful and efficient to record various aspects of the audit in a single document.

Audit Requirements

The audit requirements of small businesses and incorporated associations can vary considerably. In Australia, unincorporated businesses and sole traders are not subject to the audit requirements of the relevant regulations such as the Corporations Act (Cwlth). Many small businesses, however, choose to adopt the small proprietary company as a business form in order to obtain the benefits of limited liability. Under the Corporations Act, Australian small businesses may choose between including key financial data in their annual returns to ASIC or having the company’s accounts audited, in which case this information is not required to be submitted. Often, small businesses choose to have their accounts audited in order to maintain the privacy of their financial affairs and to deny competitors access to confidential trade-related financial information.

Associations, clubs, community groups and charities have long been, and remain, an important part of society. Such an association does not have to be incorporated, but incorporation means that it becomes a legal entity in its own right, separate from the individual members. It is therefore considered at law to have a distinct identity that continues regardless of changes to the membership. In Australia, there are a number of ways associations can incorporate — under the Corporations Act, associations, charitable or not-for-profit organisations will generally be registered as companies that are limited by guarantee. In each of the Australian states and territories, there are various Association Incorporation Acts, which contain differential accounting and audit requirements. CPA Australia has summarised these various requirements in its guide *Companies limited by Guarantee and Incorporated Associations: Reporting and Auditing/Review Obligations*.

You can access the 2017 CPA Australia’s guide on Companies Limited by Guarantee and Incorporated Associations: Reporting and Audit/Review Obligations on the CPA website at: <http://cpaaustralia.com.au/~media/corporate/allfiles/document/professional-resources/auditing-assurance/incorporated-associations.pdf>.

A tiered approach is commonly used to ease the audit burden for smaller incorporated associations. For example, under the Corporations Act (for companies limited by guarantee) the *Australian Charities and Not-For-Profits Commission (ACNC) Act 2012* (Cwlth) and various state Associations Incorporation Acts, a tiered approach is used. These tiers are outlined in table 1.10.

TABLE 1.10 A tiered approach to audit requirements for incorporated associations		
Tier	Size of tier	Audit requirement
Tier 3	Revenue of \$1m or more	Audit must be completed by a registered company auditor
Tier 2	Revenue of \$250 000 to less than \$1m	Can elect to have their financial report either reviewed or audited
Tier 1	Revenue of less than \$250 000	No audit or review requirements

Source: CPA Australia 2019.

Future Developments

The scalability and proportionality of the ISAs has been one of the key environmental drivers that shaped the IAASB’s Proposed Strategy for 2020–2023 and Work Plan for 2020–2021. To gather information on its strategic theme ‘Develop ways to address complexity, while maintaining scalability and proportionality’, IAASB published a Discussion Paper, *Audit of Less Complex Entities — Exploring possible options to address the challenges in applying the ISAs* in April 2019 for public consultation. Feedback from the Discussion paper will assist IAASB to further understand the challenges of using ISAs in audit and less complex entities and views about possible actions to address these challenges.

Although the discussion about the challenges of applying the ISAs has historically been around the difficulties experienced in audits of smaller entities as outlined in the Chairman’s Foreword, we are of the view that it is appropriate

to focus on the complexity of the entity rather than its size. This is because in today’s environment, it is not only about size — there may be entities that are smaller but may be considered complex, and there may be other entities that would not be considered smaller, but would be considered less complex (Discussion Paper, p. 4).

Further information on the project ‘Audits of less complex entities’ and the Discussion paper can be found at <https://www.iaasb.org/projects/audits-less-complex-entities>.

As a stakeholder, IFAC recently launched an *Audits of Less Complex Entities Survey* to obtain a deeper understanding of the specific challenges in applying ISAs in audits of less complex entities and capture views on the possible options to address these challenges to help inform the IAASB deliberations. In addition, IFAC provides practical support to small- and medium-sized practices in relation to implementation of ISAs while auditing SMEs through its publication, ‘Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities’.

You may refer to the fourth edition (released in 2018) of the Guide at <https://www.ifac.org/publications-resources/guide-using-international-standards-auditing-audits-small-and-medium-sized-18>.

Differential Reporting

The International Accounting Standards Board (IASB) in 2009 issued an International Financial Reporting Standard (IFRS) for SMEs. The IFRS for SMEs is a self-contained accounting standard tailored to suit the needs and capabilities of smaller businesses. Many of the principles in full IFRSs for recognising and measuring assets, liabilities, income and expenses have been simplified, topics not relevant to SMEs have been omitted, and the number of required disclosures has been significantly reduced. To reduce further the reporting burden for SMEs, revisions to the IFRS will be limited to once every three years.

In Australia, the Australian Accounting Standards Board (AASB) introduced a differential reporting framework for the types of organisations that need to issue general purpose financial statements (GPFs). The reduced disclosure requirements were introduced as a second tier of reporting requirements for preparing general purpose financial statements. The aim is to reduce reporting needs of entities that previously were required to apply full IFRSs but found the disclosures under full IFRSs burdensome. Under the differential reporting framework, Tier 1 reporting (full IFRSs) applies only to for-profit private sector entities that have public accountability, the Australian government, and state, territory and local governments.

Thus, the reporting and audit burden facing small businesses was addressed by reducing the complexity of the accounting requirements.

Public Sector Perspective

As mentioned earlier, ISAs apply to both the private and public sectors, so it is worthwhile at this point to briefly discuss public sector auditing and also to show that an audit of financial statements is only one aspect of the role of the public sector auditor. To understand public sector auditing, it is necessary to understand the environment in which the public sector auditor works. The following section examines this environment, the role of the public sector auditor and the role of the Auditor-General. In countries that adopt the Westminster system of government, the title ‘Auditor-General’ is usually applied to the public sector auditor.

The control of public expenditure is one of the main responsibilities of government. Each year parliament approves a budget, and procedures and regulations ensure that all transactions entered into by government departments and agencies are legally permissible and conform with the annual appropriations. This budgetary and appropriation system is central to financial control.

Several instrumentalities participate in the control of public expenditures.

- Parliament is responsible for authorising annual expenditures.
- The treasurer is the minister responsible for financial and economic matters. At the Commonwealth level, the treasurer is supported by the Department of Finance, and at the state level by the Treasury.
- The audit acts and finance regulations prescribe in detail the accounting practices to be followed by all levels of government.
- The Auditor-General is responsible to the parliament (the responsibilities of the Auditor-General are discussed in this section).

- Public accounts committees examine the accounts of the receipts and expenditures and the Auditor-General’s report.

Public sector audit work involves financial statement auditing. It is recognised that it is important that expenditure decisions are made wisely, and that government departments and agencies conduct their affairs effectively, and with efficiency and economy. This understanding has led to the development of performance auditing. Performance audits result in a separate report to parliament following the completion of each audit. Performance audits other than financial statement audits are covered in module 5.

Because of the considerable variance in the legislation that applies to public sector auditors worldwide, this section focuses on the standards framework at a general level.

Mandate of the Auditor-General

In this section, the work of public sector auditors is illustrated by discussion of the roles of some auditors-general.

Australia

In Australia, the audit of government departments, statutory authorities and instrumentalities is primarily the responsibility of the Auditor-General. The Auditor-General also acts as auditor for government corporations by arrangement with the responsible ministers. Each state and territory has an Auditor-General whose duties are governed by state legislation and are similar to those of the Australian Auditor-General. In the public sector, auditors work for either the Australian National Audit Office (ANAO) or state audit offices, which support the various state auditors-general.

The Australian Auditor-General is responsible under the *Auditor-General Act 1997* (Cwlth) for providing auditing services to parliament and public sector entities. The ANAO supports the Australian Auditor-General, who is an independent officer of the parliament. It is important to note that auditors-general are independent — they are not subject to control or direction by either parliament or the government. This independence is provided for by the respective legislation.

The ANAO’s primary client is the Australian parliament and its purpose is to provide parliament ‘with an independent assessment of selected areas of public administration, and assurance about public sector financial reporting, administration, and accountability’ (ANAO 2019). The ANAO conducts performance audits, financial statements audits and assurance reviews.

To obtain a better understanding of the audit work carried out by the various state audit offices in Australia, consider the following core services provided by the Audit Office of New South Wales:

Financial audits

Our financial audits provide independent opinions on the financial statements of NSW government entities, universities and councils. Our opinions provide assurance about whether these financial statements comply with accounting standards, relevant laws, regulations and government directions. Additional financial audits are undertaken each year on the General Government and Total State Sector Accounts. Financial statement audits also highlight opportunities where entities can improve their accounting and financial systems.

Performance audits

Performance audits provide information to the New South Wales Parliament and public about how well government programs and services are delivered. Ultimately, they aim

to improve public administration. Performance audits examine whether programs and services are delivered efficiently, effectively, economically and in accordance with the law.

Special reports

Special audits are sometimes conducted to confirm that specific legislation, directions and regulations have been adhered to.

Source: Audit Office of New South Wales, ‘Our work’, accessed July 2019, <https://www.audit.nsw.gov.au/our-work>
© Audit Office of New South Wales 2019.

Hong Kong

In Hong Kong, the equivalent of the ANAO is the Audit Commission. The Audit Commission was established on 1 July 1997 pursuant to the ‘Basic Law of the Hong Kong Special Administrative Region of the People’s Republic of China’ (Audit Commission 2019a).

The head of the Audit Commission is the Director of Audit. The duties and powers of the Director of Audit are set out in the ‘Audit Ordinance’ (Cap. 122) (Audit Commission 2019b). The Director of Audit:

1. is the external auditor of the accounts of the Government of Hong Kong Special Administrative Region;
2. has wide powers of access to the records of departments;
3. can require any public officer to give an explanation and to furnish such information as he thinks fit to enable him to discharge his duties; and
4. is not subject to the direction or control of any other person or authority in performing his duties and when exercising his powers under the Ordinance (Audit Commission 2019b).

Example 1.5 deals with public sector audits. Complete the example now.

EXAMPLE 1.5

Public Sector Audits

The Victorian Auditor-General’s Office (VAGO) notes that its audit findings and recommendations address the following for government organisations.

1. The effectiveness, efficiency, and economy of government agencies, programs and services.
2. The quality of resources management.
3. Opportunities for improvements in management practices and systems.

4. The fair presentation of annual financial statements and performance statements.
5. Compliance with legislative and other requirements.
6. Wastage or lack of probity in the management of public resources.

.....

Determine which of the following findings would most likely arise from a financial statement audit and/or a performance audit.

- The effectiveness, efficiency, and economy of government agencies, programs and services
 - The quality of resources management
 - Opportunities for improvements in management practices and systems
 - The fair presentation of annual financial statements and performance statements
 - Compliance with legislative and other requirements
 - Wastage or lack of probity in the management of public resources.
- Check your response against the suggested answer at the end of the book.

Source: Victorian Auditor-General's Office 2019, 'Our role', accessed July 2019, <https://www.audit.vic.gov.au/our-role>
© Victorian Auditor-General's Office 2019.

APPLICATION OF ISREs

ISREs are international standards that cover the basic principles and essential procedures governing review engagements on historical financial information. There are only two international standards covering review engagements.

1. ISRE 2410 *Review of Interim Financial Information Performed by the Independent Auditor of the Entity* — covers reviews of interim and other financial information performed by the independent auditor of the entity.
 - For example, reviewing quarterly or half-yearly interim financial statements.
2. ISRE 2400 (Revised) *Engagements to Review Historical Financial Statements* — covers engagements to review financial statements performed by an assurance practitioner who is not the auditor of the entity.
 - For example, where an entity that is not required to have its annual financial statements audited decides to have these reviewed as stakeholders such as banks or shareholders want to ensure the amounts shown on the financial statements are believable.

The following points related to review engagements are worth noting and will be discussed further in module 5.

- A review provides only limited assurance whether the financial statements conform to generally accepted accounting principles.
- When a review is performed by an independent auditor who also performed the audit of general purpose financial statements, the auditor brings the knowledge that they acquired when undertaking the annual audit to the review engagement.
- Even though a review conducted by an auditor other than the auditor who performed the audit of the general purpose financial statements starts off from a different knowledge based about the entity, both review engagements should provide a similar level of assurance.

APPLICATION OF ISAEs

The overarching standard to be applied to all assurance engagements other than audits or reviews of historical financial information is ISAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*. In addition, there are four international subject specific standards for these assurance engagements. They are:

1. ISAE 3400 *The Examination of Prospective Financial Information*
2. ISAE 3402 *Assurance Reports on Controls at a Service Organisation*
3. ISAE 3410 *Assurance Engagements on Greenhouse Gas Statements*
4. ISAE 3420 *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus*.

The subject matters which can be assured under these types of engagements range widely. Some are required by regulation and others are reported on a voluntary basis. There are five core types of other assurance engagements that can be conducted either as reasonable or limited assurance engagements. The five types of engagements and their specific international standards in addition to ISAE 3000 are as follows.

1. Historical non-financial reports — ISAE 3410.
 - Includes: Performance engagements on use of resources or value for money (e.g. greenhouse gas statements; sustainability reports; KPIs; statement on effective use of resources; statement on value for money; corporate social responsibility reporting and integrated reports).
2. Future-oriented information — ISAE 3400 and 3420.
 - Includes: Performance engagements (e.g. forecast/projected cash flow); Position engagements (e.g. forecast/projected financial position); Performance engagements on use of resources or value for money (e.g. expected emissions reductions attributable to a new technology, greenhouse gases to be captured by planting trees, or statement that a proposed action will provide value for money).
3. Systems and processes — ISAE 3402.
 - Includes: Description engagements (e.g. the description of a system of internal control); Design engagements (e.g. the design of con-

trols at a service organisation or the design of proposed controls for a forthcoming production process); Operation/Performance engagements (e.g. the operating effectiveness of procedures for hiring and training staff).

4. Aspects of behaviour.
 - Includes: Compliance engagements; Human behaviour (e.g. evaluation of audit committee effectiveness) and Other (e.g. fitness for purpose of a software package).

5. Performance of activity — ASAE 3500 *Performance Engagements*.
 - Includes: Performance engagements (e.g. performance of a public sector activity).

These other assurance engagements will be discussed further in module 5.

APPLICATION OF ISRSs

ISRSs apply to non-assurance engagements involving related services such as the following.

- Agreed-upon procedures — ISRS 4400 *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information*
 - engagements where the auditor is engaged to issue a report of findings based on procedures agreed upon with specified parties
 - these procedures are potentially broad ranging and can be in any area where the client and user perceive it to be beneficial to have a report on a matter using audit-related skills.
- Compilation engagements — ISRS 4410 (Revised) *Compilation Engagements*
 - involve the use of accounting expertise, as opposed to auditing expertise, to collect, classify and/or summarise financial information
 - usually entails preparing financial statements from transaction and other information, without the requirement to test the accuracy of that information
 - commonly used for SMEs in circumstances where there is no requirement for the entity to have an assurance report provided on their financial statements.

These non-assurance engagements will be discussed further in module 5.

AUSTRALIAN PERSPECTIVE

In Australia, Auditing standards ASA 100 *Preamble to AUASB Standards*, ASA 101 *Preamble to Australian Auditing Standards* and ASA 102 *Compliance with Ethical Requirements when Performing Audits, Reviews and Other Assurance Engagements* require assurance practitioners to comply with all AUASB standards, Auditing standards and Ethical requirements respectively. ASA 101 is an Australia-only standard that outlines how the AUASB intends the Australian standards to be understood, interpreted and applied. An important aspect of this standard is the distinction made between ‘auditing standards’ and ‘auditing and assurance standards for other purposes’, which is significant for enforcement purposes.

In Australia, the AUASB drafts Australian Auditing Standards (ASAs) equivalent to ISAs (see ASA 101). The following points are noteworthy.

- Only Australian auditing standards have the ‘force of law’ — that is, they are legally enforceable.
 - The ASAs are written in the context of an audit of a ‘financial report’.
 - Where the ASAs diverge from the ISAs, these are identified by a paragraph reference ‘Aus x.x’ in the Australian standards.
- The ASAs also include some standards that do not exist at the international level, for example:

- ASRE 2415 *Review of a Financial Report: Company Limited by Guarantee or an Entity Reporting under the ACNC Act or Other Applicable Legislation or Regulation* (discussed below)
- ASAE 3100 *Compliance Engagements*
- ASAE 3150 *Assurance Engagements on Controls*
- ASAE 3450 *Assurance Engagements involving Corporate Fundraisings and/or Prospective Financial Information*
- ASAE 3500 *Performance Engagements*
- ASAE 3610/AWAS 2 *Assurance Engagements on General Purpose Water Accounting Reports*
- APES 310 *Client Monies*
- ASRS 4450 *Comfort Letter Engagements*.

These standards will be discussed further in module 5.

In Australia, changes to the Corporations Act led to the issue of ASRE 2415 which applies to:

- companies limited by guarantee
- an entity reporting under the *Australian Charities and Not-for-Profit Commission Act 2012* (Cwlth) (ACNC Act)
- entities required to report under other applicable legislation or regulation.

Under the changes in legislation, there is a three-tiered differential reporting framework for such entities (mainly not-for-profit entities). Entities in the first tier are exempt from preparing a financial report and are, therefore, not required to have the annual report audited. Entities in the second tier (with annual revenue between \$250 000 and \$1 million or with revenue below \$250 000 and that are a deductible gift recipient) must prepare a financial report that they can choose to have reviewed instead of audited. Under the third tier, entities must continue to prepare an audited financial report; prepare a streamlined directors' report, rather than a full directors' report; and are subject to a streamlined process for distributing the annual report to members.

QUESTION 1.18

Providers of corporate sustainability assurance reports often state that the work was performed in accordance with ISAE 3000 (Revised). Obtain a copy of each of these documents. Explain why ISAE 3000 would be useful in CSR assurance.

The key points covered in this part, and the learning objectives they align to, are below.

KEY POINTS

1.1 Apply the *International Framework for Assurance Engagements* (the Framework) and the related standards and other guidance to assurance engagements.

- Different standards are applicable to different types of assurance engagements.



- ISAs are applicable to all audit engagements. However, for smaller entities and less complex entities, applicability of ISAs is different.
- The role and objectives of auditors are different for private sector and public sector audits.
- The overarching standard to be applied to all assurance engagements other than audits or reviews of historical financial information is ISAE 3000 (Revised) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*.
- International Standards on Auditing (ISAs) are to be applied in the audit of historical financial information.
- International Standards on Review Engagements (ISREs) are to be applied in the review of historical financial information.
- International Standards on Assurance Engagements (ISAEs) are to be applied in assurance engagements other than audits or reviews of historical financial information.
- International Standards on Related Services (ISRSs) are to be applied to compilation engagements, agreed upon procedures and other related service engagements.
- ISRE 2410 covers reviews of interim and other financial information performed by the independent auditor of the entity, e.g. reviewing quarterly or half-yearly interim financial statements.
- ISRE 2400 (Revised) covers engagements to review financial statements performed by an assurance practitioner who is not the auditor of the entity.
- ISAE 3410 *Assurance Engagements on Greenhouse Gas Statements* is specific to the assurance of greenhouse gas statements.
- ISAE 3400 *The Examination of Prospective Financial Information* provides guidance on performing assurance engagements related to prospective financial information.
- ISAE 3420 *Assurance Engagements to Report on the Compilation of Pro Forma Financial Information Included in a Prospectus* provides guidance on performing assurance engagements on future-oriented information related

to pro forma financial information included in a prospectus.

- ISAE 3402 *Assurance Reports on Controls at a Service Organization* covers assurance engagements on controls.
- ASAE 3500 *Performance Engagements* covers assurance engagements related to the performance of an activity.
- ISRS 4400 *Engagements to Perform Agreed-Upon Procedures Regarding Financial Information* covers engagements where the auditor is engaged to issue a report of findings based on procedures agreed upon with specified parties.
- ISRS 4410 (Revised) *Compilation Engagements* provides guidance on compilation engagements involving the use of accounting expertise, as opposed to auditing expertise, to collect, classify and/or summarise financial information.

1.5 CHANGING ENVIRONMENT

Business is evolving rapidly in response to technological developments. Business models continue to evolve with changes to technology and the way business entities transact across the globe. As part of understanding the entity, the assurance team needs to understand how the business operates and creates value.

Another area that is changing is the growing demand for entities to disclose climate risks due to climate change. Assurance practitioners will assess the need for these disclosures when assessing the entity’s risks, after gaining an understanding of the business.

Developments in automation, artificial intelligence, big data, data analytics and blockchain technologies continue to provide better insights to management and improve business efficiency.

The following sections provide an overview of changes to the assurance environment due to evolving business models, climate-risk disclosure requirements and technological innovations.

EVOLVING BUSINESS MODELS

A **business model** describes everything about how a business creates and delivers value to its stakeholders. As such, business entities around the world use countless different business models. Many successful business entities adapt elements of existing business models, whereas others develop entirely new business models to respond to the needs of customers or changes to technology.

It is now commonplace for entities to diversify and expand their operations through mergers and acquisitions, making it difficult to classify their operations, for example, as manufacturing or intellectual property entities.

Business models need to continually evolve as entities react to changes by repositioning to avoid emerging risks and to seize opportunities. Over time, these changes may transform everything about the business model. In particular, an entity may change the way that it sells to its customers, and the way customers buy, in both business-to-consumer and business-to-business transactions. Some of this change is due to digitisation, as entities pursue new economic activities in virtual online markets (Sarson 2018).

However, technological disruption will continue to impact on an entity’s business model due to the fast pace at which new technologies are evolving. For example, advances in artificial intelligence and robotics make it difficult to predict how an entity will need to transform its business model to survive.

Some of the main business model innovations currently transforming the business world are next-generation outsourcing and offshoring, the freemium model, crowdsourcing, subscription models, online marketplaces, cloud solutions, on-demand, the gig economy and the sharing economy.

Gaining an understanding of the entity, including its business model, is important when planning an audit and assessing the risk of material misstatements. Rapid changes to the environment have led to business models continually evolving to enable entities to maintain a competitive advantage. As such, business models are discussed in module 2 as a component of obtaining knowledge of the entity’s business operations.

CLIMATE-RISK DISCLOSURE

Many entities in the Australian market, across a range of different industries, face risks due to climate change. The Task Force on Climate-related Financial Disclosures (TCFD), established in 2016 by the G20 Financial Stability Board, has made recommendations on the type of information that entities should disclose to provide stakeholders with a better understanding of the entity’s climate-related risk exposure. In doing so, the TCFD identified two main categories of climate-related risks.

1. *Transition risks* — transitioning to a lower-carbon economy may entail extensive policy, legal, technology and market changes to address mitigation and adaption requirements related to climate change.
2. *Physical risks* — physical risks resulting from climate change can be acute or chronic. Acute physical risks refer to those that are event-driven, including increased severity of extreme weather events, such as cyclones or floods. Chronic physical risks refer to longer-term shifts in climate patterns (e.g. sustained higher temperatures) that may cause sea level rises or chronic heat waves (ASIC 2018, p. 5).

The TCFD released its final report in June 2017, setting out a framework for voluntary, consistent climate-related financial disclosures. Also in 2017, the Senate Economics References Committee released a report acknowledging that climate change presented material risks to Australian businesses. In their report, they set out a number of recommendations around climate change, highlighting the importance of adequate climate-risk disclosure.

To date, the majority of climate change and climate-risk-related disclosure has been provided outside of statutory disclosure on a voluntary basis. Examples of voluntary disclosures include:

- disclosure under the TCFD recommendations
- the Carbon Disclosure Project (CDP)
- environmental, social and governance (ESG) sustainability policies.

However in April 2019, the AASB and AuASB republished a joint guidance document for ‘financial statement preparers and auditors on how to consider climate-related risks in the context of the financial statements, including their potential impact on the amounts recognised and associated disclosures’ (Thomson, Fikkers & Stott 2019, p. 1). Investors place importance on climate-related risks to their decision making thereby indicating that considering these risks requires materiality judgments. Therefore, entities should no longer consider voluntary disclosures of climate-related risks as adequate. Instead, entities should consider these risks in the context of their financial statements. Climate-related risks are likely to impact financial statements of certain industries more than others, such as transportation, resources, energy, agriculture, banks and insurers.

With this increased focus on climate-related risks, auditors need to consider climate-related risks during the risk assessment phase of an audit in accordance with ISA 315 (Revised). Consideration of climate-related risks during risk assessment when obtaining an understanding of the entity and its environment is discussed further in module 2.

In addition, auditors may need to consider such risks when assessing accounting estimates used by management in accordance with ISA 540 (Revised) *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. Auditors will need to substantiate climate-related risks disclosed in the financial statements

by entities to ensure the disclosures are appropriate given the uncertainty surrounding such risks (Thomson, Fikkers & Stott 2019).

If material climate-related disclosures are reflected in the financial statements, this information would be audited as part of the annual audit. Even though auditors read and consider other information presented in the annual report to look for material inconsistencies with the financial statements, this other information is not audited. When climate-related disclosures made outside the annual report (for example, in a sustainability report) are assured, ISAE 3000 (Revised) is applicable. The assurance of sustainability reports is discussed further in module 5.

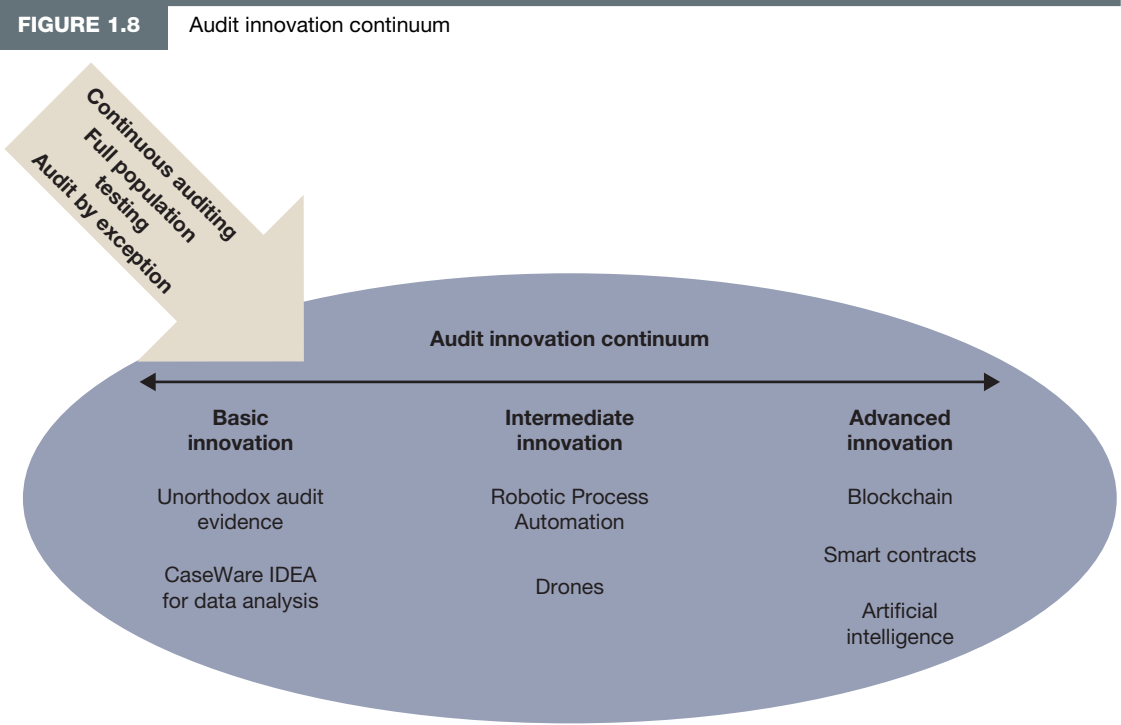
TECHNOLOGICAL INNOVATIONS

We live in a fast-moving global economy. There is much more complexity in the ways that businesses operate, and big data now provides huge amounts of information that conventional auditors with a historical snapshot approach may miss.

Developments in artificial intelligence (AI) have provided the opportunity to increasingly embed technology into the audit approach. For example, EY are developing a process of automation that provides the information needed to conduct the audit. This dramatically reduces the time clients spend supporting an audit, as well as the administrative time staff spend gathering the information. Instead, the auditors begin the process at the point they need to start applying judgment, thereby enhancing audit quality.

What this example indicates is that the auditing profession is definitely ripe for disruption. The profession has no choice but to adapt, and to do so quickly if it is to remain relevant and survive.

Entities are increasingly using disruptive technologies and big data to improve business practices. These technological innovations have the potential to fundamentally transform the financial reporting process and the way financial statements are audited. These innovations are illustrated in figure 1.8 as an audit innovation continuum. The fundamental characteristics of this continuum are continuous auditing, full population testing and audit by exception (Rozario 2019).



Source: Rozario 2019, p. 3.

As the use of technology-based data analytics becomes more prominent in financial statement audits, it is not difficult to imagine the potential use of more advanced innovation techniques in the conduct of audits. On one side of the continuum is basic innovation, which is the use of existing technologies and non-traditional sources of information. Data analytic tools such as CaseWare IDEA are used to perform audit procedures (discussed further in module 2).

In the central section of the continuum, new technologies, such as robotic process automation (RPA) and drones are used to modify the audit (discussed further later in this section). These tools are ideally suited to rules-based tasks and can achieve near end-to-end process automation.

On the opposite side of the continuum is advanced innovation, which includes the use of new technologies to redesign the audit. These technologies include blockchain and artificial intelligence, which are also discussed later in this section. These innovative technologies have the potential to substantially transform the audit process by executing unstructured, rules-based tasks, and storing audit information on a secure and distributed ledger.

These innovations have the potential to change the nature, timing and extent of audit procedures which is expected to improve audit quality.

In this section, we discuss how these innovative technologies are disrupting the business environment and impacting on the preparation and audit of financial statements.

Automation

Robotic process automation is a relatively simple and cheap approach to automating routine business processes. More ambitious automation projects, projects that involve re-engineering how processes work, or enterprise-wide automation projects may instead be built on artificial intelligence platforms and will often use application program interface (API) based automation to integrate with other systems.

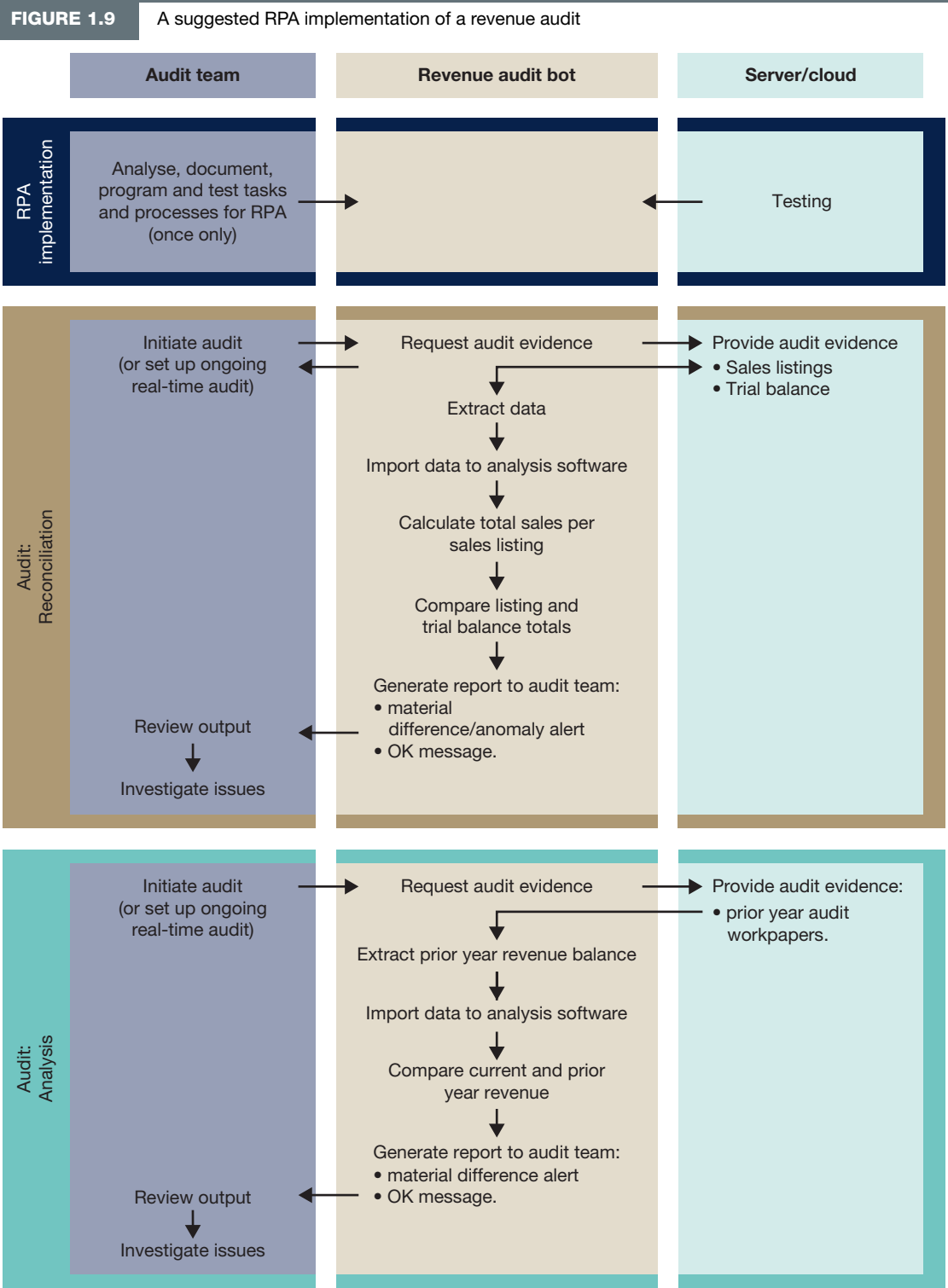
In accounting, software such as Xero, QuickBooks and Sage have APIs that allow third parties to connect their own applications to those accounting platforms. For example, an entity’s application for storing scanned documents can connect with QuickBooks via an API to provide the data from the documents to the records in QuickBooks. This avoids needing to export (or manually retype) data from the scanned documents and then uploading it to the accounting software.

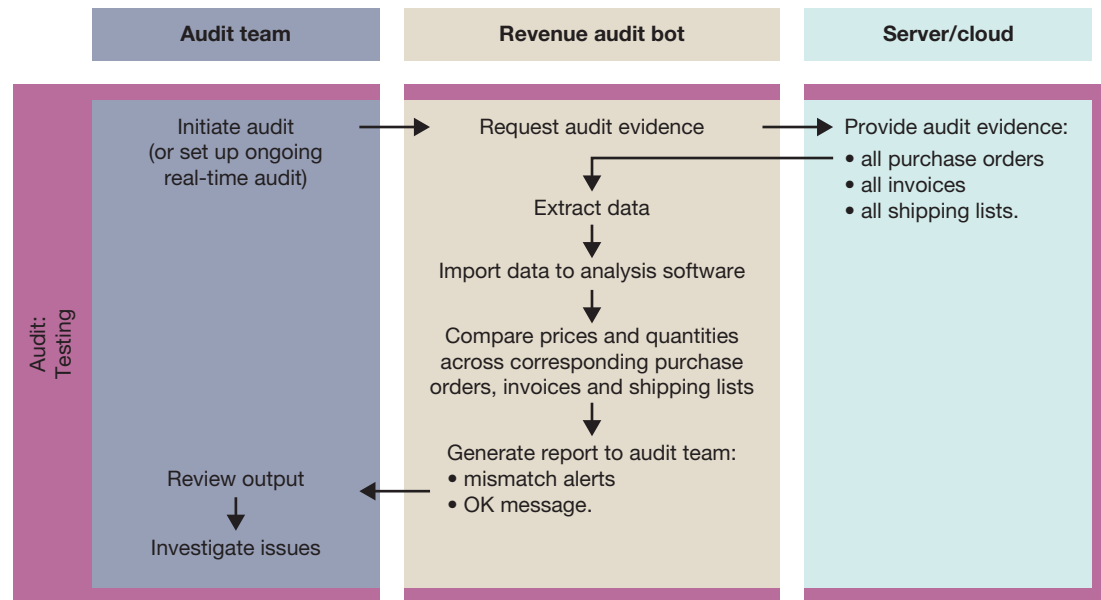
Examples of APIs in business are integrations with banking software, credit control applications, automated book-keeping systems and online payments.

Auditing is a mix of mechanical, rules-based tasks and professional judgment. Vasarhelyi and Rozario (2018) have provided an example of how the rules-based tasks could be implemented using robotic process automation (figure 1.9). They point out that by automating these types of tasks, auditors can spend more time using their professional judgment to analyse the difference and anomaly reports generated by the RPA software, resulting in an overall improvement in audit quality.

An RPA revenue audit could remotely log into a client’s systems to retrieve relevant data, such as current and prior year sales and the trial balance, total the sales and compare against the trial balance, then compare whether the total revenue amounts are materially different. If the difference exceeds a predetermined threshold, the system will generate an alert so the auditors can investigate further. Similar RPA can access and compare orders, shipping documents and invoices (Vasarhelyi & Rozario 2018).

An implementation of RPA involves understanding and defining each process, standardising data records so the system can compare data from different sources, and finally implementing RPA to run the processes on the data and generate alerts and on-demand reports (Vasarhelyi & Rozario 2018).





EXAMPLE 1.6

Automation of Accounts Payable Process

WNS Holdings Ltd (WNS) explored the potential for robotic process automation of the accounts payable process. A number of significant obstacles were found:

- inconsistencies among invoices
- imperfect optical character recognition
- invoices not supported by a purchase order
- discrepancies requiring communication and/or negotiation between organisations
- concerns that a coding error could create chaos.

Nevertheless, the accounts payable process is a mix of rules-based components and aspects that require judgment. If invoicing processes can be standardised, then the rules-based components can be automated and some other aspects can be managed by the system in combination with human input. Generally, any aspect requiring dealing with an external party (other than merely exchanging data) will at present require a human.

WNS said that near-term automation of accounts payable was likely to be the automation of the rules-based processes, essentially replacing human labour with a cheaper, faster and more accurate robot. However, it believes long term, RPA will continue to evolve and improve as analytics-enabled processes drive re-

engineering of processes rather than digital reproduction of existing ones.

WNS suggests a software robot can cost as little as one-ninth of a full-time human employee but works 20 times faster.

What is the likely impact that the automation of accounting processes will have on auditors when understanding an entity's accounting information system?

Check your response against the suggested answer at the end of the book.

Artificial Intelligence and Auditing

As we described earlier in relation to big data and blockchain, auditing is an area particularly suitable for the application of technology. By automating the mechanical checks involved in auditing, it has the potential to free up auditors to focus on complex areas requiring significant judgment and expertise. The use of big data and analytics can further increase audit efficiency and reduce risk. Artificial intelligence goes a step further than the automation technologies described earlier, in that it can act intelligently and deal with unstructured data, thereby making decisions or suggestions to the auditor. This reduces the need to filter and code data into standardised data formats. However, irrespective of the advancement in various technologies, some continue to argue that accounting is not just a set of rules and hence, artificial intelligence cannot replace human input. Accounting requires professional judgment to a degree that would make such complete automation impossible.

EXAMPLE 1.7

Use of Robotics to Catch Fraud in Expenses

The Association of Certified Fraud Examiners (ACFE) reports that only a small percentage of companies' expense reports are closely examined, resulting in over \$7 billion in annual losses from fraud. The ACFE's director of research says that, by using robots rather than random spot checks, companies can catch fraud more than twice as fast and cut their fraud losses in half. Business owners can now get a 100% overview of incoming employee expense reports using artificial intelligence tools such as SAP Concur's Concur Detect by AppZen, which only sends a charge for examination by a human auditor if it has a red flag.

Why is this important for auditors and their clients?

Check your response against the suggested answer at the end of the book.

Source: Adapted from Marks 2019; Pinsker 2019.

Big Data

One of the weaknesses of traditional auditing is the reliance on investigating only a sample of documentation and transactions. It is quite possible for an audit — although performed professionally and diligently — to fail to detect errors and fraudulent transactions amidst the mass of data available.

Big data refers to structured or unstructured data sets that are commonly described according to the four Vs.

- *Volume* — data sets are too large for traditional tools to analyse.
- *Variety* — different data formats such as quantitative, images, video, text-based etc.
- *Velocity* — frequency at which new data become rapidly available.
- *Veracity* — quality and relevance of the data changes dramatically over time (Gepp et al. 2018).

The auditing profession has access to a large and growing volume of data available in real time, much of which is automatically generated and captured by online processes and transactions.

Big data encompasses the techniques and technology used to draw inferences from the data. Often these techniques seek to infer relationships and causal effects from sparse data. Computer scientists approach big data as a method of uncovering patterns using algorithms to analyse all the data whereas statisticians treat data as observations of an underlying process and extract information using sampling to make inferences about the underlying process (Gepp et al. 2018). Insights into patterns and relationships will not only allow auditors to provide a bird eye view of the financials but also a thorough view of the accounting records. Focus on detecting fraudulent activities will also increase as auditors can now identify every transaction that deviates from the expected norm. However, research by Gepp et al. (2018) found that the use of big data techniques in auditing lagged behind its use in financial distress modelling, financial fraud modelling and stock market prediction. Some leading auditing firms have started adopting big data techniques in practice, but others are reluctant to adopt technologies that are yet to be adopted by their audit clients.

Challenges in adopting the technical advancements persist. More flexible models are used in big data as traditional structured regression models are unlikely to fit big data well. Algorithms used to analyse big data enable patterns to be identified that would not be possible using traditional statistical methods. Big data offers limited value unless it is processed and analysed so that meaningful conclusions can be drawn. Data analytics is the process of analysing data.

Data Analytics

Given the evolving environment, the Big Four firms in particular are investing in technology, especially data analytics, as a means of making the audit more effective and efficient. In a major study, *The future of assurance: how technology is transforming the audit*, the professional services firm Ernst & Young (EY) has made a number of predictions. The report highlights the following points.

- Technical advances in high-performance computing mean that audit teams can gain access to more client data than was ever before available to support the audit process.
- Advanced analytics and visualisation tools can enable auditors to concentrate their resources on high risk areas where more judgment is required.
- There are now greater expectations of the value of audit, not only from clients but also from regulators and investors, and auditors need to deliver.

Major business entities have recognised the opportunity that big data and analytics provide, and as a result are making significant investments to better understand their business, risks and opportunities. Data analytics is being increasingly discussed at the board of directors’ level. As clients continue to adopt data analytics in their business, they expect auditors to do the same. It becomes imperative for auditors to understand technological advancements for not only meeting client expectations but also for effective communication with them.

As noted in an EY publication, ‘How big data and analytics are transforming the audit’:

... the transformed audit will expand beyond sample-based testing to include analysis of entire populations of audit-relevant data (transaction activity and master data from key business processes), using intelligent analytics to deliver a higher quality of audit evidence and more relevant business insights. Big data and analytics are enabling auditors to better identify financial reporting, fraud and operational business risks and tailor their approach to deliver a more relevant audit.

EY also notes that:

It's a massive leap to go from traditional audit approaches to one that fully integrates big data and analytics in a seamless manner ... while the profession has long recognized the impact of data analysis on enhancing the quality and relevance of the audit, mainstream use of this technique has been hampered due to a lack of efficient technology solutions, problems with data capture and concerns about privacy. However, recent technology advancements in big data and analytics are providing an opportunity to rethink the way in which an audit is executed.

Overall, big data and analytics is providing opportunities to rethink how an audit is performed. In some ways, the audit does not change. The auditor must still audit the same assertions, must still understand the business and industry, and must still understand an entity's system of internal control. However, technology allows the auditor to rethink how risks are assessed and how audit tests are performed. However, simply utilising a small team of data analysts is not recommended when attempting to utilise data analytics on a large scale and in new ways. Individuals with data analytics skills need to be fully integrated with the rest of the audit team so new opportunities for risk analysis and substantive testing can be identified and utilised. An understanding of what data analytics techniques can offer audit firms is essential for every member of the audit firm that influences the audit.

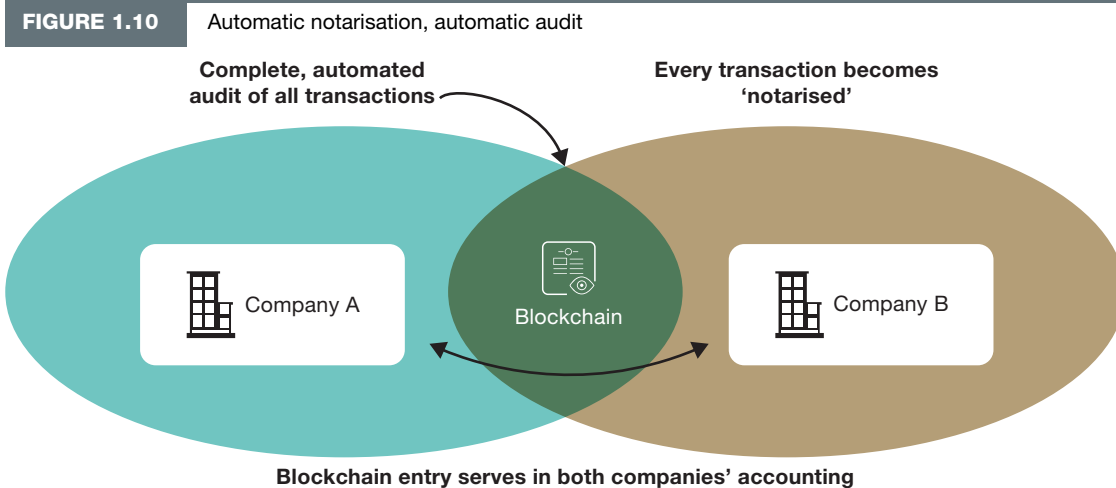
Blockchain

Blockchain is a type of distributed ledger technology that some say has the potential to disrupt and transform entire industries. Blockchain technology uses the concept of peer consensus on a computer network to create an immutable, decentralised public ledger without the need for a central trusted authority.

The blockchain functions as an open ledger that can record transactions in a way that is efficient, verifiable and permanent. This sharply differentiates blockchain technology from other database technologies and from the separate private ledgers maintained within business entities.

Implementing blockchain provides entities with the opportunity to write their transactions directly into a joint register. This could replace separate records based on transaction receipts and would create an interlocking system of enduring accounting records. Since all entries in a blockchain are distributed and cryptographically sealed, falsifying or destroying them is practically impossible. It is similar to the transaction being verified by a notary — only in an electronic and automatic way (figure 1.10) (Andersen 2016).

Standardisation would allow auditors to verify a large portion — or even all — of the most important data behind the financial statements automatically and at any point in time, or even continuously, rather than periodically as currently occurs. The cost and time necessary to conduct an audit — including the need to involve a company's accountants for



Source: CPA 2019.

long periods — would decline considerably. Machine learning could also be used to interrogate transactions in real time in order to alert auditors to anomalies or other incidents requiring investigation (Haimes 2018).

At present, cryptocurrencies, such as Bitcoin, are the best known and most widely adopted application of blockchain technology, but increasingly, the financial sector and other industries are investigating and experimenting with other blockchain applications. Blockchain technology has various potential advantages for specific uses in accounting, but at present, such proposed uses remain largely theoretical. However, a shift towards any of these would clearly represent a major disruptive event in the accounting industry.

Due to data security concerns and businesses' preference for control, an alternative — more likely — application of blockchain is in a permissioned or private network where only trusted parties are able to participate. Alternatively, blockchain data structures may merely be used as another database approach, recording information in ways that largely mirror current processes.

Auditors will need to understand blockchain technology as it is implemented by their clients because it has the potential to impact all record-keeping processes. As new techniques and procedures emerge with the use of blockchain, the auditor's role may continue to change. For example, 'methods for obtaining sufficient appropriate audit evidence will need to consider both traditional stand-alone general ledgers as well as blockchain ledgers' (Bible et al. 2017, p. 2). In addition, more efficient data extraction and analysis may be possible due to greater standardisation and transparency in reporting and accounting using blockchain technology.

Overall, the use of blockchain technology will result in multiple benefits to businesses and the accounting profession.

- Blockchain-based accounting systems could greatly expand the scope and quality of information able to be captured within accounting systems. As a distributed, tamper-proof ledger, a well-designed blockchain doesn't just cut out intermediaries, reduce costs, and increase speed and reach, it also offers greater transparency and traceability for many business processes.
- Smart contracts hosted in a blockchain give rise to the ability to invoke and record the transactions automatically. The automated nature of record keeping reduces the costs and risks of errors or fraud encountered in manual record keeping and also reduces the associated costs (Carlin 2018).
- By capturing each transaction, and all relevant supporting documents and associated data in time-stamped records in the blockchain, the entire life of every accounting incident can be captured. Entire business processes — including accounting processes, but also numerous other dealings, such as the supply

chain — spanning over multiple departments or companies, become easily traceable (Andersen 2016; O’Leary 2017).

As a result, blockchain technology can further enhance audit efficiency and effectiveness. Big data and analytics offer the potential of auditing 100% of an entity’s transactions. Blockchain technology can further contribute by preventing records from being changed, falsified or destroyed.

The key points covered in this part, and the learning objectives they align to, are below.

KEY POINTS

1.1 Apply the *International Framework for Assurance Engagements (the Framework)* and the related standards and other guidance to assurance engagements.

- Gaining an understanding of the entity, including its business model, is important when planning an audit and assessing the risk of material misstatements. Rapid changes to the environment have led to business models continually evolving to enable entities to maintain a competitive advantage.
- The majority of climate change and climate-risk-related disclosure provided to date have been provided on a voluntary basis.
- With an increased focus on climate-related risks, auditors need to consider climate-related risks during the risk assessment phase of an audit, in accordance with ISA 315 (Revised).
- By automating rules-based tasks, auditors can spend more time using their professional judgment to analyse the difference and anomaly reports generated by the RPA software, resulting in an overall improvement in audit quality.
- Insights into patterns and relationships possible with the use of big data will not only allow auditors to provide a bird’s eye view of the financials but also a thorough view of the accounting records.
- Technology allows the auditor to rethink how risks are assessed and how audit tests are performed.
- Implementing blockchain provides entities with the opportunity to write their transactions directly into a joint register. This could replace separate records based on transaction receipts and would create an interlocking system of enduring accounting records.
- With the fast developing technologies such as blockchain, big data and analytics, the future of audit



will be very different from what it is today.

- Standard-setters, regulators, educators and the professionals will need to challenge their mindset and continuously seek solutions to arising issues.

REVIEW

This module started by providing an overview of the current assurance environment, including the regulation of auditing in Australia. It then discussed the development of the *International Framework for Assurance Engagements* (the Framework) that shapes auditing and other assurance engagements.

Following the structure of the Framework, the module introduced the key matters pertaining to an assurance engagement, including:

- ethical principles — including requirements set out in the Code
- quality control standards — including ISQC 1 requirements
- description of assurance engagements
- attestation and direct engagements
- reasonable and limited assurance engagements
- scope of the Framework
- elements of an assurance engagement:
 - three-party relationship
 - underlying subject matter
 - criteria
 - evidence
 - assurance report.

The discussion of evidence emphasised the importance of professional scepticism and professional judgment in collecting and evaluating evidence. Expanding on various types of assurance engagements, this module distinguished between audits of historical financial statements, audits of specialised areas, review engagements, historical non-financial reports assurance, future-oriented information assurance, assurance on systems and processes, assurance on aspects of behaviour and performance of an activity.

The module then discussed the application of standards to different types of entities, including private sector, public sector and small and medium-sized entities. The typical mandates of auditors-general in Australia and Hong Kong were also discussed briefly.

The final section outlined the impact a changing environment is having on auditing. The challenges faced by the audit profession due to evolving business models, enhanced disclosure requirements related to climate-risks and the incorporation of technological innovations, which are impacting on auditors when gaining an understanding of the entity and its environment, were discussed.

WESTERWAYS CASE STUDY ACTIVITY

The Accounting Firm and the Audit of Westerways Pty Ltd

When Westerways Pty Ltd was founded, Campbell Lee Taylor was a three-partner firm of accountants in public practice. Ray Campbell was the firm’s audit specialist, Alina Lee its tax and financial planning specialist, and Anne Taylor its specialist

in business systems consulting. The firm had developed a good clientele over the previous 12 years. It employed 14 young professional staff and 4 secretarial and administrative staff. Five of the professional staff spent much of their time on audit work. One of these, Fiona Kerr, had four years' experience in audit work and was in charge of some of the larger audits under Ray Campbell.

Ray Campbell had known Len Lewis for many years and had performed various professional services for him, including the audit of three of his businesses, a motor vehicle agency, a farm machinery agency, and an engineering works, each of which has branches in Arnton and nearby towns. He knew him to be a good business manager and had always had good relations with him. He did not know Mark Valenti. Nearly four years ago, Len Lewis first approached Ray to perform the audit of the annual financial statements of the new business that Mark Valenti was setting up assisted by Len's finance.

The CLT audit clients included various agricultural, engineering, wholesale and service companies, as well as the Lewis motor vehicle and farm machinery agencies, but, as it happened, no retail stores. The partners decided that they should not turn down an opportunity to move into retail store auditing and accepted the job.

Ray needed evidence that he would be taking on a client that brought in a satisfactory fee income for the firm and would not damage the firm's professional reputation. He therefore interviewed Len Lewis about the proposed business and the entrepreneurs. Later, Len called in Mark and Joy Valenti and Ray interviewed them also. With the permission of Len Lewis and the Valentis, the discussion was recorded and the Minutes in Appendix 1 in the end-of-book case study contains a transcript of part of the discussions.

Additional Services for the New Company

In the first few months of the company's existence, CLT performed a number of professional services for its directors. Ray Campbell, who made the contact, passed the company establishment services to his partners. Alina Lee, Corporate Services partner, had one of her division's staff work with the Westerways to prepare a financial plan, as well as to register the company for administration and taxation purposes. Business Consulting partner, Anne Taylor, having assessed the company's immediate needs and growth



prospects, advertised for proposals for an accounting system, analysed the submissions, and passed on two proposals for consideration by the Valentis. They chose *OurBiz*, a system developed by System Solutions Ltd (SSL), a Ventura-based I.T. firm. Through periodic visits, she monitored the installation of the system and the training provided until she was sure, after two months, that the Valentis were using the system effectively.

The CLT tax and planning division prepared the company's tax returns in subsequent years and in the first year provided some assistance with the budget. When the Westerways directors decided in mid 20X7 to set up another store in Tannam, the same division assisted with the financial planning. No further information system services were required from CLT because *OurBiz* had proved to be a satisfactory system and Westerways negotiated with SSL system expansions involving new hardware and software for the new store's LAN and some upgrading of the Arnton LAN to allow access to the Tannam system by modem from the Arnton system for inquiry and data transfer.

Professional Integrity and Independence

CLT recognise that they have ethical responsibilities as professional accountants and auditors. They must be competent to perform the audit, possessing both the skills required and the staff available at the times required. They must have a high degree of integrity based on the principle that, as professional accountants in public practice, their task is to serve the community and for that purpose to put service before profit.

The partners of CLT are very conscious of their need to be, and to appear to be, independent of the companies they audit. They know that in their audit work they must be entirely objective with respect to the company and its management. This is because an auditor, even though dealing from day to day with the management, and in practice normally agreeing the audit fee with the management, is actually working primarily for the benefit of the shareholders and other parties external to the company, such as lenders to it.

In accordance with professional guidelines, the firm for each audit client analyses the threats to its independence. The threats are as follows.

- *Self-interest*. The loss of the firm's objectivity from financial or related reasons.

- *Self-review*. The loss of its objectivity through situations of reviewing its own work.
- *Advocacy*. The loss of its objectivity through development of a ‘pro-client’ state of mind.
- *Familiarity*. The loss of its objectivity through becoming too close to the client.
- *Intimidation*. The loss of objectivity through pressure from client management.

Then, following professional guidelines, CLT make use of a variety of methods to offset these threats. As general safeguards, the partners never allow themselves to rely on one client or set of related clients (including staff of an audit client) for more than 10% of their fee income in a year. The partners lead their staff by themselves participating in staff development seminars containing discussion of ethical issues. Every six months, the firm circulates a document containing a list of all audit clients, and all partners and staff are required to respond by submitting a statement of any financial or other interests (e.g. a relative working for a client) that might threaten the firm’s independence or appearance of independence with respect to any of the clients. The firm also has policies on assignment of staff; for example, staff in Audit Division may perform assurance or other compliance services, such as taxation work, but do not perform consulting services.

Using the information provided above, and within the Westerways case study at the end of the Study Guide, complete the following tasks.

CASE STUDY TASKS

1. Using part 3 Professional accountants in public practice of IESBA’s *International Code of Ethics for Professional Accountants (Including International Independence Standards)* (the Code) as guidance, outline the evidence provided in the case study that demonstrates whether Campbell Lee Taylor (CLT) considered the following specific issues before accepting the Westerways audit for the first time.
 - Issue 1. Conflict of interest — objectivity
 - Issue 2. Professional appointments — integrity and/or professional behaviour
 - Issue 3. Professional appointments — professional competence and due care



- Issue 4. Fees and other types of remuneration — professional competence and due care.

Complete the Campbell Lee Taylor standard audit working paper, IF1-EPI.

Hint: Read the memorandum contained in Appendix 1 for additional background information.

2. Identify the five essential elements of the Westerways assurance engagement in accordance with the International Framework for Assurance Engagements.

Note: Working papers are available in Appendix 9 at the end of the case study information provided in the Study Guide.

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