Test will cover weeks 1-5 and consist of 40 multi-choice questions

**Week 1- Course book readings**

**Auditing**
Assurance service which improves the quality of information presented in the financial statements or its context by having examined evidence about the assertions making up the financial statements and convinced management to make changes that improve the accuracy and informativeness of financial statements

- More credible and more reliable information

Auditing is necessary because financial reporting misstatements are dangerous and also because the public lacks technical knowledge to be able to judge whether the assertions made by the management are reasonable

Auditor does not give an opinion of the company’s worth or whether it is a wise investment as rather, they are to provide assurance about the information provided by the management

**Expectation gap**
Occurs whereby the users have a different idea of what the auditor can do compared to what the auditor intends to do

Auditing may be undertaken for its benefits but in many cases, auditing is required by law as legislators intend to look after the interests of stakeholders

**Roles of auditing**
1. Information role
2. Agency role
3. Insurance role
4. Organisational control role
5. Confirmation role
6. Risk management role

**Information role / Signaling role**
- Auditing as a way to improve information to facilitate better informed decision-making process
- Addressing the imbalance in knowledge between management and outside investors known as ‘information asymmetry’
- Auditing as a way to signal to investors that they can place more credibility on the company’s financial statements
- Where auditing is compulsory, management can signal higher quality by appointing an auditor of higher quality, perhaps from an international firm or a firm that specializes in the client’s industry
**Agency role /Monitoring role**
- Shareholders may discount the information they receive if managers act in their own interests, hence pay a lower price for shares compared to if the financial statements could be trusted known as *price protection*
- Management providing auditing as a form of bonding of the manager or monitoring on behalf of the shareholders
- Better response or a lower interest rate when asking for a loan if they have audited financial statements
- Where auditing is compulsory, management can reduce agency costs by providing auditing beyond the minimum standard required
- Auditing claimed to reduce the cost of capital by 1% to 3%

**Insurance role/Deep pockets role**
- Lenders and shareholders demanding audits as a way of increasing the chance of recovering certain types of losses
- Audit providing a ‘target’ that shareholders might be able to sue to recover their investment losses
- Management may not have enough resources to make up the losses of investors but auditors are seen as the ‘deep pockets’ defendant
- Treating audit almost as a put option against future bad behavior or misleading reporting

**Organisational control role**
- Auditing for the benefit of internal management
- When company grows larger thus delegation becomes necessary, risk of moral hazard and opportunism also increases
- Owners seeking voluntary audits as a compensatory control system for organisational loss of control in hierarchical organisations
- Common in smaller companies

**Confirmation role**
- Financial statements arrive ‘too late’ for it to be useful
- However, still necessary for market announcements to be independently verified at a later stage through audited financial statements
- Firms that commit to higher audit fees, which acts as a measure of greater financial statement verification, are regarded as being more credible and thus they attract larger market reactions
Risk management role
- Auditing as an element in an organisation’s risk management strategy alongside internal audits, audit committees and independent directors
- Auditing proving useful for organisations whose stakeholders are subject to higher risk as each stakeholder benefits from a greater level of control
- Audit fees being higher when a company has an audit committee, discloses a relatively high level of financial risk management and has a larger proportion of independent board members

Auditing is a way of signaling better quality financial reporting\(^1\), a way to provide voluntary monitoring and bonding- addressing agency costs\(^2\), a means of insurance for losses by some of the stakeholder groups\(^3\), a way to help managers provide organisational control\(^4\), a means of confirming information in earlier market announcements\(^5\) and also an integral part of an overall risk management strategy\(^6\)

Regulation of auditing
1. Auditing is seen as a form of public good given once an audit is performed, many stakeholders can benefit. However, these groups may not be able to impose audit on a company and for this reason, legislators impose auditing requirements for the benefit of the community
2. Auditing is beneficial to a country’s economy given auditing acts as an agent of transparency in the development of an economy in which better accounting leads to greater investment and more economic growth
3. Political groups having an incentive to regulate auditing in order to avoid perceived responsibility for investor losses

Week 1- Lecture materials

Audit is a way of obtaining second opinion on financial statements for reliance purposes, acting as a system of investor protection
- Audit protects stakeholders from ‘bad’ information but they are not protected from making bad decisions

Role of auditors
Providing an opinion on the accuracy thus reliability of the financial statements

Auditing facilitates better decision-making by stakeholders\(^1\), reduces risk of material misstatements through recommending error adjustments to the management\(^2\), improves the quality of information in financial statements\(^3\) and makes accounting useful\(^4\)

There may be conflicting incentives for the auditor between
- Following management’s wishes as they may put pressure on the auditors
- Protecting their own reputation through delivery of high quality audit
Objectives of an audit
To provide reasonable reassurance about whether financial report as a whole is free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial report is prepared, in all material respects, in accordance with an applicable financial reporting framework
1. Reasonable reassurance
2. Free from material misstatement
3. Auditor to express an opinion
4. Prepared in accordance with applicable financial reporting framework

Assurance
An engagement whereby an assurance practitioner expresses a conclusion about the evaluation of the subject matter against suitable criteria, which is designed to enhance the level of confidence of intended users
- Audit is an example of assurance

Elements of assurance engagement
1. Three-party relationship between practitioner Auditor, party responsible for presenting the information Client being audited and intended user Shareholders
2. Subject matter Financial statements
3. Suitable criteria IFRS
4. Sufficient appropriate evidence
5. Written assurance report Audit report

Levels of assurance
1. Reasonable assurance Audit
2. Limited assurance Review engagement which is less extensive than an audit
3. Other services such as agreed-upon procedures which may be audit of one specific section

Before engaging in an audit, the auditor must consider some of the following factors
- Knowledge about the client and the industry the client participates in, as in the level of expertise
- Measure of capacity as in base of personnel
- Reputation of the client indicated by other factors such as management integrity

Audit in practice involves assessment of inherent risk as in what can go wrong and also assessment of control risk as in the risk of internal controls in place not being effective

Economic hypotheses for explaining demand for audit
1. Agency theory / Stewardship hypothesis
2. Information hypothesis
3. Insurance hypothesis
4. Management control
5. Corporate governance
6. Confirmation hypothesis
**Agency theory / Stewardship hypothesis**

Users of financial statements are aware that managers, agents of the company, may be self-interested and thus they price-protect themselves. Users want and value assurance thus auditing reduces price-protection.

**Price-protection**

Stakeholders imposing higher cost of capital through higher interest rates and lower share prices as to protect themselves from ‘bad’ information.

**Information hypothesis**

Addressing information asymmetry between users of financial statements and management through using auditing as a way of signaling the quality of information presented in financial statements.

**Insurance hypothesis**

Stakeholders potentially being able to sue auditors in the event of the company collapsing as even if the management lacks financial resources, auditors are seen as the ‘deep pockets’.

**Management control**

Management using auditing as a way of obtaining assurance about information provided from lower levels, given they may not be able to verify all the information themselves.

- Way of protection against risk arising from delegation

**Corporate governance**

Auditing being a part of corporate governance, as in being part of the entity’s risk management strategy alongside the board of directors, internal audit and audit committee.

**Confirmation hypothesis**

Management making unadjusted announcements and the market accepting the announcements based on later audited results.

- Audit providing for confirmation of market announcements

**Wider benefits of an audit**

1. Auditing reduces cost of capital, given the agency theory
2. Investor protection and protection of other stakeholders, as the public may lack the resources and the knowledge to verify financial statements themselves
3. Good auditing leading to economic growth

**Expectation gap**

The gap between society’s expectations of auditors and the auditor’s performance as perceived by the society:

1. Reasonableness gap
2. Performance gap
   - - Deficient standards by the society
   - - Deficient performance by the auditors
Expectation gap between
1. Society’s expectations of auditors
2. Auditor’s performance

<table>
<thead>
<tr>
<th>Audit expectation gap</th>
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<tr>
<td><strong>Performance gap</strong></td>
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<tr>
<td>Deficient performance by the auditors</td>
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- The left side of the audit expectation gap is the perceived performance of the auditors
- The right side of the audit expectation gap is the society’s expectations of auditors
- Deficient performance and deficient standards are auditor’s existing duties as well as duties reasonably expected of auditors
- Deficient performance and deficient standards can be resolved through better auditing
- Unreasonable expectations, thus reasonableness gap, can be resolved through public education

**Expectation gap duties of auditors**
1. Preparation of financial statements
2. Examining all items
3. Fraud
4. Internal control
5. Going concern

**Expectation gap duties— Fraud**

**Expectations by society**
Auditors find all fraud, prevent fraud, mainly concerned with fraud

**Duties of auditors**
Auditor must consider the risks of material misstatements in the financial reports due to fraud ISA 240 ‘International Standards on Auditing 240’

Over time, auditors are being held more responsible for fraud than before
Expectation gap duties - Internal control

Expectations by society
Auditors to find any weaknesses in internal controls and reporting on them

Duties of auditors
- Auditors may assess control risk at the maximum and rely on other types of testing, in that they may not test controls at all
- Auditors are required to report weaknesses they find to management during the audit process, but they are not required to find all control weaknesses

However, more countries are requiring reports on management’s assertions about adequate internal control such as in US, Japan and China

Expectation gap duties - Going concern

Expectations by society
Auditors to predict company collapse or even to prevent it from happening

Duties of auditors
Auditors are to examine the issue of going concern and only comment on it in its report if there are concerns regarding meeting going concern

Due to the presence of the audit expectation gap which comprises of reasonableness gap - unreasonable expectations and performance gap - deficient standards by society and deficient performance by auditors, there has been a great level of developments in auditing standards, reduced public support for auditors and increased legal proceedings against the auditors

Auditor’s liability
1. Auditor owed duty of care
2. But audit was carried out negligently
3. Plaintiff suffered a loss
4. The loss suffered was in connection to the auditor’s negligence

Ways to bridge the expectation gap
1. Engagement letter by the auditors to clarify responsibilities to management
2. Audit report now distinguishing directors’ responsibilities from those of the auditors
3. Going concern now a duty of auditors alongside fraud and internal controls
4. Co-regulation between FMA and CA ANZ
5. Requirements for auditors in NZ to be licensed and their firms registered
Structure of the auditing profession
- Previously, the audit profession was self-regulated by NZICA
- However, such self-regulation was heavily criticized after the collapse of finance companies between 2009 and 2010
- NZ was also out of step with the rest of the world as after the Enron scandal, the international accounting profession moved towards co-regulation
- Simon Power the Minister of Commerce at the time proposed co-regulation of the accounting profession
- Although NZICA, now CA ANZ, still carries out the regulatory functions; FMA overlooks the licensing and registration functions, with FMA being the independent government appointed party

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<thead>
<tr>
<th>External Reporting Board ‘XRB’</th>
<th>Financial Markets Authority ‘FMA’</th>
<th>Accounting institutes e.g. CA ANZ and CPA</th>
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<tbody>
<tr>
<td>- NZ Auditing and Assurance Standards Board</td>
<td>- Licensing and registration of auditors via accounting institutes</td>
<td>- Code of Ethics</td>
</tr>
<tr>
<td>- International Standards on Auditing ‘ISA’</td>
<td>- Inspection</td>
<td>- Practice review and disciplinary action for its members</td>
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<td></td>
<td>- Disciplinary action</td>
<td>- Institute responsibility plus on behalf of FMA</td>
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**Week 2 - Course book readings**

Duties of directors and auditors
- **Directors** have the responsibility to maintain records and prepare annual financial statements which comply with GAAP and give a true and fair view of the financial position, financial performance and cashflows of the company
- **Auditors** have the responsibilities to express an opinion on whether the financial statements comply with GAAP and give a true and fair view of the matters to which they relate

Purpose of an audit is to enhance confidence in the financial statements but audit is not intended to provide an opinion on the financial health of an entity as that is a matter for the readers of financial statements to determine for themselves

The time it takes to prepare and audit the statements may take anywhere between 3 to 18 months, which relates to the confirmation hypothesis which suggests that audited statements are still required to verify market announcements after they are made
Although auditors will conclude in their judgement whether is any material uncertainty around the entity’s ability to continue as a going concern; such conclusion is limited given the auditors’ views are at a certain point in time after which situation may change.

Audit in general has never had the detection of fraud as its primary objective given fraud may involve sophisticated schemes which are designed to conceal the fraud, which may be even more difficult to detect when accompanied by collusion.
- Leads to the audit expectation gap, particularly deficient standards by society as part of the performance gap.

There is an unavoidable risk that some material misstatements may not be detected even though the audit is properly planned and performed in accordance with NZICA’s accounting standards, as in now CA ANZ’s accounting standards.

**Expectation gap**
Audit expectation gap between the society’s expectation of what the auditors’ responsibilities are and the auditors’ perception of their responsibilities:
- Society’s expectation of auditors’ responsibilities
- Auditors’ perception of their responsibilities / Auditors’ performance

**Week 2- Lecture materials**

Auditors are watchdogs, responsible for giving warnings, and not bloodhounds as in detectives.

**Regulation of auditing**
1. **FMC Reporting Entities**
2. **Other entities**
3. **Companies Act requirements**

Companies may need to be audited under both Financial Markets Conduct Act and the Companies Act.

**FMC Reporting Entities**
Reporting entities under the Financial Markets Conduct Act
- Must be audited by a licensed auditor and disclose the audited financial statements publically
- Reporting entities include financial markets participants such as issuers as in publically listed companies, banks, insurers, credit unions and building societies.

**Other entities that are to be audited**
- Public entities
- Charities audited if expenditure > $1 million
- Charities in review engagement if expenditure > $0.5 million
- Retirement villages
- Incorporated societies if their Constitution requires an audit, but audit may not necessarily be by a qualified auditor.
Companies Act requirements
1. **Large companies**
   - Assets > $60 million or revenue > $30 million
   - Can opt out if 95% of shareholders agree
   - Subsidiaries may be exempt
2. **Large overseas companies**
   - More than 25% overseas ownership
   - Assets > $20 million or revenue > $10 million
3. **Companies with 10 or more shareholders**
   - Can opt out if 95% of shareholders agree
4. **Companies with less than 10 shareholders who have opted in to have a voluntary audit**

Regulation of auditors
1. **Licensed auditors**
   - FMC reporting entities are required to be audited by licensed auditors
   - FMA via CA ANZ and CPA
2. **Qualified auditors**
   - Companies as per the Companies Act and other entities such as public entities, charities, building societies, retirement villages
   - CA ANZ and CPA

Imposition of duties on auditors
1. **Legislation**
   - Statute as the basis for duties
2. **Standards**
3. **Profession**
4. **Firms**
   - Auditing firms
5. **Courts**
   - Common law

Legislation as basis for duties of auditors
Auditors report must comply with **GAAP** as in Generally Accepted Accounting Standards which requires for financial statements to be true and fair
   - If the financial statements do not comply with the Financial Reporting Act, the auditors must send a copy of the report to the Companies Office

Auditing standards
Set by **XRB** as in External Reporting Board and its **AuASB** as in Auditing & Assurance Standards Board
   - Enforced by **FMA** as in Financial Markets authority
   - Some functions are delegated to professional accounting bodies as in **CA ANZ** and **CPA Australia**
   - Based on international standards set by **IAASB** as in International Auditing and Assurance Standards Board and **IESBA** as in International Ethics Standards Board for Accountants
Co-regulation regime
Auditors’ duties are regulated by CA ANZ / CPA and FMA
- CA ANZ / CPA control the entry standards and ethical standards
- CA ANZ / CPA conduct inspection and discipline
- FMA oversees inspection and discipline
- CA ANZ / CPA overlooking qualified auditors
- FMA overlooking licensed auditors
- Auditing firms are responsible for international quality control
- Each auditing firm is overlooked by other offices of the audit firm network for international quality control

General principles in the Auditing Standards
1. Plan the audit work
2. Professional skepticism
3. Knowledge of the audit environment
4. Assess risk
5. Obtain sufficient appropriate audit evidence
6. Review and assess conclusions
7. Document evidence to support audit opinion and to prove that audit has been conducted in accordance with relevant standards
8. Audit report
9. Communicate significant matters

Potential criticisms of audit
- Inadequate supervision
- Incompetent team as in lack of competency amongst team personnel
- Failure to identify material misstatements
- Lack of planning
- Inadequate documentation

Auditor’s liability
1. Auditor owed a duty of care to the plaintiff
2. Audit was carried out negligently
3. Plaintiff suffered a loss
4. The loss suffered was in connection with the auditor’s negligence

Auditor’s duty of care
Auditor owes duty of care based on
1. Special relationship
2. Reasonable foreseeability as in being aware of such users of financial statements existing
3. Proximity and actual reliance on audit reports are required

Auditors owe duty of care to shareholders as a group, and not to individual shareholders
- Auditors owe duty of care to existing shareholders and not to others that auditors do not know of
Negligent audit
Lack of reasonable care and skill
- Standards to which the audit conducted will be compared to are the professional auditing standards but the Courts may also further decide what is reasonable care and skill

In a negligent audit, contributory negligence as in the plaintiff not having met the standard of care from their end could be a defence for auditors

As illustrated in previous legal proceedings, auditors must be conservative as in display professional skepticism all the way throughout the audit and also be cautious about what clients to accept, which is associated with assessment of risk

Auditors must report potential problems identified throughout the audit to management. However, misstatements in the accounts should be reported to shareholders in form of a formal report as opposed to being reported to management

Limitation of liability
1. Limited liability partnerships as in incorporation of auditors
2. Removal of joint and several liability and replacement with proportionate liability, as in auditors now only being responsible for a portion of liability rather than the whole
3. Statutory cap on auditors’ liability
4. Professional indemnity insurance is difficult to obtain and is expensive

Effects of liability on audit work
- Selection of clients
- Quality of work and review of work
- Qualified and well-trained staff through supervision and training
- Follow professional standards
- Understanding of client business
- Engagement letters by setting expectations and responsibilities, for example, imposing responsibilities of preparation of financial statements in accordance with relevant accounting standards on directors

Liability is a major concern for auditors but the probability of audit failure or lawsuit is low

Week 2- Textbook readings
Sanctions by professional accounting bodies
1. Exclusion from membership
2. Suspension from membership
3. Disbarment from practice
4. Being fined up to $100,000

Where auditors have breached the duty of care they owe and have been negligent in conducting the audit work or has committed fraud, auditor may be liable for any loss suffered by the plaintiff which was caused by the auditor’s actions
In order to sue for negligence
1. Auditor owed duty of care
2. Audit was carried out recklessly or negligently
3. Plaintiff suffered a loss
4. Loss was suffered due to the negligent audit

Auditors have a duty of care to exercise reasonable care and skill expected of auditing professionals when conducting an audit.

Third parties who rely on an auditor’s opinion and suffered a loss caused by auditor’s negligence have no contractual claim for recovery of losses but may be able to bring in an action for tort if auditor owed them a duty of care.

Mitigation of risk of negligence
1. Complying with auditing standards and ethical codes
2. Exercising professional skepticism and applying sound professional judgement
3. Maintaining a sound system of quality control throughout the audit process
4. Having appropriate client acceptance procedures to guard against accepting clients with high risk of inappropriate behavior or high risk of collapse

Incorporation of auditors, in the event of a legal claim protects the personal assets of partners other than the partners who conducted the audit, but does not protect the audit firms’ assets nor the personal assets of the partners being sued.

When a company collapses or suffers a significant loss, legal action is usually undertaken against the company’s directors. However, if directors have limited financial resources as to satisfy the legal claim then the bulk of the damage is usually claimed against the auditors or the auditing firm instead even if they were only partially responsible for the liability given they are perceived as the ‘deep pocketed’ defendants, which is related to the insurance hypothesis.

Week 3- Lecture materials

The basis for duties of auditors is ISA which stands for International Standards on Auditing.

Elements of the audit process
1. Financial report assertions
2. Audit procedures and evidence
3. Risk evaluation and audit risk model
4. Types of audit test
5. Materiality
6. Documentation
Assertions
- Management makes assertions within the financial report
- Auditors use assertions to assess risks
  1. By considering potential misstatements
  2. Designing audit procedures in response to risks

Assertions are covered by ISA (NZ) 315, which was recently revised in 2017 not to introduce fundamental changes but as to simplify the assertions to facilitate easier understanding

ABCOTD
1. Account balances
   Balance sheet
2. Classes of transactions
   Income statement
3. Disclosures
   Notes

Assertions about classes of transactions and events
1. Occurrence
   Whether the transaction actually took place or not
   - Sales
2. Completeness
   Whether all transactions which should have been recorded have been recorded
   - Expenses
3. Accuracy
   Whether the transactions have been correctly recorded as to the amounts
4. Cut-off
   Whether the transactions have been recorded in the correct period
   - Particularly relevant to sales
5. Classification
   Whether the transactions have been recorded in the proper accounts
6. Presentation
   Whether the transactions are clearly described and are understandable
Assertions about account balances

1. Existence
   Whether the assets, liability and equity actually exist or not
   - Assets of inventory

2. Rights and obligations
   Whether the entity actually has rights to the assets recorded and obligations to the
   liabilities recorded

3. Completeness
   Whether all the assets, liabilities and equity that should have been recorded been
   recorded

4. Accuracy, valuation and allocation
   Whether the assets, liabilities and equity have been recorded at correct amounts
   and any valuation adjustments have been properly recorded
   - Assets of inventory, PPE, goodwill

5. Classification
   Whether the assets, liabilities and equity have been recorded in correct accounts

6. Presentation
   Whether the assets, liabilities and equity are clearly described and are clearly
   understandable

As to determine whether the company has legal right to inventory in testing for assertion of
rights and obligations, the auditors will consider risk and rewards of ownership

Auditors will perform audit procedures to test for assertions, which leads to obtaining audit
evidence which must in turn be documented

Common audit procedures

1. Inspection
   Inspecting assets or documents

2. Observation
   Conducting walk-throughs of specific entity procedures which also includes
   observing internal controls

3. Confirmation
   External confirmation for verification purposes e.g. Bank and debtors’ confirmation

4. Recalculation
   Testing arithmetic calculation such as the summation of GL

5. Re-performance
   Re-performing steps of transactions as in steps of specific entity procedures

6. Analytical procedures
   Calculating ratios and conducting auditor’s own calculation using other information
   to test for reasonableness of the data input by management into GL

7. Inquiry
   Inquiry into management
Examples of audit evidence
1. Documents
2. Confirmations
3. Information obtained from management inquiry, observation such as walkthroughs and inspection of assets or documents
4. Business strategy of the entity
5. Other information obtained by the auditor

Audit evidence must be both reliable and relevant, of which there may be a trade-off between the two

When testing for rights and obligations for inventory, rights in particular, auditors may
- Inspect shipping documents and contracts for terms of sale
- Look at when is the ownership transferred? And
- Also, subsequently look at whether sales and COGS have been recorded in the correct cut-off periods

Difference between analytical procedures and re-calculation is that
- Analytical procedures are re-calculating figures based on the auditors’ understanding of the entity and using its own estimates and information
- Re-calculation involves rather simpler ‘checks’ of adding, and subtracting using the client’s figures as they are

Appropriate audit evidence
- Sufficiency
  Adequate quantity of audit evidence, often determined by reference to sampling
- Appropriateness
  Adequate quality of audit evidence
  1. Relevance
     Relevant to the assertion of interest within the financial statement
  2. Reliability
     Influenced by the source and nature of evidence

Reliability of audit evidence
- Evidence from sources outside the entity is more relevant than evidence from sources within the entity
- Evidence from sources within the entity is more reliable if entity has implemented effective internal control structures
- Evidence obtained directly by the auditor is more reliable than evidence indirectly obtained from the client
- Documents or written representations as in prose proof are more reliable than oral representations
- Original documents are more reliable than documents that have been faxed or photocopied
As a summary, the reliability of audit evidence depends on any probability of the information as in the financial data being vulnerable to opportunities of compromise, alteration or interception.

**Audit risk**
Risk of the auditor giving an inappropriate audit opinion when the financial report is materially misstated
- Risk of the auditor failing the audit objective as in providing reasonable and genuine assurance regarding the financial statements as a whole being free from any material misstatements

Audit risk cannot be fully eliminated given the inherent limitation of audit in that auditors are unable to provide absolute assurance regarding the financial statements being free from material misstatements
- However, auditor must still reduce audit risk to an acceptable level to ensure the opinion can still be deemed reliable
- Usually, audit risk is reduced to approximately 5% or so

**Components of audit risk**
1. Inherent risk
2. Control risk
3. Detection risk

**Inherent risk**
Susceptibility of an assertion to material misstatement given inherent and environmental characteristics
- Risk of ‘things’ going wrong within the audit

**Control risk**
Risk that material misstatement may not be prevented or detected by internal control procedures implemented by management within the entity
- Risk of internal controls not being effective

**Detection risk**
Risk that auditors’ testing through test of controls and substantive testing will not uncover material misstatements
- Risk that auditors will conclude that no material misstatements exist based on their testing when, in fact, material misstatements do exist

**RMM / RoMM**
- Risk of material misstatement within the financial report prior to audit
- Either at overall financial report level and assertion level for AB, COT, D
- Combination of inherent risk and control risk
- Inherent risk increases RoMM
- Lower control risk reduces RoMM
Reducing audit risk - inherent risk and control risk
- Auditors cannot reduce inherent risk
- Auditors cannot directly change control risk but they can rely on internal controls if controls are proven to be effective as per test of controls, but may not rely on internal controls if controls are ineffective and thus carry out substantive testing.

Reducing audit risk - detection risk
- Adequate planning
- Proper assignment of competent personnel to the audit engagement team
- Application of professional skepticism all the way throughout the audit
- Appropriate decisions on types, timing and extent of audit procedures as to obtain sufficient audit evidence
- Effective performance of audit procedures and professional evaluation of the results
- Supervision and review of audit work performed

Detection risk is best thought of as being a non-detection risk, as in risk of auditors’ non-detection of material misstatement.

Relationship between inherent risk and control risk with detection risk
Inherent risk and control risk share an inverse relationship with detection risk
  - If inherent risk and control risk are high then detection risk must be kept low
  - If inherent risk and control risk are low then detection risk may remain high yet audit risk still be of an acceptable level

If detection risk is low, then the extent of audit work increases in effort to reduce detection risk. But if detection risk is high, then the extent of audit work decreases given detection risk can remain high rather than being minimized to its absolute minimum.

Audit risk is the combination of inherent risk X control risk X detection risk
  - Inherent risk relating to assertions as in their susceptibility to material misstatement
  - Control risk relating to internal controls as in their effectiveness
  - Detection risk relating to auditors as in auditors’ ability to identify material misstatements based on their testing

Types of audit test
  1. Test of control
     Testing the effectiveness of internal controls whereby auditors may rely on internal controls for testing of certain assertions for which control risk is low
  2. Substantive testing
     Alternative method of testing either when control risk is too high or if test of controls is not cost-efficient or too complex
     - Obtaining direct evidence about assertions
     - Reduces detection risk

Generally, substantive testing will almost always be carried out even if control risk is low.
Substantive testing
1. Analytical procedures
   - Re-calculation based on auditors’ understanding of the entity as well as use of external information such as ratios
2. Test of details
   - Substantive tests of balances relating to balance sheet
   - Substantive tests of transactions relating to income statement
   - Substantive tests of disclosures relating to notes

Materiality
Information, individually or aggregate as in as a whole, that if misstated or omitted form the financial report may adversely affect the decisions made by financial report users
   - Material in nature or amount

Materiality
Selecting a base then a suitable percentage
   - Net profit is the most common base for publically traded companies

Determining materiality, through selecting a base and a suitable percentage, depend on who the financial report users are and what their pivotal information needs are

Choice of base in calculating materiality
1. Net profit
   - Can fluctuate significantly
   - Commonly used for public companies, but not suitable for non-profit organisations
   - Advantage being its relevance to financial report users
   - 5 – 10%
2. Revenue
   - 0.5 – 1%
3. Total assets
   - 0.5 – 1%
4. Equity
   - 1 – 2%

Revenue, total assets and equity are all relatively stable figures to be used as bases

Applying materiality
1. An amount that is equal to or greater than 10% of the base is presumed to be material
2. An amount that is equal to or less than 5% of the base is presumed to not be material
3. An amount that is between 5% and 10% of the base requires judgement when determining if it is material or not
Qualitative materiality
Certain information may be material to financial report users not because of its amount but due to the nature of the information
- Information could be particularly significant to the entity
- Information could be pervasive as in its misstatement affecting numerous other items within the financial report
e.g. Inventory being misstated will affect sales and COGS

Materiality for
1. Financial statement as a whole
2. Particular classes of transactions as in within income statement
3. Particular account balances as in within the balance sheet

Performance materiality
Amount that is less than materiality for the financial statements as a whole
- Potentially 60% of the set materiality
1. To allow for aggregation of individual immaterial amounts
2. To provide margin for possible undetected misstatements

Documentation is crucial in auditing
“If it is not documented, it is not done”
- Should not only be records of work but include reasons why such actions were taken as to justify the overall work itself

Week 4- Lecture materials
Business risk, as in risk inherent within the business operations, affect audit as potential business problems increases audit risk
- Audit risk is the product of inherent risk, control risk and detection risk
- Inherent risk refers to susceptibility of assertion to material misstatement, subject to management
- Control risk refers to internal controls not being able to detect material misstatements
- Detection risk refers to auditors concluding an opinion that the financial report is free from material misstatements, when indeed it is not

Auditors cannot directly change control risk but can conduct test of controls to see if controls can be relied upon

Inherent risk and control risk share an inverse relationship with detection risk
- High inherent risk and control risk means detection risk must be minimized thus extensive audit work
- Low inherent risk and control risk means detection risk may remain high yet audit risk still be acceptable thus lighter audit workload
Major steps within the audit process
1. Understanding the entity and its environment
2. Understanding internal controls
3. Assessing risks of material misstatement
4. Developing responses to assessed and identified risks
5. Performing test of controls to determine if controls can be relied upon
6. Performing substantive testing through analytical procedures and test of details
7. Completion and review

Client acceptance and continuance evaluation process
Accepting a client engagement or continuing on with a previous client is an important step to the overall audit process given accepting an engagement itself has risks such as damage to the brand reputation and legal proceedings
- Must obtain and review financial information
- Must make inquiries of third parties such as solicitors and bankers to get an understanding of the business reputation
- Communicate with previous auditors, to determine whether there are any professional reasons they should not engage in the audit of this client
- Evaluate own ability to audit the client based on level of expertise and capacity
- Evaluate independence which is a key component given auditors are not to only have a level of independence but also appear to have a level of independence in the eyes of the public

Understanding the environment
- Industry and related regulations
- Nature of the entity such as ownership, structure of the entity in light of related parties and ownership as in board of directors and perhaps whether they have relevant expertise in the industry the company operates in
- Entity’s accounting policies including what type of accounting policies are common and allowed in the industry the entity participates in
- Objectives and strategies and related business risks

Components to entity’s environment
1. Internal environment
2. Local environment
   - Direct competition, competitor innovation, local labour markets and customer-supplier relationships
3. Global environment
   - Regulations, global competition, natural resources and cultural advantages

Techniques for assessing business risks
1. SWOT analysis of strengths and weaknesses relating to internal environment and opportunities and threats relating to external environment
2. PESTE analysis of political, economic, social, technological and environmental factors relating to external environment
**Business risk**
Risk that an entity’s business objectives will not be met as a result of the external and internal factors, pressures and forces
- Risk associated with the entity’s survival and profitability

Assessing business risk requires extensive knowledge of the client’s business and industry
- Thinking of what could go wrong?

Assessment of business risk is crucial in the audit process given business risk leads to accounting problems, raising risk of material misstatements thus increasing chance of audit problems such as around going concern in example of asset valuations
- Business risk has a direct consequential effect on audit risk

**Audit implications of business risk**
1. **Expectations** of what the performance should be
2. **Viability** as in going concern
3. **Risk of material misstatement**
4. **Control environment** including quality of management
5. **Recommendations**, as in auditors’ ability to recommend different processes which may be more suitable

Going concern assumption is also highly important in the audit process given if there is any material concern around the entity being able to continue as a going concern; accounting treatments will differ for example, asset valuation

**Relationship of business risk and audit risk**
1. Assess business risk
2. Assess RoMM which consists of inherent risk and control risk
   - Business risk mainly affects inherent risk but can also affect control risk
3. Audit risk = RoMM as in inherent risk and control risk as well as detection risk

**Response to assessed risks**
Also known as ways to reduce detection risk
1. More experienced staff
2. Using experts to rely on their technical expertise
3. More supervision through review of work
4. Incorporating unpredictability into selecting audit procedures given business risk may affect expectations

Understanding internal controls through conducting walk-throughs to determine how a particular business process is carried out and to what extent different types of internal controls are in place
- Relevant to the second step within the audit process, which is understanding internal controls
**Assessing risk of material misstatement**

Identifying RoMM at both
1. Financial report level
2. Assertion level
   - ABCOTD
   - AB, account balances of balance sheet
   - COT, classes of transactions of income statement
   - D, disclosures of notes

RoMM = Inherent risk + control risk

**Inherent risk**
Susceptibility of account balances within the balance sheet or classes of transactions within the income statement to material misstatements given inherent and environmental characteristics
- Auditors are required to assess inherent risk at report level as part of audit planning
- Assessment must then be related to assertions to account balances or classes of transactions when developing audit procedures

**Examples of inherent risk at financial report level**
1. Management integrity
2. Management knowledge, such as management being dominated by one person
3. Business declining putting pressure on management
4. Nature of the business such as inventory being susceptible to obsolescence or business transactions being quite complex such as hedging
5. Industry factors such as new competitors

**Examples of inherent risk at assertion level**
1. Errors in inventory valuations last year
2. Lease accounting, which is complex in nature
3. Accounts which require judgements such as doubtful debts and other provisions and other transactions such as asset write-offs
4. Assets which are susceptible to loss such as cash, alcohol and jewellery
5. Acquiring a new subsidiary near year end which is complex and may also be unusual

Employee bonus schemes including management bonus schemes which are tied to the performance of the business also raises inherent risk at assertion level, particularly revenue which will affect net profit, as management and employees could be incentivized to inflate earnings
- Valuation affected for accounts receivable and inventory
- Completeness affected for accounts payable
Analytical procedures
Method of substantive testing alongside test of details, which investigates fluctuations
- Ratios, trend analysis, operating statistics for comparison with internal data such as previous years’ performances and external data such as industry benchmarks
- Forming expectations based on previous years’ figures
- Preliminary analytical procedures may be carried out in planning stage and or as part of the final review in form of substantive analytical procedures

Four-step method for analytical procedures
1. Determine suitability of substantive analytical procedures for the assertions e.g. Payroll, commission for sales personnel
2. Evaluate reliability of data from which the auditors’ expectation is derived
   - Source documents
3. Develop an expectation of amounts or ratios
4. Determine the amount of any difference from expectation that is acceptable without further investigation
   - Threshold

Simple analytical procedures
- Simple comparisons
- Ratio analysis
  - Common-size statements of which figures are shown as percentage of chosen bases
  - Trend statements showing comparison against PY
  - Time series analysis

Complex analytical procedures
- Time series modelling
- Regression analysis
- Financial modelling

Common-size statements
- Expressing balance sheet components as a percentage of total assets
- Expressing income statement components as a percentage of total revenue

Trend statements
- Expressing each item as a percentage of its own level from a base year

Analytical procedures
Defined in ISA (NZ) 520 as being an evaluation of both financial and non-financial information and their relationships, and necessary investigations into fluctuations and unexpected relationships

Fraud
Defined in ISA 240.11 as being an intentional act using deception, to obtain an unjust or illegal advantages
1. Fraudulent financial reporting
2. Misappropriation of assets
Fraud in an accounting perspective relates to intentionally misleading users of financial statements

**Fraudulent financial reporting**
1. Manipulation, falsification or alteration of documents or records
2. Omission of effects of transactions from records
3. Recording transactions without substance, as in recording transactions which are not real which relates to the occurrence assertion within income statement
4. Intentional misapplication of accounting policies
   - Use of SPEs by Enron

**Misappropriation of assets**
1. Embezzling receipts as in stealing receipts
2. Stealing assets
3. Causing an entity to pay for goods not received
4. Charging falsified sales before YE then issuing credit notes right after YE to make sales look better than they actually are
5. Using an entity’s assets for personal use

**Increased attention to fraud**
Driven by the audit expectation gap, and in particular, the deficient standards by society component of the performance gap
- ISA 240 requires auditors to pay greater attention to fraud
- Auditors need to consider risk of material misstatements due to fraud
- Must discuss within the audit team the entity’s susceptibility to fraud
- Must make more extensive enquiries of management with respect to fraud
- Auditors are now specifically required to cover risk of fraud in revenue recognition and the possibility of management override of controls

**Red flag indicators of fraud**
1. Management such as their integrity and level of experience
2. Unusual pressure within the entity such as culture or inadequate working capital
3. Market pressures
4. Unusual transactions
5. Unsatisfactory records
6. IT environment

Main factors allowing fraud to occur have been identified as
1. Poor internal controls
2. Override of controls
3. Collusion between employees and third parties
4. Collusion between employees and management

It has been researched that majority of fraud are perpetrated internally
Earnings management
Judgement being used to misrepresent the underlying economic performance in the financial reports by management such as CEO and CFO
- Incentives to ‘manage’ earnings may be behavioral or market-based
- Lowering profits given high profits may lead to criticism and negative publicity as does petrol stations
- Pressure from debt covenants within loan facilities
- **Big bath** as in making financial performance look even worse if the performance is already bad
- Tax implications of lowering profit as to pay lesser tax

Related parties
Auditors must assess risk that related parties and related party transactions will not be identified or appropriately disclosed or measured
- Related party transaction might be motivated by other than ordinary business operations such as fraud

**Week 4- Guest lecture materials (Jaclo from FMA)**

Revenue is subject to higher risk of fraud and management override of controls
- May be overstated to make the financial report appear better than it really is
- May be understated as management takes a ‘big bath’ in example of earnings management, if performance is already bad

Auditors are therefore, now required by ISA 240 to specifically consider risk of fraud in revenue recognition

**Testing of revenue**
1. Test of controls
2. Audit sampling as in test of details which is a form of substantive testing alongside analytical procedures
3. Testing cut-off of before YE and after YE
4. Analytical procedures which is another form of substantive testing

**Key audit matters in NZ**
1. **Impairment of goodwill**, given this requires high level of judgement
2. **Valuation of PPE**, given majority of the large listed companies in NZ are property related firms
3. **Revenue recognition**
4. **Investment in related parties**
5. **Capitalization**, given the great number of tech companies in NZ
6. **Taxation**, which is not as complex compared to other jurisdictions

Net profit is the most common base for setting materiality (5 - 10%) by publically listed companies given its relevance
- Revenue is the second most common base for setting materiality (0.5 – 1%)
**Week 5- Lecture materials**

**Internal control**
Process designed and implemented by management to provide reasonable assurance regarding the achievement of the entity’s objectives concerning
1. Financial reporting
2. Effectiveness and efficiency of operations
3. Compliance with law

**Auditor’s requirements**
- Understand the internal controls relevant to the audit
- Assess the control environment at financial report level
- Assess control risk at assertion level

**Control risk**
Risk of the internal control not preventing or detecting a material misstatement on a timely basis
- Control risk can never be fully eliminated as with detection risk, given internal controls are never 100% effective

Internal controls have inherent limitations given the cost of establishing and maintaining controls may outweigh the benefits of implementing the controls
- Possibility of management override
- Existence of non-routine transactions for which internal controls are not designed for, requiring human judgement

**Internal controls**
1. Management controls
2. Transaction controls

**Management controls**
Controls undertaken by senior management to mitigate strategic risks to the entity which are concerned with overviewing the overall business performance
- Communicating business objectives and goals
- Establishing lines of authority and accountability
- Establishing and enforcing appropriate codes of conduct
- Monitoring risk environments
- Defining policies and procedures for dealing with the monitored risks
- Monitoring performance through performance indicators and benchmarking such as having monthly accounts for sales
**Transaction controls**

Controls undertaken by staff and lower level management concerned with *authorization, execution and recording*

- Focused on internal risks
- Reflect policies and procedures defined by senior management
- Primary deal with the reliability of accounting information and compliance with rules and regulations
- Authorizing and recording transactions
- Restricting access to assets
- Checking for existence of recorded assets

Transaction controls are influenced and set by management controls

**Corporate governance**

System by which *companies are directed* and managed

- Covering the conduct of the Board of Directors and the relationship between the Board, management and shareholders through the presence of internal auditors and audit committees

**Audit committees**

Sub-committee of Board of Directors which is concerned with the overall audit objectives

- Should only consist mainly of non-executive directors to achieve a level of independence
- Important component of corporate governance
- Listed companies are required to have an audit committee and if not, they are required to provide an explanation as to why they do not have one
- Should include directors with accounting or finance expertise

**Effective audit committees**

1. Active role in overseeing the company’s accounting reporting
2. Direct line of communication between the Board of Directors and the auditors
3. Discuss sensitive matters with auditors including disagreements with management
4. Nominate external auditors
5. Strengthen auditor independence by being the independent communication link between management and auditors

**Management ↔ Audit committee ↔ Auditors**

**Elements of internal controls**

Based on the COSO framework, outlined in *ISA 315.14-23*

1. Control environment
2. Entity’s risk assessment process
3. Information system
4. Control activities
5. Monitoring of controls

Objectives of internal controls are reporting, compliance and operations
Control environment
Entity’s environment influenced by governance and management’s overall attitude, awareness and actions regarding internal controls and its importance in the entity

In relation to control environment, auditors should consider
1. Communication and enforcement of integrity and ethical values
   - Is there a code of conduct for the wider organisation?
2. Commitment to competence
3. Active involvement by management in the audit
4. Management’s philosophy and operating style
   - High risk vs conservative style
5. Organisational structure
   - Loose? Structured?
6. Assignment of authority and responsibility
   - Is there an accountant higher up in management in example of CFO?
7. Human resource policies and practices
   - Does HR policies involve checking references prior to hiring candidates?

Entity’s risk assessment process
The risk assessment process refers to the entity’s way of identifying and responding to business risks

- Management considering risks and evaluating how they should be managed
- Risk response by management may include introducing plans to address risk or accepting risk on a cost-benefit analysis as is the case with insurance providers and casinos
- Having a risk committee or risk assessment employees

Information system
An effective information system will establish records and methods that
1. Identify and record all valid transactions
2. Correct any incorrect processing of transactions
3. Account for system overrides
4. Automatically post transactions to the general ledger
5. Capture information, which are not transactions, that are still relevant to financial reporting

Audit trail
Ability for each transaction to be traced through each step of the accounting process to the financial report and from the financial report back to its original source document
- Through ledgers, journals and source documents and vice versa
Control activities
Activities of policies and procedures established by management to ensure its directives are carried out
- Performance reviews, which is a management control
- Information processing, IT controls and application controls
- Physical controls over safeguarding assets
- Segregation of duties

Segregation of duties
1. Authorization of approving the transaction
2. Execution of executing the transaction
3. Custody of having access to the physical asset
4. Reporting of the entry of the transaction data into the accounting system

Control activities may be related to financial report assertions (Income statement for below)
1. Occurrence- authorization of transactions
2. Completeness- accounting for sequence of transactions
3. Accuracy- checking dollar amounts back to supporting documentation
4. Cut-off- independent review of transactions recorded around year end
5. Classification- independent checking of account coding

Monitoring of controls
Process undertaken by management alongside internal auditors to assess the effectiveness of the performance of internal controls
1. Evaluating the design and operation of controls
   - Supervisory activities
   - Separate evaluations
2. Taking corrective action where necessary

Steps in the auditor's consideration of the internal control structure
1. Understand the internal control environment
2. Understand the risk assessment process
3. Understand the information system
4. Understand the control activities
5. Understand the monitoring of controls
6. Document overall understanding of internal controls
7. Make preliminary assessment of control risk as being high / med / low

Preliminary assessment of control risk
1. If control risk is high, perform planned and also additional substantive procedures of analytical procedures and test of details
2. If control risk is low, perform tests of controls and planned substantive procedures of analytical procedures and test of details
3. If control risk is low, but deviations were found when performing test of controls; perform planned and also additional substantive procedures of analytical procedures and test of details
Procedures for understanding control activities
1. Making inquiries of appropriate client personnel
2. Inspection of documents
3. Observation of entity’s activities, operations and procedures
4. Walkthroughs of tracing transactions of each type through related documents, observing related processing and control procedures in operation

Methods of documenting the auditors’ understanding of internal controls
1. Internal control questionnaires and checklists
2. Narrative memoranda of written description of internal control procedures
3. Flowcharts to illustrate procedures and applicable internal controls

Role of internal auditors in external audit
- Internal auditors, another important element of corporate governance alongside the audit committee, strengthen monitoring of controls
- Internal auditing reduces audit risk

Evaluation of internal audit work by external auditors
1. Objectivity
   Internal auditors’ status within the entity, which should be relatively high
2. Technical competence
   Whether or not internal auditors have adequate technical training and proficiency
3. Due professional care
   Considering whether internal auditing is properly planned, documented, supervised and reviewed
4. Effectiveness of communication
   Whether the external auditor can effectively communicate with the internal auditors

Alongside these four factors to consider when evaluating the work of internal auditors, external auditors must also consider the differences between an internal and external auditor
1. Objectives given external auditors are required by law whereas internal auditors are only an option, despite being an important part of corporate governance
2. Independence
3. Qualifications given internal auditors do not need a qualification although in NZ, the trend for internal auditors is that they are either working towards a professional qualification or have previous external audit work experience

Audit strategies
- For low assessed level of control risk, auditor may predominantly rely on test of controls and to do so, auditors must gain an extensive understanding of relevant parts of internal controls
- For higher assessed level of control risk or cases where test of controls is inefficient, auditor may predominantly rely on substantive approach of test of details and analytical procedures
Key functions in typical revenue, receivables and cash receipts cycle

Sales / AR
Debit accounts receivable
Credit sales
- Order entry and order approval by credit department
- Shipping the goods
- Invoicing the customer
- Accounting the sales through sales journal, accounts receivable master file

AR / Cash
Debit cash
Credit accounts receivable
- Mail opening of cheques sent by customers
- Accounting the receipt through cash receipts journal, accounts receivable master file
- Bank reconciliation, which especially relates to bank transfers

Bank reconciliation is a significant internal control activity alongside segregation of duties which suggest that duties of authorizing, executing, having custody and recording should be kept separate

Sales transactions
1. Routine transactions
   Transactions that are routinely such as sales and cash collections are well controlled thus well suited to test of controls
2. Non-routine transactions
   Transactions that are not routinely in nature such as the return of goods and estimates of doubtful debt provisions are less suitable for test of controls, thus more subject to substantive test approach

Control objectives / assertions for sales
1. Occurrence- all sales recorded are bona fide transactions
2. Accuracy- invoices have been recorded correctly in regard to amounts
3. Completeness- all sales shipped are invoiced and recorded in accounting records
4. Cut-off- invoices have been recorded in the correct periods
5. Classification- sales correctly classified in accordance with written policies

Types of potential misstatements
1. Clerical mistakes
2. Employee fraud
3. Misapplied accounting principles, especially around revenue recognition issues
Expenditure, payables and disbursements cycle
Cycle of all transactions and events related to when an entity acquires assets, usually inventory and or services such as utilities
- Payroll
- PPE
- Inventory
- Income taxes
- Selling expenses and administrative expenses
- Miscellaneous expenses paid using petty cash

Key functions in typical expenditure, payables and disbursements cycle
Debit inventory / expense
Credit accounts payable
Debit accounts payable
Credit cash
- Purchasing from approved suppliers
- Receiving goods or service
- Updating accounts payable ledger and recording the purchase
- Payments department recording the payment and making the disbursement

Control objectives / assertions for payables
1. Existence- purchased inventories do exist in reality
2. Rights and obligations- entity does have the right to inventory as recorded in the accounting records
3. Valuation, amount, accuracy- inventory has been recorded correctly as to amount
4. Completeness- the inventory balance and payables balance shown on the balance sheet are complete
5. Classification- all inventory and payables have been correctly classified in accordance with written policies

Control objectives / assertions for purchases
1. Occurrence- all recorded purchases are bona fide purchases
2. Accuracy- purchases of inventory are recorded correctly as to amounts
3. Completeness- all purchases for the period have been recorded
4. Classification- purchases are correctly classified in accordance with classification policies
5. Cut-off- purchases have been recorded in the correct periods

Types of potential fraud in expenditure cycle
- Disbursements fraud
- Kickbacks of accepting bribery from suppliers regarding purchases
- Illegal acts
- Unauthorized executive perks
- Kiting as in bank fraud of taking advantage of the timing delay in deposits from one bank account to another not showing immediately

Internal controls must be understood, observed, inspected and documented by the auditors
Tracing
Tracing source documents to the figure in the financial statements
- Testing for completeness
- Going towards the financial statement

Vouching
Tracing financial statements to the source documents
- Testing for occurrence
- Going away from the financial statement

Any changes in the audit procedures performed, such as performance of alternative audit procedures, must be documented in the auditors’ work papers.

There are two types of substantive testing which are analytical procedures and test of details thus auditors would place most reliance on analytical procedures when balance is immaterial and internal controls are good, as in when inherent and control risk are low
- On the other hand, if internal controls are poor in that inherent and control risk are high then detection risk must be minimized through extensive audit procedures upon which auditors will need to perform more than just analytical procedures thus also relying on test of details

The systems analyst reviewing output and controlling the distribution of output from the IT department constitutes a weakness in IT control.

If company is currently under financial pressure, there is a risk of big bath in that management incorrectly take up expenses this year as to make next year look better.

Inspecting invoices from law firms is one way to identify related party transactions given solicitors may be involved in large and or complicated related party transactions.

Company policy regarding credit and collection efforts is an example of internal controls whereas classification of sales and cost records by products is not an internal control of major interest to the auditors.

Auditors may engage in special audit planning if inventory is rather specialized, for example, inventory consists of precious gemstones which will have significant valuation implications.

Auditor who finds the client has committed an illegal act is most likely to withdraw from the audit engagement when illegal act affects auditors’ ability to rely on management representations given financial data contained in financial statements is effectively the outcome of management representations.

The expertise of client personnel and expected involvement from them is least likely to affect the quantity, type and content of audit working papers unlike the need for supervision, assertions being tested and nature and condition of the clients’ records and internal controls.
When auditing purchases, auditor is most likely to engage in tracing of tracing source documents to financial statements to test for completeness given the pressure of meeting earnings can be translated into omitting certain expenses from the financial statements as to meet the profit target.

When auditing sales, auditor is most likely to engage in vouching of tracing financial statements to relevant source documents as to test for occurrence.

Slow-moving and obsolete items being properly identified most relate to the assertion of accuracy, valuation and allocation as to the amount of the balance sheet item.

Inventory listing being accurately compiled and totals being included in the overall inventory figure as well as inventory quantities including all items, materials and supplies owned by the company relate to the assertion of completeness of inventory within the balance sheet.

Substantive testing
1. Test of details of balances
2. Tests of details of transactions
3. Test of disclosure
4. Analytical procedures

As the level of acceptable detection risk decreases due to high risk of material misstatement, consisting of inherent risk and control risk; auditor may change substantive testing from less effective procedures to more effective procedures.

Audit risk is effectively the risk that auditors will give an unmodified opinion on a financial statement that is materially misstated.

When performing an audit, the auditors are likely to be found negligent the most when they have failed to warn the client of any internal control weaknesses they have found, as opposed to failing to include a negligence warning in their client engagement letter.

Auditors owe a contractual duty to the company itself, but a duty of care in common law to users of financial statements, shareholders in particular.

It is the management who has the responsibility of preparing financial statements and ensuring adequacy of accompanying notes.

Independent auditor is required to report on the financial reports of a company given different interests may exist between the preparer of the financial statements as in the company and the users of financial statements as in the stakeholders.

Prospective auditor should not discuss with client’s management any issues disclosed by the previous auditors of the client.

Unexplained decrease in gross profit to sales ratio may indicate unrecorded sales, given COGS has gone up leading to decrease in gross profit yet sales remaining the same.
The first step you take after accepting an audit engagement is likely to be touring the client’s facilities and inspecting conditions of records.

Audit evidence should be corroborating as in strengthen audit opinion.

During preliminary audit planning, auditor considers risk of business failure.

The AWA case determined that auditors are only responsible for partial damages, as opposed to having the burden of full liability.

When audit client is under pressure to meet earnings target:
   1. Occurrence assertion for sales at risk, as in falsifying sales.
   2. Completeness assertion for purchases at risk, as in understatement.

**Caparo case**
Auditors owe a duty of care to shareholders as a whole, but not to individual shareholders nor third parties.

**AWA case**
Contributory negligence and auditors only being liable for damages attributable to their actions.

**Kingston Cotton Mill case**
Auditors are watchdogs and not bloodhounds.

Material frauds perpetrated by CFO are the most difficult frauds to detect.

Segregation of duties, which emphasize that the duties of reporting, custody, authorization and execution should all be kept separate, is an example of internal control thus testing to check assurance provided by segregation of duties is an example of test of controls.

Independent auditors are referred to as being independent given they are not employees of the entity being audited.

Exemplar analytical procedure is comparing information with similar information regarding the industry in which the client operates in
   - Use of ratios.

If client lacks receiving reports and there are many adjusting entries to accounts payable which is a material balance, the assertion of completeness is most at risk for accounts payable.

Auditor obtains support for segregation of duties through personally observing the employees applying the control procedures.
Getting a sample of shipping documents then seeing whether invoices were prepared best relate to the assertion of completeness, as in ensuring that each transaction is invoiced for which is concluded in the sales figure.

It is invalid to say that one evidence will be denied because it is only persuasive and not convincing.

Auditors should have no doubt about the audit evidence they use:
- Seldom convinced beyond all reasonable doubt with respect to all aspects of the evidence.

Audit is viewed as a discipline that assures financial information presented by management.

Auditor must plan the audit so as to have reasonable expectation of discovering material fraud.

In determining whether transactions have been recorded, direction of audit testing should start with source documents because the assertion of interest is completeness which can be tested through tracing of going towards financial statement.

When testing segregation of duties as a control over inventory, auditor would least likely to be concerned with inspecting documents:
- But inspection itself is a common procedure in test of controls.

Auditor may assess control risk as being high if conducting test of controls as in evaluating the effectiveness of control policies and procedures are inefficient.

Tracing shipping documents to pre-numbered invoices is an example of tracing which tests for completion, determining whether all shipments have been properly invoiced.

When testing for completion of purchases, auditors would be concerned about the receiving reports before and after year-end to ensure they have been appropriately recorded.

Opinion of an independent party as in an auditor is required given a company may not be able to objective with respect to its own financial report, and rather be biased.

Assurance services include providing an opinion regarding accuracy of statements made on the client’s web.

In any assurance engagement whether audit or another engagement type; auditors are always required to consider the reliability of evidence.

Audit is a disciplinary function that assures financial information presented by management and not a regulatory function as per say.
Audit evidence is the evidence produced by substantive testing which supports the audit opinion concluded.

Auditing focuses on the most important transaction processes:
- Transactions involving high degree of judgement
- Processes with a high volume of similar transactions e.g. Revenue

*Tranz Rail* used to not know what freight it was carrying for 15 years given the lack of proper information systems, which is estimated to have cost the company $600 million:
- Represents weakness in control around assertion of completeness of revenue
- If Tranz Rail never intended to collect the revenue, perhaps the financial report could have been said to be true and fair
- However, understatement of revenue by $600 million over the 15 years is rather material

Controls testing VS Substantive testing:
- Controls are built around transaction flows in that they are built for systematic and repetitive transactions
- Controls testing is better suitable for repeated transactions of high volume
- Controls testing is concerned with whether the related controls are working efficiently and effectively or not
- Substantive testing may be suitable not only for repeated transactions of high volume but also transactions involving estimates and judgements such as warranty provisions
- Substantive testing is concerned with whether monetary errors have occurred or not

Dual-purpose tests address both the control testing and the substantive testing aspects.

**Substantive testing**
1. Test of transactions
   - Focus on individual transactions, as in specific journal entries
2. Test of balances
   - Focus on the ending balance of an account which has accumulated after multiple transactions

For example, to test for the $5,000 balance of accounts receivable, the auditor could conduct test of balance through getting the debtor’s confirmation to verify the $5,000 balance or also conduct test of transactions as in examining supporting documentation for the individual journal entries which make up the $5,000 balance.

**Direction of testing**
- Tracing refers to going towards the financial statement
- Tracing tests for completeness
- Vouching refers to going away from the financial statement
- Vouching tests for occurrence and existence
Substantive testing
1. Test of details
   - Test of details of balance, of transactions, and of disclosure
2. Analytical procedures
   - Ratios and forming expectations

Auditing cash balance
Cash balance is affected by cash receipts upon sale and cash payments upon purchases
- Testing the assertions of occurrence and completeness of transactions
- Assessing control risk in the sales and cash receipts system
- Assessing control risk in the purchases and cash payments system
- Testing the assertion of valuation, accuracy and allocation especially if the cash balance involves foreign currency transactions given potential foreign currency translation issues
- Testing the assertion of completeness and existence through external bank confirmations and testing bank reconciliations

Assertions relating to cash balance, cash receipts and cash payments
1. Cash balance
   - Completeness
   - Existence
   - Valuation, accuracy and allocation
2. Cash receipts / payments
   - Occurrence
   - Completeness
   - Valuation, accuracy and allocation

General procedures
Procedures carried out, not specific to an account balance, but potentially relevant to all accounts in general e.g. Board minutes, contracts

Bank confirmations
Form of external confirmation which serves as evidence that the cash balance in the balance sheet does exist at the balance date and that it is owned by the entity
- Existence and completeness assertion of cash asset
- Bank confirmation also lists other relevant information such as loans, loan securities and forward exchange contracts which may need to be disclosed
- Electronic confirmation through confirmation.com

Kiting
Fraud of making falsified payments and receipts through use of multiple bank accounts to make the bank account balance of specific banks appear different to what they genuinely are
Lapping fraud
Similar to Ponzi schemes, whereby receipts to the company are stolen yet the money subsequently received from other customers are ‘over lapped’ to conceal the theft
- May be detected when the employee committing the lapping fraud goes on holiday upon which another employee will fulfill his or her role

Testing bank reconciliation
Bank reconciliation is regarded as an internal control over cash, especially in relation to the existence and completeness assertions
- Extent of testing depends on the control risk
- If control risk is low, minimal substantive procedures may be carried out through examining the client’s bank reconciliation and comparing it against the bank confirmation
- If control risk is high, substantive procedures will be more substantial in example of examining the individual reconciling items

Auditing accounts receivable
Mainly concerned with the existence and valuation, accuracy and allocation assertions
- Existence assertion can be tested through debtors’ confirmation
- Valuation, accuracy and allocation assertion can be tested through debtors ATB as in aged trial balance

Common substantive testing procedures for sales, accounts receivable and cash
1. Substantive analytical procedures as in ratios, which may form expectations
2. Test of sales transactions, as in individual sales journal entries
- Testing for sales will also provide some reassurance over the accounts receivable balance given they are the two sides to the sales recording journal entry
3. Looking at transactions close to before and after year end, as to test for the cut-off assertion
4. External confirmation from banks and debtors
5. Subsequent receipts review, given if the company receives subsequent receipts, this suggests that accounts receivable balance did exist from those payers as in the customers, as in assuming that money must have been owing if payment was received
6. Review of aged trial balance

Testing sales
1. Occurrence can be tested through vouching as in selecting journal entries and obtaining relevant source documents to verify the journal entries
2. Completeness can be tested through tracing as in selecting few supporting documents and seeing if they are recorded in the general ledger
3. Accuracy can be tested through testing the prices and calculations of invoices
4. Cut-off can be tested through reviewing the journal entries leading up to the balance date and journal entries recorded shortly after the balance date
5. Classification can be tested through the coding of the journal entries
Issues relating to revenue recognition
- The earnings process must be substantially completed in order for revenue to be recognized e.g. Xerox recognized revenue in the first year the photocopiers were leased but they should have been recognized spread over the lease term
- Likelihood of collection must be reasonably assured as in the valuation, accuracy and allocation assertion e.g. Doubtful debts provision and bad debts

Debtors’ confirmation
1. Positive form
   Auditor asks the debtor to respond whether or not they agree
2. Negative form
   Audit asks the debtor to respond only if they disagree with the client’s records
   - Only when risk is low

Confirmation procedures
Controlled by the auditor through
- Selection of accounts to receive confirmations for
- Reviewing the letters sent out for confirmation purposes
- The confirmation letter responses must be sent directly to the auditors

Confirmation results
Confirmation process may expose errors or require explanations
- Timing differences with delivery or cash (which may be revealed as reconciling items as part of the clients’ reconciliation process)
- Disputes about goods or price
- Errors about goods or price

The confirmation process provides reassurance over the existence assertion but not necessarily over the valuation, accuracy and allocation assertion given it does not indicate potential doubtful debts or bad debts
- Given the confirmation process does not directly relate to the valuation, accuracy and allocation assertion; the auditors can supplement this testing with reviewing the debtors’ ATB to review potential doubtful debts and bad debts

The subsequent cash receipts testing process on the other hand provides reassurance over both the existence and valuation, accuracy and allocation assertions

Week 6 Guest Lecture- Ann-Marie Leclair-Johnstone from SFO

SFO, Serious Fraud Office, was established in 1990 to fill the identified gap in the general law enforcement capability upon the corporate collapses during the 1980s
- Purpose is to detect, investigate and prosecute serious or complex fraud
- Purpose is not necessarily to prevent fraud nor look at civil proceedings
Criteria for investigation

1. Impact
2. Scale, in that is the case large scale enough in measure of amount or the potential impact on undermining public confidence?
3. Complexity, in that are no other agencies such as the police able to take the case on?
4. Public interest

There is no statutory definition of fraud but generally, it is defined by the intention to deceive and dishonesty
e.g. Investment fraud, Ponzi scheme, debt factoring fraud, embezzlement or employee fraud, bribery and corruption such as kickbacks during the procurement process or not disclosing conflicts of interest

**Week 7**

**Computer-Assisted Auditing techniques ‘CAATs’**

Use of computers in substantive testing for audit purposes
- Use of audit software to read clients’ master files and transaction files

**Advantages of computer-assisted audit techniques ‘CAATs’**

1. Time efficiency for routine audit tasks
2. Directs auditors’ attention to items of high risk or of high materiality

**Generalized audit software ‘GAS’**

The first step is to read the clients’ master and transaction files
- Specify file format in consideration that the client may have a very specific and unique database, of which the format does not work with generalized audit software, GAS
- Set out processing instructions e.g. Perform processing tasks such as add, sort, merge and filter specific transactions

**Examples of using generalized audit software, GAS**

1. Sending out debtor’s confirmation to test for existence assertion of accounts receivable
2. Reviewing subsequent receipts to test for existence assertion of accounts receivable
3. Using the exception reporting function of the audit software to test for valuation, accuracy and allocation assertion of accounts receivable
   - E.g. Reviewing accounts with outstanding balance that are greater than the set limits, reviewing accounts with aged balances
4. Using the sampling function within the software

**Other general functions of the generalized audit software, GAS**

- Select sample items
- Exception reporting function
- Test and perform calculations
- Compare data of two separate files
- Summarize data and generate reports e.g. Summarizing sales by date, location
Benford’s Law
Technique which can be used in detecting fraud
- Claim that numbers which have been made-up will not be distributed like naturally occurring numbers as in numbers which are real and have existed
- Looking at whether the distribution of the numbers in the clients’ file fall within the distribution under Benford’s law and if not, fraud?

Distribution under Benford’s law

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<th>Leading number</th>
<th>Occurring frequency</th>
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<tbody>
<tr>
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<tr>
<td>2</td>
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<tr>
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<td>5.1%</td>
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<tr>
<td>9</td>
<td>4.6%</td>
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Fraud triangle
1. Pressure / Incentive
   Pressure on employees to misappropriate assets
2. Opportunity
   Circumstances that allow an employee to misappropriate assets
3. Rationalization
   Mindset that allows employees to misappropriate assets then justify their dishonest actions

Fraud
1. Fraudulent financial reporting
2. Misappropriation assets

Week 7 Guest Lecture- Anthony Steele & Dayak Randewa from PwC

Key advantages of data analytics in auditing
1. Higher degree of coverage across financial statements being audited
2. Targeting risks more effectively
3. Increase reliability of data by pulling both internal and external data together
4. Provide further value to clients by interpreting what data means
5. Some transactions that do not follow the standard transaction paths, such as irregular transactions, can be identified through data analytics

Key areas where data analytics are used
1. Investigating exceptions within revenue, through exception reporting function
2. Manual journals
One time vendors are rather risky given they may bypass the registration evaluation process
  - Background checks, company office tour

Duplicate invoices are common
  - Can investigate which users have recorded invoices in the accounting system, indication of fraud

**Data analytics in wider data context**

1. Audit support
2. Risk based approach
3. Reviewing validity of data in master files e.g. Duplicate vendors, employees as vendors
4. Conflict of interest e.g. employees as vendors
5. Control overrides
6. Validity of invoices
7. Inappropriate spending
8. Fraud indicators

**Week 8**

**Inventory** being one of the most significant auditing items
  - Phantom inventory of ‘creating’ inventory which does not actually exist
  - Inflating inventory values e.g. Fortex
  - Shipments between plants
  - Multiple branches of entity

**Reasons to overstate inventory**

1. To ‘meet’ debt covenants in lending requirements
2. Not writing off inventory that should be written off, given such could negatively affect the entity’s share price
3. Overstating inventory understates cost of goods sold, which leads to overstated gross profit

**Inventory related procedures**

- Observation of physical inventory, to test for existence assertion
- Substantive analytical procedures as in calculating ratios, to test for existence, completeness and valuation, accuracy and allocation assertions
- Physical examination of inventory, to test for completeness and valuation, accuracy and allocation assertions
- Cut-off testing around balance date
- Tests in relation to valuation, accuracy and allocation assertion
- **General procedures** such as review of board minute and contracts to test for rights and obligation
Inventory related procedures audits look out for

- Written instructions and manuals
- Adequate supervision
- Stocktake by an independent entity, such as the warehouse managing entity
- Conducting stocktake in pairs as opposed to stocktaking by individuals given the potential for inventory theft
- Pre-numbered tags or sheets, which may be scanned
- Systematic procedures to ensure all stocks are included and not double counted
- Method of identifying and recording obsolete or damaged inventory

Inventory tags serves as the inventory identifier

In relation to the valuation, accuracy and allocation assertion; inventory must be recorded at the lower of cost and net realizable value

- Decline in the entity’s competitiveness within the marketplace and increased competition could indicate reduced net realizable value of the entity’s inventory

Test of controls for inventory
Reviewing the effectiveness of the client’s methods of counting and recording inventory

Inspection and observation of inventory count, as in inventory stocktake, is required under auditing standards unless there is a better suitable auditing measure

Inventory valuation
Inventory must be valued appropriately under FIFO, Weighted Average Cost, or LIFO

- Also, lower of cost and net realizable value with net realizable value depending on the selling price and salability with the cost depending on the current inventory price

Cut-off of inventory is closely associated with revenue and expense recognition

- Affects sales, purchases, profit for this year and profit for next year

Testing for cut-off

- Observe procedures for shipping goods
- Inquire about any formal instructions around cut-off such as the when the shipments and or sales will last be recorded
- Review the journal entries recorded prior to and after cut-off and obtain supporting documents

If goods are dispatched prior to balance date, the relevant sales journal entry should be recorded in the current income year

Test receiving reports to test that receiving inventory has been correctly recorded
Test shipping documents to test that shipped inventory has been correctly recorded
Main assertions relating to inventory

1. Existence - physical stocktake, analytical procedures
2. Valuation, accuracy and allocation - analytical procedures, inspection, vouching as in obtaining supporting documents for the sample journal entries as to test for the occurrence of purchases

Tracing, of going from supporting documents to financial report, to test for completeness

Vouching, of going from financial report to supporting documents, to test for occurrence

Common audit procedure to test for the classification assertion is inspect supporting documents to check account coding

Liabilities are generally at risk of being understated whilst assets are at risk of being overstated
- Thus, analytical procedures in relation to liabilities are typically focused on searching for unrecorded liabilities

Accounts payable audit procedure
Account at risk of being understated
- Searching for unrecorded liabilities
- External confirmation to confirm the completeness and valuation, accuracy and allocation assertions

Inspection of invoices can assist in testing for existence and rights and obligation assertions of accounts payable

Confirmation of accounts payable balances with creditors can assist in testing for existence, rights and obligation and completeness assertions of accounts payable

Confirmation procedure is particularly relevant to accounts payable and accounts receivable

Searching for unrecorded liabilities ‘Out-of-period liability search’
- Inspect receiving reports prior to balance date
- Review as to whether the receiving reports have been included in accounts payable
- Inspect payments after the balance date, as in subsequent payments testing given if the entity has made payments then this suggests that such payments were owed to the suppliers

Searching for unrecorded liabilities relate to the completeness assertion of accounts payable

Main assertions relating to accounts payable

1. Completeness as in no unrecorded liabilities
2. Valuation, accuracy and allocation
- Can be tested via verifying prices and quantity on suppliers’ invoices
Analytical procedures can be used in testing for property, plant and equipment as in the existence and valuation, accuracy and allocation assertions

**PPE testing**
Auditor must be satisfied that the property, plant and equipment is valued in accordance with the relevant accounting standards
- Cost model
- Revaluation model
- Impairment which may be identified through observation of physical plants, and inquiry of management

**Main assertions relating to PPE**
1. Existence
2. Valuation, accuracy and allocation
3. Rights and obligations

**Payroll**
Employee related expenses such as salary or wages
- High level of tests of controls
- Substantive analytical procedures, given the ability to form expectations based on previous years’ figures

**Main assertions relating to payroll liability**
1. Completeness
2. Valuation, accuracy and allocation

**Week 9**
Sampling effectively determines the extent of procedures

**Sampling**
Examining less than 100% of the population of items
- Cost-ineffective to look at 100% of the population
- Looking at a smaller number of items which represent the population

**Detection risk**
Risk of the auditor incorrectly accepting an assertion as in, in that the auditor has not detected material misstatement

Inherent risk refers to the susceptibility of the assertion of interest to material misstatement

Control risk refers to the risk of the internal control in place not effectively detecting, preventing and or correcting material misstatement
Combination of inherent risk and control risk share an inverse relationship with detection risk
- If inherent and control risk are high, detection risk must be low meaning more audit work
- If inherent and control risk are low, detection risk can remain high meaning light audit work

Detection risk can be controlled by the auditor whereas inherent and control risk cannot be given they depend on the management and those charged with governance

Detection risk components
1. Sampling risk, quantitative
2. Non-sampling risk, qualitative

Sampling risk
Risk associated with the quantity of evidence
- Unavoidable, given sample is less than 100% of the population thus sampling risk does not exist only when the auditor looks at the entire population

Non-sampling risk
Risk associated with the quality of evidence
- Can be controlled through the quality of audit evidence such as using techniques of good supervision and having the most competent personnel on the audit team

Non-sampling risk
Risk that despite having selected an appropriate sample which is a good representation of the population, the auditors will still arrive at the ‘wrong’ conclusion as in not detect material misstatement and incorrectly accept an assertion

Sample selecting methods
1. Statistical
2. Non-statistical

Statistical sampling
Choosing a sample based on mathematical statistic technique
1. Random sample selection
2. Dollar unit sampling

Non-statistical sampling
Choosing a sample based on professional judgement
- Application of audit experience and knowledge about the client e.g. Increasing the sample size off what was chosen in the statistical sampling given the risk associated with the client currently being under financial pressure
Planning and designing the sample
- Consider audit objectives, which usually relates to an assertion or control
- Consider the population from which the sample will be selected
- Consider the possible use of stratification

Stratification
Recognition of the different characteristics within the population which resemble sub-populations thus the need to divide the population into sub-population prior to sample selection to strengthen the sample’s representativeness of the entire population
- May reduce sample size
- Able to better identify risky or material items e.g. Sub-population of $1 million and over and the other sub-population being of less than $1 million

Sample size depends on the sampling risk the auditor is willing to take
- Audit risk comprises of inherent risk, control risk and detection risk
- Risk of material misstatement comprises of inherent risk and control risk
- Detection risk comprises of sampling risk and non-sampling risk with sampling risk relating to the risk of the sample not accurately representing the population and the latter being related to the risk that despite having minimized sampling risk, the auditor still incorrectly accepts an assertion as in do not detect material misstatement

Sampling risk is inevitable when choosing to evaluate a sample, as opposed to looking at the entire population whereas non-sampling risk can be better controlled by the auditor through improving the quality of the audit evidence using techniques such as increased level of supervision

Planning for substantive testing
- Considering assertions
- Making preliminary judgements about materiality levels
- Conducting preliminary analytical procedures
- Determining allowable risk of incorrect acceptance
- Looking at the characteristics of the population that is being audited

Allowable risk of incorrect acceptance
Better known as the RIA, as in risk of error the auditor is willing to tolerate and accept
- The other part of the equation to the desired level of assurance

Allowable risk of incorrect acceptance, RIA
- If RIA is low, sample size will be high
- If RIA is high, sample size will be low

Sample size and allowable risk of incorrect acceptance as in RIA share an inverse relationship
Sample selection
- Sample must be typical as in representative of the population or stratum in case of stratified population
- Sample must be selected without bias
- For random sample selection, every item of the population must have an equal chance of being selected as part of the sample

Common sampling techniques
1. Random sample selection
2. Systematic selection
3. Haphazard selection

Systematic sample selection
1. Selecting a random number
2. Determining the sample interval
3. The first sample being the random number, and the rest of the sample being chosen at every sample interval

\[
\text{Sample interval} = \frac{\text{Number of items in population}}{\text{Sample size}}
\]

Dollar-unit sample selection
Sample selection which is concerned with the individual dollar units, not the physical units. e.g. Population with 1,000 physical units and $100,000 dollar amounts is considered to have 100,000 sample units available
- Item that contains ‘more’ dollars, as in an item of a higher value, has a greater chance of being selected thus material items are more likely to be selected ‘probability proportional to size’
- Directs auditors’ attention towards overstatement errors given material items have a higher chance of being selected but draws auditors’ attention away from understatement errors

Dollar-unit sampling looks at which item within the population contains the ‘A’th dollar according to the cumulative total of the item

Dollar-unit sampling is an application of systematic sampling, but looking at dollar units

Probability proportional to size
\[
\text{Probability of item being selected} = \frac{\text{Interval}}{\text{Total dollar units of that specific item}}
\]

e.g. Item of $5,000 has a 25% probability of being selected as part of the sample if the interval is $20,000
Determining sample size

\[
Sample\ size = \frac{(Population \times \text{reliability factor})}{Tolerable\ materiality}
\]

- Tolerable materiality is also known as total tolerable misstatement

Qualified audit opinions are ‘concerned’ whereas unqualified audit opinions are ‘positive’

If auditor is unable to test on a selected item, it is treated as an error

e.g. If the auditor is unable to receive response for a debtor’s account, the amount contained in the debtor’s account will be treated as an error unless it can be tested via alternative procedures such as subsequent receipts testing

Evaluation of sample results

1. Determine the level of misstatement within the sample
2. Project the misstatement to the population
3. Compare the projected misstatement with tolerable misstatement
   - Accept projected misstatement if below tolerable misstatement, as account not at risk of being materially misstated
   - Reject projected misstatement if above tolerable misstatement, as account at risk of being materially misstated

Projection of misstatement

Misstatement of the sample must be projected onto the population given we are testing the population through the use of sample and reliance in the sample being representative of the population

\[
Projected\ misstatement = \text{Total errors in the sample} \times \left(\frac{Population}{Sample}\right)
\]

Projection of misstatement involves the assumption that if there are samples in the error, the population should contain similar errors

Sample deviation rate, SDR

Rate of errors contained in the sample, related to internal controls and control risk

\[
SDR = \frac{Total\ errors}{Total\ sample}
\]

- If SDR < TDR, sample results support the auditor’s reliance on internal controls
- If SDR > TDR, sample results do not support the auditor’s reliance on internal controls, thus further substantive testing must be carried out

Tolerable deviation rate, TDR

Rate of errors the auditor is willing to tolerate
Likely misstatement in the population

\[ \text{Likely misstatement} = \text{Projected misstatement} + \text{Sampling risk} \]

- Taking into consideration that although the sample contains errors, such errors may not be representative of the errors contained in the population due to sampling limitation, hence adding sampling risk

Principles of evaluation
1. Actual errors
2. Probable errors / Projected misstatement
3. Possible errors

If sample results are unacceptable
- Increase sample size
- Ask management of client to adjust the error
- If aggregate misstatement exceeds the tolerable materiality level, auditor should not give a standard unqualified opinion

Week 9 Guest Lecture- Ann Tod from KPMG

Factors in trend of audit quality
- Increasing expectations
- Intensifying regulatory pressure, in example of audit firms being put to tender and the mandatory rotation of auditors
- Value of audit being redefined, in example of fraud risk
- Acceleration of technological disruptions
- Increasing competition
- Required skillsets and drivers of retention broadening

Benefits of technology in context of auditing
1. Increased efficiency
2. Better tools for sophisticated analysis
3. Increased coverage, such as the ability to test the entire population as opposed to having to rely on a sample of the population

Audit quality factors
1. People such as their attitude, skepticism and technical knowledge
2. Commitment towards continuous improvement
3. Association with the right clients
4. Clear standards and robust tools
5. Recruitment, development and assignment of appropriate qualified personnel
6. Commitment to technical excellence and quality service delivery
7. Tone at the top, as in setting the culture and expectations from management
Data analytics are helpful in identifying key risk areas and unexpected transactions
- Controls testing
- Substantive analytical procedures such as calculation
- Entire population testing, providing greater coverage
- Specific item testing
- Journal testing
- Fraud risk procedures

**Week 10**

Audit procedures after balance date
1. Cut-off testing
2. Subsequent receipts testing for accounts receivable for those debtors which the audit was unable to obtain the confirmation from
   - Assumption that if payments are received after balance date, receivables of corresponding amounts would have existed as of balance date
3. Searching for unrecorded liabilities
   - Concerned with the completeness assertion
     e.g. Late invoices, the case of unrecorded payroll expenses for Smith city / Briscoes

Analytical procedures near completion of audit
1. Reviewing the overall reasonableness of the financial figures
2. Corroborating audit conclusion
3. Ensuring financial report is consistent with auditor’s knowledge of the client

Analytical procedures near or at completion of audit are conducted prior to the audit opinion being signed off

Analytical procedures are carried out
1. During the planning phase, as preliminary analytical procedures
2. During testing as a form of substantive testing technique
3. Near or at completion of audit prior to signing the audit report

Other procedures performed near the end of the audit
1. Carrying out general procedures such as reviewing the board minutes
2. Reading the directors’ report to search for any significant events occurring after the balance date
3. Obtain legal advice regarding any current material litigation involving the client as such will lead to either adjustment of liability or disclosure of contingent liability depending on how probable the lawsuit is
4. Consider the company’s ability to continue as a going concern as otherwise, the accounting method will change
5. Make inquiry of management regarding any material changes in the subsequent period or any planned sale of assets despite inquiry not being the strongest form of evidence
Searching for unrecorded liabilities
1. Analytical procedures to review as to whether the current liability balance fits in with the auditor’s understanding of the client
2. Subsequent payments testing in assumption that if the client has made payments to external parties after balance date, then liabilities of corresponding amounts would have existed as of balance date

Subsequent events review
1. Adjusting event
   Events are to be adjusted in the financial statements if the basis of conditions existed as at balance date
   - e.g. Title passing before balance date yet the purchase not having been recorded, investment having been written down prior to balance date in assumption that the relevant regulatory approval was not going to be given but the approval having been given after balance date but before the auditor’s report was signed
2. Non-adjusting event
   Events are not to be adjusted in the financial statements if the basis of conditions did not exist as at balance date
   - If the event is material enough, the event should still be disclosed in the notes to this year’s financial statements
3. Irrelevant event
   Events which took place after the auditor’s report was signed thus unable to be adjusted even if material
   - Auditor may call for restatement if the event was material

Role of auditors in subsequent events review
Auditor must consider subsequent events up to the point in time at which the auditor signs the audit report

Timeframe for auditor’s report
1. Balance date
   - Events before the balance date will already have been included in the financial report
2. Audit report signed date
   - Adjust if the event provides evidence of conditions that existed as at balance date
   - Not adjust but disclose if the event does not provide evidence of conditions that existed as at balance date but still deemed material

After the audit report signed date, the events can no longer be adjusted nor disclosed in the current year financial report but if the event is material, the auditors may make an announcement of restatement

After the balance date, the directors of the client company will sign the financial statements only after which then can the auditors sign the audit report
**Adjusting event**
Event, which took place after the balance date, that provides evidence of conditions that existed as at balance date

**Examples of adjusting events**
- If a significant amount of inventory was sold at below cost in that they were sold at a discount after balance date suffice as evidence of condition for the net realizable value of inventory to be written down in the current year’s financial statement
- Collection of a material account receivable after balance date which was written off prior to balance date
- Legal determination subsequent to the balance date which establishes that a claim did exist as at balance date
- Changes in company tax rates made after the balance date but for the fiscal period ended prior to the balance date
- Major debtor having been declared bankrupt after balance date would suggest the condition for bankruptcy existed as at balance date

With adjusting events, the shareholders reading the client company’s financial statements will not be able to see that such adjustment has been made given they will simply be a part of the current year’s financial statements
- Adjustments can only be viewed in the audit working file

**Non-adjusting event**
Event, which took place after the balance date, but does not relate to a condition that existed as at balance date
- If the non-adjusting event is material, the auditor must request for management to still disclose details of such event in the current year’s financial report

**Examples of non-adjusting events**
- Major currency fluctuations after balance date
- Raising of additional shares or loan capital after balance date
- Mergers and acquisitions after balance date which are deemed to be material thus very likely they will be disclosed in the notes of current year’s financial statements
- Fire or flood that took place after balance date of which the related amount of damage is not fully covered by insurance but unable to quantify the contingent liability, would be disclosed in the notes given its material substance

**Representation letters**
Formal representation letters sought by auditors towards the completion of the audit
1. Solicitor’s letter
2. Management representation letter

**Solicitor’s letter**
Formal representation letter obtained by the auditors from the client’s solicitors to obtain evidence on existence, completeness, valuation and presentation of legal contingencies
- E.g. Contingent payroll liability for Smith City
Management representation letter
Formal written representation letter that is prepared by the auditor but signed by management
- Documents management responses to all inquiries made by the auditors
- Clarifies management’s responsibilities and auditor’s responsibilities
- Any significant assumptions made in the financial statement such as fair value assumptions which are deemed to be reasonable

Auditor is required to obtain both the client’s solicitor’s letter and management letter prior to signing its audit report

Multiple review procedure
Process of continuous review of audit working papers
- Analysts to supervisors to managers to partners

Multiple review procedure also involves a high degree of planning and supervision all the way throughout the engagement

The final audit review prior to signing the audit report should be aimed at ensuring all significant matters and problems have been identified already

Final assessment of materiality and audit risk
As audit progresses through the testing phase, audit staff may identify material errors in the financial report and accordingly propose relevant adjustments

Evaluation of effects of misstatement
1. Factual misstatement
   Actual misstatement
2. Judgmental misstatement
   e.g. Warranty provisions, amortizations
3. Projected misstatement
   Potential misstatements in the future

Any identified misstatement, usually the projected misstatement as in the level of misstatements found within the sample projected onto the population, should be compared against the materiality level first
- Material misstatements must be adjusted

Accounting estimate
Approximation as in estimate of an amount of a financial report item in the absence of the precisely measured figure, which falls under management’s responsibility as to make reasonable estimates
- Provision for doubtful debts, usually a percentage of accounts receivable based on past collection history
- Provision for warranty expenses
- Useful lives of assets for depreciation, which usually involves using a set formula
Management may make certain accounting estimates in attempt to smooth out their earnings from one financial year to the next and the auditor’s responsibility in this context is to determine whether such ‘smoothing out’ is reasonable and appropriate or not.

**Auditors in context of the rest of the annual report**
- The annual report contains not only the financial report but other reports such as director’s report
- The audit opinion only extends to the financial statement and not any other reports contained in the client’s annual report

**Auditor’s responsibility for other information**
Auditor should review other information contained in the client’s annual report to identify
1. Material inconsistencies with financial report
2. Misstatements of facts

If the auditor finds material inconsistencies with the financial report or misstatements of facts in other information sections of the client’s annual report, the auditor should request for management to adjust accordingly but if they refuse, such refusal should be noted in the other matters paragraph within the auditor’s report.

**Related party transaction**
Business deal or arrangement between two parties who are joint by a pre-existing special relationship, as in being joint by a special relationship prior to entering into the arrangement
- Parent and subsidiary
- Subsidiaries of the same parent

**Related party transactions**
- When planning the audit, the auditor must identify related parties so that transactions with them can be noted and tested during the audit
- Auditor needs to verify compliance with the related party disclosure requirement
- Related party transactions are considered to be of high risk of material misstatement due to previous scandals of improper use of related parties such as Enron and finance companies

The high-risk nature of related party transactions comes from the concern with whether the transaction is an arms-length transaction or not, as in both parties to the transaction having acted in self-interests as to enter the arrangement rather than in influence of the other party nor collusion with the other party.

After the audit has been completed, the auditors may prepare a management letter covering internal control weaknesses that were discovered during the audit as to add value to the client.
The date of the audit report, as in the date on which the audit report is signed, is significant given it determines the critical period which is between the balance date and the date of the audit report in which if there are any events that take place during the critical period which provide evidence of conditions that existed as at balance date, then they must be adjusted.

- Inventory having been sold at a heavy discount after balance date suffice as evidence for inventory to be written down as of balance date to its net realizable value.
- Debtor being declared bankrupt after balance date suffice as evidence for the debt owed to this specific debtor to be written off.
- Legal determination after balance date which establishes the liability existed as of balance date.

The purpose of conducting analytical procedures near or at completion of audit is to test for overall reasonableness and appropriateness of the financial report and to confirm the audit opinion.

Auditor’s responsibilities with respect to subsequent events are to either classify them as adjusting events in which management will need to adjust for them in the current financial report or as non-adjusting events in which if they are material enough, management will need to disclose in the notes of the current year’s financial statements.

**Going concern basis**

Auditor is required to assess the risk of the client going concern issues at both the planning phase and during the final review, as in near the completion of the audit.

- Additional procedures are to be carried out when there is significant doubt about the client’s ability to continue as a going concern.
- E.g. Loss of patent, loss of major customer.

**Reporting doubt about going concern**

1. Previously
   - Addressed under ‘Emphasis of matter’ paragraph
2. Now
   - Addressed separately to ‘Emphasis of matter’ paragraph in ‘Material uncertainty related to going concern’ paragraph

**Assessment of going concern at completion stage of the audit**

1. Review events occurring after balance date
2. Analyze last interim financial statements
3. Read board minutes
4. Review terms of loan agreements given for heavily debt financed entities or entities who are currently struggling; failure to renew the loan may be material enough to affect the going concern ability of the client.
5. Request information from solicitors of the client to obtain evidence about any potential contingent liabilities.
6. Consider the effect of unfilled customer orders as such will affect the cash flow of the client.
**Going concern**
Is the going concern assumption appropriate for the client for the next 12 months starting current balance date?

**Issues in relation to going concern**
1. Self-fulfilling prophecy
2. Opinion shopping

**Self-fulfilling prophecy**
The idea that if the auditor has concerns about the client’s ability to continue as a going concern, such concern may suffice as basis for the client to fail due to suppliers and customers no longer wishing to transact with the client
- Auditor’s mere prediction of going concern issue affecting the actual going concern ability of the client

**Opinion shopping**
The idea that companies may look for a ‘soft’ auditor as in look for different auditors who will agree with the management decisions that current auditors do not agree with
- Not searching for the right answer, but rather searching for the auditor who will give the answer the ‘shopper’ as in the client desires

**Issuing an audit report with going concern issues**
High risk with either issuing or not issuing such report when the auditor should
- Issuing such report may lead to the self-fulfilling prophecy and or the auditor being sacked by the current client
- Not issuing such report may lead to damaged brand reputation and status for the auditors

**Week 11**

**Audit process**
1. Pre-engagement activities
2. Planning the audit
3. Obtaining audit evidence through test of controls and substantive testing
4. Evaluation of audit evidence
5. Conclusion

Auditor’s reports are addressed to the company’s shareholders

**Objective of an audit**
To enable the auditor to express an opinion as to whether the financial report is prepared, in all material respects whether fraud or error, in accordance with the applicable financial reporting framework as in GAAP
- Verification, truth, fraud, errors, trust, compliance, moral check
Objective of an audit
For auditor to express an opinion as to whether the financial report gives a ‘true and fair’ view as in ‘present fairly, in all material aspects’ in accordance with GAAP
- The statement of objective of an audit being only concerned with whether the financial report gives a true and fair view in all material aspects is an attempt to reduce the audit expectation gap which consists of the performance gap and reasonableness gap

True and fair view
- True view is concerned with whether financial statement is factually correct or not
- Fair view is concerned with whether the financial statement has been prepared without bias, reflects economic substance of the transaction rather than just the legal form in the example of SPEs by Enron

Generally Accepted Accounting Practices, GAAP
Accounting standards which enforce compliance
- NZ IFRs of New Zealand International Financial Reporting Standards

Audit is concerned with whether the financial report being audited has been prepared, in all material aspects, in accordance with GAAP however, such still leaves room for unfair behavior

Recent changes to the audit reports
- Contains more information
- Information presented in clearer language
- Inclusion of Key Audit Matters, also known as KAMs, which highlight what the focus of the audit has been as in the major issues addressed or concerned by the auditors
- Material doubts about the company’s going concern ability now being addressed in Material Uncertainty related to Going Concern as opposed to under Emphasis of Matter
- Enhanced description of the responsibilities of the auditor, which can be seen as an act to narrow the expectation gap such as by containing the link to XRB which outlines such responsibilities
- Identification of what in the other information as in information provided by those charged with governance materially differs from what is contained in the financial report

In terms of Key Audit Matters, goodwill impairment is a common item given it requires a high level of judgement thereby being an item at material risk

Material Uncertainty related to Going Concern
To be separately addressed in the financial report if the auditor has material doubts about the entity’s ability to continue operating at a going concern
- But not included in the financial report if no material doubts about the entity’s going concern ability
Types of audit opinions

1. Unqualified
2. Unqualified with emphasis of matter
3. Modified
   - Qualified
   - Adverse opinion
   - Disclaimer

Potential sections contained in the audit opinions

1. Material Uncertainty related to Going Concern
2. Other matter
3. Key Audit Matters
   - Paragraphs of emphasis, rather than being paragraphs of concerns
4. Emphasis of Matter

Unqualified opinion
Unmodified audit opinion whereby the auditor has obtained reasonable assurance that the financial report as a whole is free from any material misstatements whether due to fraud or error
- Sufficient audit evidence has been obtained to support such opinion
- Any uncorrected misstatements are immaterial
- Financial report is prepared in accordance with GAAP

Emphasis of matter
Unqualified audit opinion whereby the auditor highlights a matter that is appropriately presented or disclosed in the financial report but deems significant enough to bring it to financial statement users
- Such matters do not affect the auditor’s opinion

Examples of emphasis of matter
- Uncertainty relating to the future outcome of a significant litigation against the company
- Early application of a new accounting standard, which means financial report figures may be different had the standard not been applied
- Major catastrophe which has affected the entity’s financial position

Other matters
Paragraph within the auditor’s report which draws user’s attention to any other matters that are not presented in the financial report yet which the auditor believes to be sufficiently material enough
- Different from other information which is prepared by those charged with governance such as the chairman’s report
- Highlighting any information contained in other information which materially differs from the financial report
Auditor’s responsibility in relation to other information
Auditor’s opinion does not extend to provide assurance beyond the financial report information but the auditor still reviews other information contained in the entity’s annual report
- Auditor reviewing other information to ensure it does not contain any material inconsistencies or misstatements based on what is contained in the financial report

Qualified opinion
1. Material but not pervasive disagreement
2. Material but not pervasive limitation of scope

Adverse opinion
Material and pervasive disagreement with management
- Auditor knows about the material misstatement

Disclaimer
Material and pervasive limitation of scope
- Auditor does not know about the material misstatement

Modified audit opinion when
1. Material disagreement
   Audit evidence suggest that the financial report is not free from material misstatement
2. Material scope limitation
   Auditor is unable to obtain sufficient and appropriate audit evidence to reach the conclusion that the financial report is free from material misstatement

Prior to issuing a modified opinion- be it a qualified audit opinion, disclaimer or adverse opinion; the auditor should take all reasonable steps to overcome the issues giving rise to the material disagreement and also the issues causing the auditors to be unable to obtain sufficient appropriate audit evidence

Pervasive
Effects are considered pervasive if they
- Not confined to specific accounting elements, accounts or items in the financial report
- If confined, could represent a substantial proportion of the financial report figures
- In relation to notes of disclosure, are fundamental to users’ understanding of the financial report

Qualified opinion
Opinion whereby auditor concludes that the misstatements are material but are not pervasive in nature
- Material differences from what the accounting standard requires
- Material disagreements in relation to the carrying value of an entity’s asset or liability and its subsequent effect on profit
Adverse opinion
Opinion whereby the auditor concludes that the material disagreements are both material and pervasive to the extent that the financial report taken as a whole is misleading or is of little practical use
- Financial report having been prepared based on a going concern basis yet the auditor concluding and disagreeing with management in that it believes the client is highly unlikely to be able to continue as a going concern

Disclaimer of opinion
Opinion whereby the auditor faces a scope of limitation in not being able to obtain sufficient and appropriate audit evidence thus concluding that the possible undetected misstatements may be both material and pervasive
- Limitation on the audit evidence gathering procedures

Week 11 Guest lecture- Indy Sena, partner from PwC
Audit profession is becoming more regulated
- Increased level of regulation serving as a benchmark

‘Big Four methodology’ is often more thorough and detailed compared to the regulatory requirements given the big fours work are based on an international firm standard

Introduction of Key Audit Matters, as in KAMs, provide greater information to financial statement users as in providing insight
- Leads to better practice on part of client which can be used as leverage by the auditors

Audit opinions
1. Unqualified
2. Emphasis of matter
3. Modified
- Qualified of either material disagreement or material limitation but both of which are not pervasive
- Adverse of material and pervasive disagreement
- Disclaimer of material and pervasive limitation


**Week 12**

**Current issues in auditing**
- Co-regulation of auditors by FMA and the professional accounting bodies such as CPA and CA ANZ
- Demand for auditing
- Expectation gap which is driven by performance gap and reasonableness gap of the performance gap being pushed by deficient standards and deficient performance whilst the reasonableness gap is pushed by unreasonable expectations
- Auditor liability which may be reduced through clearly outlining management’s responsibilities and distinguishing them from the auditor’s liability and addressing the audit report to the shareholders of the company
- Risk-based audit model using inherent risk X control risk and detection risk of detection risk increasing if inherent and control risk are low but detection risk decreasing if inherent and control risk are high
- Internal controls
- IT audit
- Audit reports including unqualified, unmodified with emphasis of matter, qualified of material but not pervasive disagreement or limitation, adverse of material and pervasive disagreement and disclaimer of material and pervasive limitation, key audit matters, material uncertainty related to going concern
- Going concern

Auditing provides a high level of assurance but as a result, it is costly and the report is complex

**Audit**
- Reasonable level of assurance which is high
- Positive opinion ‘We believe the financial report is fairly presented in all material aspects, in accordance with the appropriate financial reporting framework’

**Limited assurance engagement ‘Review’**
- Lower level of assurance compared to audit, which is limited or also called moderate
- Negative opinion ‘We have not found any evidence which suggests that the financial report is not fairly presented’

**Agreed-upon procedures**
Procedures specific to an account or a process
- No level of assurance
- Produces report of factual findings

Special-purpose engagements will provide different levels of assurance and also produce different expression of opinions

**XRB standards** govern audit and reviews as well as other assurances such as sustainability reports and privacy but not non-assurance engagements such as agreed-upon procedures
Limited assurance engagement ‘Review’
Also known as a review, which provides a limited as in moderate level of assurance
  - Less costly
  - Negative opinion whereas an audit opinion provides a positive opinion

Limited assurance engagement ‘Review’
Evidence mainly gathered through means of analytical procedures and enquiries of management despite enquiries being considered a less reliable method in terms of gathering audit evidence
  - No tests of controls and no other substantive testing carried out in a review engagement which contrasts with audit

Review reports outline the directors’ responsibility and the assurance practitioner’s responsibility whereas audit reports outline the directors’ responsibility and the auditor’s responsibility

Why would some companies conduct review engagements although such is not required?
  - Entities which are not required to be audited may still want to be ‘reviewed’ as to be assured about its financial information
  - Regular assurance through reviews given reviews are less costly in comparison to audits

Agreed-upon procedures
Also known as due diligence work
  - Specific to an assertion or an account
  - Private report to be produced for the client who engaged the company to conduct agreed-upon procedures
  - No assurance provided but rather produce a report of factual findings

Special purpose engagements
Produce a public report similar to an audit report

Assurance services provided other than on financial reports
  1. Prospective financial information
  2. Environmental and sustainability reports

Prospective financial information
Assurance provided about the future financial information of the company
  - On forecasts of assumptions of future events
  - On projections of hypothetical assumptions which will depend on the satisfaction of contingent event A
  - Limited assurance on the basis of the assumptions
Environmental and sustainability reports
Assurance provided on environmental and sustainability reports of the company
- Increasing proportion of companies getting independent assurance on their environmental related information, although such trend is not yet visible in New Zealand
- Provided either by auditors or engineers
- Basis provide by the International Assurance Standard ISAE 3000

Future of assurance
Continuous assurance to match the continuous reporting by companies in real time
- Information to users on a timely basis
- Assurance simultaneous with events

Role of forensic auditors
- Investigate engagements such as fraud investigations
- Business economic loss analysis such as contract disputes and product liability claims
- Provide litigations support such as review of evidence

Privacy auditing
Limited assurance provided in relation to the management’s assertion that companies practice adequate privacy standards in relation to its customer’s private information

Ethics in context of assurance
- Code of Ethics issued by CA ANZ
- Professional Ethical Standards, PES, issued by the XRB / NZ AuASB

However, despite such code of ethics and professional ethical standards; ethics are attitudes of mind

Fundamental ethics principles
1. Objectivity as in not being biased nor subjective
2. Professional behavior such as not committing crime whether in professional capacity or personal capacity
3. Integrity
4. Professional competence and due care
5. Confidentiality

Code of ethics / Professional ethical standard 1
- Auditor must be independent of the entity and the subject matter on which they are reporting as in not have any conflict of interest
- Independence of mind
- Independence in appearance

Auditor must be in fact and also in appearance, be free of any interest which may lead to the auditor be incompatible with integrity, objectivity and independence
Threats to independence

1. **Self-interest threats** such as having financial interest in the client
2. **Self-review threats** such as the same auditing firm providing both consulting and auditing work for the client in which the auditor will have to re-evaluate his or her own work, affects independence in appearance
3. **Advocacy threats** of the auditor having the tendency to promote the client’s point of view, affects objectivity
4. **Familiarity threats** of the auditor becoming too familiar and subsequently ‘friendly’ with the client, thus giving need for the rotation of auditors
5. **Intimidation threats** of the auditor being deterred from acting objectively due to threats from client such as the possibility of opinion shopping

Examples of threats to independence

- Auditor employee relationship such as the auditor now being an employee of the client or the employee of the client now being the auditor
- Investment in audit clients
- Loans made to and or received from clients
- Supplier relationship with clients but in reality, such is a rather small threat
- Provision of non-audit services given such affects independence in appearance
- Personal relationships

Safeguards against threats to independence

- Education to promote the required characteristics of auditors
- Professional standards
- Monitoring and disciplinary processes
- Inspections and reviews
- Safeguards within the audit client through competent employees and corporate governance structures
- Independence policies by the audit form
- Quality control policies and procedures implemented by audit firms

Loss-leader issue

Issue of auditors charging low audit fees when the audit client also receives non-audit services from the firm

- Not true in reality given research findings suggest that audit fees are higher when the auditor also provides consulting services

Soft audit opinion issue

Issue of auditors potentially being less likely to give a modified opinion when they also receive consulting work given such could compromise the relationship with the client

Tame auditor issue

Issue of auditors who also provide consulting work always agreeing with client management to ensure they maintain the ‘profitable’ relationship
European Union requirements
- Audit to be put out for tender every 10 years
- Audit firms to be changed every 20 years, as in mandatory rotation of auditors
- Audit firms being prohibited from providing certain additional services
- Fees of non-audit services, which are allowed, to be limited to 70% of the audit fee

The future development of auditing standards will be heavily influenced by the audit expectation gap, in example of fraud having been an outcome due to increasing public demand

NOCLAR ‘Non-compliance with laws and regulations’
Issues such as money laundering, terrorist financing, poor data protection of sensitive information and bribery and corruption are now to be reported to management or the board upon finding by the auditors
- If management or the board does not respond to the issues of non-compliance with laws and regulations; auditors are required to report to the authorities when it is in the public interest to do so
- Imposes changes to the confidentiality rules in context of auditing given prior to such rule introduced in 2017; the auditors had to maintain 100% confidentiality of its client information

Reasonable assurance provides high level of assurance in example of an audit
Moderate assurance provides limited level of assurance in example of a review
‘True and fair view’ and ‘Presented fairly in all material aspects’ are equivalent in purpose of approved auditing standards

If ending inventory, as in the inventory shown on the entity’s balance sheet, has been overstated; cost of goods sold will fall and if cost of goods sold falls, gross profit will increase thus increased gross profit percentage mainly raises concern around the existence assertion of inventory

Exception reporting function in context of generalized accounting software mainly relates to the assertion of valuation, accuracy and allocation to identify any exceptions above the set limits