ACC707: Auditing and Assurance
Tutorial 1: Suggested Solution

Question 1: What is audit and what an audit does?
Answer: An audit is a systematic process of objectively obtaining and evaluating evidence regarding the assertions made about the economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested party.

Or simply, an audit is an objective examination and evaluation of company financial statements.

Or Audit is the independent review and examination of records and activities to assess the adequacy of system controls, to ensure compliance with established policies and operational procedures, and to recommend necessary changes.

What an audit does?
An audit enables auditor to express an opinion on the financial report. In order to express an opinion, auditor must obtain sufficient evidence to validate management assertions and ensure economic events are appropriately communicated to users.
Generally, an audit involved three main elements,

(1) Substantial risk assessment -where auditor build up a detailed understanding of the business so that they can highlight and assess the key areas in the financial statements most at risk of material misstatement

(2) Evidence gathering- which focusing on their efforts on the identifying high risk areas and

(3) Reporting- where auditor report their opinion to the shareholders.

Question 2: Explain how agency theory results in the demand for audit?
Answer: In an agency relationship, investors (as principals) entrusted their resources to managers (as agents). The agent's self-interest is expected to diverge from the principals' interest, giving rise to agency costs. A consequence of this agency problem is that investors will "price protect" themselves on the assumption that managers are acting for themselves. It is therefore a rational response that there is a demand for a financial statement audit to verify the assertions made by management.

Question 3: Explain how corporate collapses influences auditing role?
Answers: The corporate collapses in the US and Australia have had a fundamental impact on the role of auditing in recent years. Recent events have led to closer public scrutiny on the role of the auditor, audit independence and the methodology on how an audit is carried out.
Significant changes had been made to emphasise the following;

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

Question 4: Discuss auditor independence?
Answer: Auditor independence refers to the independence of auditor. It is characterised by integrity and requires the auditor to carry out his/her work freely and in an objective manner.

There are two important aspect of auditor independence which must be distinguish from each other
1. Independence in fact - The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional scepticism.

Example of Independence in fact would be an auditor auditing a firm where his/her son owning a share -

2. Independence in appearance - The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional scepticism had been compromised

Example would be other people would think that the auditor is biased because he/she is auditing the company where his/her son had share in it. Even though the auditor might have the state of mind being independence in fact, people will see it a bias and that is independence is appearance

Threat to Independence
Auditors are expected to provide an unbiased and professional opinion on the work that they audit.
There are the five things that can potentially compromise the independence of auditors:

1. Self-Interest Threat
A self-interest threat exists if the auditor holds a direct or indirect financial interest in the company or depends on the client for a major fee that is outstanding. For example, the audit team is preparing to conduct its 2020 audit for ABC Company. However, the audit team has not received its audit fees from ABC Company for its 2019 audit.

Issue: The audit team might be tempted to issue a favourable report so that the company is able to secure a loan to settle the fees outstanding for their 2019 audit.

2. Self-Review Threat
A self-review threat exists if the auditor is auditing his own work or work that is done by others in the same firm. Example, the auditor prepares the financial statements for ABC Company while also serving as the auditor for ABC Company.

Issue: By having the auditor review his or her own work, the auditor cannot be expected to form an unbiased opinion on the financial statements.

3. Advocacy Threat

An advocacy threat exists if the auditor is involved in promoting the client, to the point where their objectivity is potentially compromised. For example, the auditor is assisting in selling ABC Company while also serving as the auditor for the company.

Issue: The auditor may issue a favourable report to increase the sale price of ABC Company.

4. Familiarity Threat

A familiarity threat exists if the auditor is too personally close to or familiar with employees, officers, or directors of the client company. For example, ABC Company has been audited by the same auditor for over 10 years and the auditor regularly plays golf with the CEO and CFO of ABC Company.

Issue: The auditor may have become too familiar with the client and, thus, lack objectivity in their work.

5. Intimidation Threat

An intimidation threat exists if the auditor is intimidated by management or its directors to the point that they are deterred from acting objectively. For example, ABC Company is unhappy with the conclusion of the audit report and threatens to switch auditors next year. ABC Company is the biggest client of the auditor.

Issue: The auditor's independence may be compromised, as ABC Company is their biggest client and they, quite naturally, do not want to lose such a client. Therefore, the auditor may issue a report that appeases ABC Company.

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Tutorial 2: Suggested Solution

1. What is earning management? How do you think the concept of earning management might have influence the auditor's role in the audit of financial statement?

Answer: Earning management occurs when the management manipulates financial statements and transactions in order to influence the public's perception about the economic performance of the entity.

Common earning management techniques are accruals, revenue recognition, restructuring charges, estimation of liabilities, delaying sales, manipulating research and development write off and so on.

Incentives for earning management are inherent in the management structure and culture. They can be result of political considerations, executive's remuneration, ambiguity and complexity of accounting standards, financial distress, market expectations, analysts forecast and management transactions. In extreme cases, earning management can amount to fraud.

Earning management played a big part in contributing recent audit failures. The auditor's role has changed quite significantly, with increasing audit resources and techniques in place to focus on detecting earnings management practices. Auditors are playing a more active role in gaining knowledge of its audit client's business risks, which help setting up the most appropriate audit approach.

ASA240 also recommends auditor to carry out a greater number of procedures to enhance the prospects of detecting material financial misstatements resulting from fraud and earning management practices.

2. Discuss Audit Committee and Board of Directors in Corporate Governance.

Answer: The audit committee plays a key role in enhancing corporate governance and the accountability of an organisation. The main objectives of an effective audit committee include the following;

• Assisting the Board of directors to discharge their responsibilities with due care, diligent and skill; in particular, the audit committee is concerned with

  o Financial statements and other financial and non-financial information

  o The appropriateness of accounting policies used

  o Adequacy of financial management policies and procedure

  o Proper risk management plan and processes

  o Business practice

  o Protection of assets, including intellectual property

  o Compliance with relevant laws, regulations, standards, and best practice guidelines.

• Improve the credibility and objectivity of the accounting process

• Improve the effectiveness of the internal and external audit function and provide an objective forum for improving communication between board and the internal and external auditors.

• Facilitate the independence of the internal and external auditors

• Strengthen the role and influence of non- executive directors

• Fostering an ethical culture throughout the organisation.

3. What does Australia Security Exchange (ASX) suggest should be make-up of an audit committee?

Answer: ASX suggest that an audit committee should consist of only non-executive directors, a majority of independent directors, an independent chairperson who is no the chairperson of the board and at least three members.

4. Should the Internal Auditor report to the Director Finance or Board audit committee/Board of Directors? Give reasons

Answer: It would be inappropriate for the internal auditor report to the Director Finance as it is likely that many of the area under review or investigation will be the responsibility of the Director Finance who could choose to suppress reports that failing in his department.

Reporting to the Board Audit Committee would ensure that reports are tabled at the highest level and cannot be stopped by the Director of Finance. Any deficiencies of internal control will therefore have to be considered and addressed.

It is therefore very important to have board audit committee made up of non-executive directors with financial expertise who could assess the internal audit reports.

5. What are the differences between the independence of internal auditor and that of an external auditor? How can an internal auditor be truly independent?

Answers: Independent for internal auditors differs from the external auditor's because internal auditors are employees of the companies they audit. Independence is achieved through organisational status and objectivity. Some ways to enhancing independence are:

• The chief internal audit executive is responsible to an individual in the organisation with sufficient authority to promote independence and to ensure broad audit coverage and adequate consideration of an audit reports, and appropriate action on audit recommendations.

• The Chief internal audit executive has direct communication with the board of directors and the audit committee.

• The internal audit department has a formal charter that defines its purpose, authority and responsibility.

6. What is meant by economy, efficient and effectiveness in relation to a performance audit?

Answer: The term 'economy', 'efficiency' and 'effectiveness' are defined in Standard of Engagement Assurance ASAE3500 Performance Engagement as follows;

• Economy- means the acquisition of the appropriate quality and quantity of resource at the appropriate times and at the lowest cost

• Efficiency – means the use of resource such that output is optimised for any given set of resource inputs or input is minimised for any given quantity of output.

• Effectiveness- means the achievement of the objectives or other intended effects of activities at a program or entity level.

7. Discuss the work of the audit committee in enhancing corporate governance.

8. What are the five (5) phases to an operational audit? Briefly describe each phase

Answer

I. Preliminary Preparation- In this phase the auditor gains a comprehensive understanding of the organisation's structure, characteristics, history, policies and operation. Documents such as flow charts are prepared

II. Field Survey- In the second phase, problem areas and sensitive issues are identified through probing questions, observations, and inspections.

III. Program Development – The auditor then develops a detailed audit plan, with objectives and a step by step program. The audit plan should detail outcomes expected so that benchmarks and expectations are assessed.

IV. Audit application- Once the auditor is satisfied with the program, application of the program is done through detailed review of problem areas, sensitive activities and crucial operations. The measurement of the actual performance of the operations is based on how predetermined criteria such as stated productivity, budgets or externally generated standards are met. Performance is analysed to determine the degree to which criteria are satisfied.

V. Reporting and follow up- An operational audit report may include a statement of the objective and scope of the audit, a description of the work carried out, a summary of the findings, the auditor's discussion and comments about the findings, recommendation for improvement, and follow up mechanisms. The operational audit report should be sent to senior management and to the board audit committee. The auditor should ensure that further discussions on the auditee's responses, future improvements and issues take place so that proper improvements are implemented and monitored.

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Tutorial 3: Suggested Solution

Question 1: How is ethical behaviour related to organisation success?

Answers: History shows that companies with strong corporate governance and high ethical standards generally perform better than those with weak corporate governance and low level of ethical expectations. Further these companies typically have higher quality financial discourse.

Question 2: Why ethical behaviour by auditors required to justify the public's trust in the profession?

Answers: Auditors add value to the financial markets by providing an independent assessment of the reliability of the client's financial report. That independent assessment is only valued by the public to the extent that the auditors providing it have acted, and are perceived to have acted, with the highest level of integrity and ethics.

Question 3: Why is independent considered most important characteristics of an auditor?

Answer: Without independence, the work product of public accountant would be worthless. Public accountants are expected to judge the truth and fairness of the information to which they are attesting. If public accountants were not independent, the users of the financial reports would have no reason to believe the truth and fairness of the financial report any more than if the report had not been audited.

Question 4: What can a public accounting firm do to manage the threat to independence? Explain why each approach you listed should be effective and how it would be implemented.

Answer: Public accounting firm can manage the threat to independence in several ways;

• Establishing a strong code of conduct that reinforced by firm's senior personnel and with appropriate action when the conduct is violated.

• Providing compensation package that do not place attracting and keeping clients ahead of performing quality audit.

• Having a high-level committee evaluate the acceptance and retention of clients based on risk model rather than just on increasing revenue.

• Separation of audit service from other service that could impair independence. Separation can take by separating the audit function from the consulting function within the firm.

• Requiring a quality review of each audit during the audit and before issuing the audit opinion. Knowing your work will be reviewed for quality during and at the end of the audit provides motivation to perform a quality audit.

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Chapter 4: Quality and Standards of assurance engagement.

Tutorial 5: Suggested Solution

Multiple Choice Questions

1. Under the Framework for Assurance Engagements, which of these is one of the type of assurance engagement

A. Partial assurance

B. Absolute assurance

C. Reasonable assurance

D. All are types of assurance engagement.

2. An assurance engagement as compared to a non-assurance engagement, requires;

A. an opinion to be provided

B. a positive not negative opinion

C. the assurance practitioner to reduce the assurance risk to a level is appropriate to the engagement

D. all of the above

3. A negative opinion is a limited assurance engagement;

A. Is not as strong as a positive opinion

B. Normally is not based on detailed sustentative or control testing

C. Express the opinion that nothing has come to the attention of the practitioner to suggest that the outcome is not in compliance with the criteria.

D. All of the above are true concerning negative opinion.

4. Auditors may be asked to give an audit opinion on only one part of a financial report based on historical financial information. This includes all of the following except for;

A. a statement of financial position

B. forecast information in support of a bank loan application

C. accounts receivables

D. provisions for income taxes

5. When an auditor performs a review of an interim financial report which of the following steps would not part of the review;

A. A review of rations and trend

B. Testing of computer controls

C. Reading the minutes of the shareholders' meeting

D. Inquiry of management

Long Answers

Question 6: Define an assurance and list its characteristics?

Answers: An assurance engagement is "an engagement in which a practitioner express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement for a subject matter against criteria.

An assurance engagement has the following characteristics;

• An identifiable subject matter which is capable of consistent evaluation or measurement against a set of identifiable criteria; the subject matter should be in a form suitable for the gathering of evidence.

• A set of suitable criteria, available to the intended users

• Sufficient evidence in support of the practitioner's conclusion

• A written assurance report of the practitioner's conclusion, in a form appropriate to either an audit-level engagement or a review -level engagement.

Question 7: Briefly outline the difference between compliance engagement and performance engagements

Answers: Organisation 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

Performance engagements involve obtaining and evaluating evidence about the efficiency, economy and effectiveness of an entity's operating activities in relation to specified objectives. The organisation may wish for any of their processes to be investigated to ensure maximising performance. The difficulties for the auditor in these engagements relates to the appropriateness of the subject criteria of the subject matter and the suitability of the criteria. The auditor needs to determine if the activity being tested (subject matter) is capable of consistent measurement to ensure that procedure can be applied to allow sufficient and appropriate evidence is obtained. The other issue is the criteria against which the activity is to be measured; it may be difficult to establish what actually constitute appropriate benchmarks against which to compare the activity.

Question 8: Describe the difference between a reasonable assurance engagement and a limited assurance engagement.

Answer: The objective of both a reasonable assurance a limited assurance engagement is the reduction in assurance engagement risk to a level that is acceptable to the circumstances of the engagement. A reasonable assurance engagement will have a lower level of acceptable engagement risk as the basis for a positive form of the practitioner's conclusion.

Both forms of engagement use evidence gathering procedures to obtain sufficient appropriate evidence. However, a reasonable assurance engagement will require more procedures in order to support the positive form of expression of the practitioner's conclusion.

The main difference between the two engagements is in the assurance report. A reasonable assurance engagement will have a positive form of expression of the conclusion. A limited assurance engagement will have a negative form of the conclusion. The procedure necessary to support the positive expression result in a higher level of assurance for the reasonable assurance engagement.

Chapter 5: Overview of the audit of financial report
Tutorial 6: Questions

Multiple Choice Questions
1. The Corporations Act requires that auditors are competent. To be suitably qualified the person must:

A. Be a fit and proper person to be registered as an auditor

B. Be a member of recognised professional accounting bodies or CPA, the institute of public accountants or other prescribed body

C. Hold a degree, a diploma or certificate from a university or a prescribed body

D. All of the above

2. The removal and resignation of auditors must be

A. A resolution of the company

B. With special notice to ASIC for its consent

C. Both A and B

D. None of the above

3. It is regarded as best practice in regard to the composition of audit committee to:

A. Have an executive director as chairperson.

B. Have the internal auditor as a member.

C. Have the external auditor as a member.

D. None of the above are regarded as best practice in regards to the composition of audit committees.

4. The group which has the legal responsibility for removal of the auditor is

A. Management.

B. The shareholders.

C. The audit committee.

D. The board of directors.

5. The work of an internal auditor can be used to compliment, but not substitute for, the work of external auditor. Which of the following factors is not one of the considerations listed by ASA 610 that relevant in determining the effect of an internal auditor's work on the audit?

A. Past communications of internal auditors with management.

B. The organisation status.

C. The scope of work.

D. Technical training and proficiency of the internal auditor.

Long Answers
Question 6: Identify and explain two of the limitations of audited financial statements

Question 7: ABC Ltd recently established an audit committee in compliance with the Australian Stock Exchange Listing requirements. The committee is made up of Ian Wright, John Small and Todd Smith. Ian is an executive of the company and has worked his way up from a factory worker through management. Ian is the chairperson of the audit committee. John is not a member of management and is therefore a non-executive director, but he does serve on a number of boards. John's background is an accounting and before he became a director he was the CFO of a large corporation for many years.

Todd is the chairperson of the board of directors and he is an executive of the company. Todd's background is in manufacturing and has been with the current company for 5 years.
The committee has just completed having its formal charter drawn up which details its rights and responsibilities.
Identify the strengths and weakness of ABC's Ltd.'s audit committee?

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Chapter 7: Client evaluation and planning the audit.

Tutorial 6: Questions

Multiple Choice Questions

1. In accepting an engagement, an auditor takes on professional responsibilities to:

A. The public. B. The client.

C. The client and the public. **D. The public, the client and other members of the profession.**

2. The auditor should regularly evaluate clients in respect of specified events to determine whether to continue the relationship. Which of the following is not a specified event that should prompt an evaluation?

A. the expiration of a time period. B. a significant change in the business.

C. a change in the audit partner.

D. the existence of conditions that would lead to the auditor to reject a client had those conditions existed at the time of the initial acceptance of the audit engagement.

3. In the investigation of a potential new client, beside inquiring of the existing auditor, the prospective auditor should make inquires of other third parties. Which of the following is least likely to be included in this inquiry?

A. Banker **B. Customers**

C. Chamber of Commerce/ Company Registration D. Legal advisers/solicitors

4. Which of these is not an ethical consideration for the auditor in deciding whether to accept an audit engagement?

A. identifying intended users of the financial statements.

B. evaluates circumstances that would compromise their independence.

C. assessing their competence to perform the audit

D. determine their ability to use due care in performing audit.

5. Which of these would not be part of a typical audit team?

A. an audit Manager. **B. internal auditor.**

C. an audit partner. D. an audit senior.

Long Answers

Question 6: Identify the primary considerations that apply to accepting an audit engagement. For each consideration, indicate the primary steps involved in the decision to accept or reject the engagement.

Question 7: To adequately plan an audit, the auditor should obtain sufficient knowledge of the entity and its selection and application of accounting policies. This includes obtaining knowledge about the entity's business operation, investments, financing and financial reporting and accounting practices.

For each of these areas, list two activities that the auditor would need to gain an understanding of.

Business operations:

–The auditor needs to gain knowledge of:

• Method of obtaining revenues (retailing, banking etc.)

•Products or services and markets

•Conduct of operations

•Location of production facilities, warehouses and offices

•Employment and transactions with related parties.

Business operations:

–Knowledge of business operations

•Influences the selection and application of accounting

•Policies helps auditor to:

–Develop a knowledgeable perspective about financial amounts and disclosures specific to the entity

–Identify significant inherent risks and related parties.

Investments:

–Capital investment activities, including investments in plant and equipment, technology, and any recent or planned changes

–Acquisitions, mergers or disposals of business activities

–Investments and disposition of securities and loans

–Non-consolidated activities such as partnerships, joint ventures, and special-purpose entities.

Financing:

–Debt structure including covenants, restrictions, guarantees and off-balance-sheet financing arrangements

–Group structure –major subsidiaries and associated entities

–Leasing of property, plant and equipment for use in the business

–Beneficial owners

–Use of derivate financial instruments.

Financial reporting and accounting practices:

–Accounting principles and industry-specific practices

–Revenue recognition practices

–Accounting for fair values

–Inventories

–Industry-specific significant accounts and transaction classes

–Accounting for unusual or complex transactions

–Financial statement presentation and disclosure.