



# Auditing

3RD EDITION

## A PRACTICAL APPROACH

MORONEY | CAMPBELL | HAMILTON



WILEY



# Auditing: A Practical Approach

3RD EDITION

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# ABOUT THE AUTHORS

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# PREFACE

Welcome to the third edition of *Auditing: A Practical Approach*. This is not just another auditing text. As the title suggests, the resource focuses on how audits are conducted in practice. As authors, we bring our diverse experiences to this book to provide a very different approach to teaching and studying auditing. In addition to covering essential auditing topics, the text provides insights into how an audit is conducted and the issues that are of greatest concern to practising auditors.

As each chapter unfolds, students are introduced to the various stages of an audit. Key auditing concepts are addressed in a succinct manner making them understandable to all. To underpin this approach, each chapter begins with a diagrammatic depiction of the stages of an audit, with the current stage highlighted as we progress. The diagram provides a useful reference point to ground the discussion in each chapter to the relevant stage in the audit process.

To underpin our discussion of how an audit is conducted, we use a case study of a hypothetical client, Cloud 9. The discussion in each chapter is kept general, with our case study providing an example of how the general principles behind each audit may be applied in practice. By using this approach, students are provided a continuing example of how the concepts discussed may apply in practice.

The Cloud 9 case study provides a flexible learning tool to be used within an auditing and assurance course. Details about Cloud 9 and its audit are provided in each chapter. These details provide an insight into how an audit is conducted, the issues that auditors face at each stage of an audit, and the processes used to gather evidence and arrive at conclusions. The Cloud 9 case materials can form the basis for class discussions, student role plays or online exchanges between students. At the end of each chapter, a case-study problem is set using Cloud 9 as a base. These problems can be used as part of the weekly tutorial program, or as an assignment for students to work on individually or in groups (or some combination of the two).

## Overview of the text

*Chapter 1: Introduction and overview of audit and assurance.* This chapter begins with a definition of assurance engagements, an explanation of how they can differ, and the different levels of assurance and opinions that can be provided by auditors. The role of the financial report preparer is contrasted with that of the auditor, which leads into a discussion of the source for the historical and ongoing demand for audit services. The regulations surrounding the provision of assurance services are outlined and the expectation gap explained. This chapter provides the background that underpins the remainder of the text.

*Chapter 2: Ethics, legal liability and client acceptance.* This chapter provides an overview of the fundamental principles of professional ethics that apply to all accountants. Particular attention is given to auditor independence, including threats and safeguards. The auditor's legal liability to their client and third parties is explained, together with the concept of contributory negligence. This chapter ends with a discussion of the factors to consider in the client acceptance or continuance decision, which marks the commencement of our discussion of how an audit is conducted.

*Chapter 3: Risk assessment I.* The first stage of every audit involves risk assessment. This important topic is covered in two chapters. Chapter 3 begins with a discussion of the different phases of an audit. The key components of the risk assessment phase are: gaining an understanding of the client, identifying the risk of fraud, evaluating the client's going concern assumption, gaining an understanding of the client's corporate governance structure and evaluating how a client's information technology (IT) can impact risk. These components of risk assessment are described in detail in this chapter, along with a discussion of how client closing procedures can impact reported results.

*Chapter 4: Risk assessment II.* This chapter continues our discussion of risk assessment. Specifically, this chapter includes a definition of audit risk and describes its components (inherent risk, control risk

and detection risk). The concept of materiality, the development of planning materiality and how it is used when conducting an audit is then described. The process used by auditors in arriving at their audit strategy, which provides a blueprint for the remainder of the audit, is explained. The chapter concludes with an overview of the use of analytical procedures during the risk assessment phase of an audit.

*Chapter 5: Audit evidence.* This chapter contains an overview of the different types of audit evidence and the processes used by auditors to gather that evidence throughout the audit. The audit assertions, which aid in risk identification and the design of audit procedures, are defined. The concept of sufficient appropriate audit evidence is explained. The relative persuasiveness of audit evidence is explained. The procedures used when using the work of an expert or another auditor are described. This chapter concludes with a discussion of the evidence gathering procedures most often used by auditors.

*Chapter 6: Gaining an understanding of the client's system of internal controls.* This chapter provides an introduction and overview to internal controls and a background to understanding how they are tested. In this chapter, internal control is defined and the seven generally accepted objectives of internal control activities are outlined. Internal control at the entity level and transaction level are explained and contrasted. A description is provided of how an auditor documents their understanding of their client's system of internal controls. Based upon that understanding an auditor will then identify strengths and weaknesses in their client's system of internal controls and communicate their findings to those charged with governance in the organisation being audited.

*Chapter 7: Sampling and overview of the risk response phase of the audit.* This chapter provides the backdrop for chapters 8 to 11, where tests of controls and substantive procedures are described in detail. This chapter commences with a description of audit sampling. Sampling and non-sampling risk are explained and contrasted, which are followed by a discussion of the difference between statistical and non-statistical sampling. Various sampling methods used in practice are then described. The factors that impact sample sizes when testing controls and conducting substantive tests are then outlined. The discussion around sampling is concluded with an explanation of how to evaluate the results of tests conducted on a sample. The difference between tests of controls and substantive procedures and the factors that impact the nature, timing and extent of audit testing are then explained. Once testing is completed an auditor must interpret the results of their testing and the implications of the findings on the remainder of the audit. A description is provided of how an auditor does this along with how they document the details of evidence gathered in their working papers.

*Chapter 8: Execution of the audit — testing of controls.* This chapter provides a description of how an auditor conducts their tests of their client's internal controls. The description includes a discussion of the different types of controls, the different techniques for testing controls, how an auditor selects and designs tests of controls, a comparison and contrast of the results of testing of controls and finally a discussion of how to document tests of controls.

*Chapter 9: Execution of the audit — performing substantive procedures.* This chapter provides an overview of the substantive procedures used by auditors when testing the details of their client's transactions and account balances. This chapter provides a backdrop to the detailed discussion in chapters 10 and 11. This chapter includes a discussion of the link between audit risk and the nature, timing and extent of substantive procedures conducted by the auditor. An overview is provided of common substantive audit procedures used in practice and the level of audit evidence obtained when conducting different tests. This chapter concludes with a description of the documentation of the conclusions reached by auditors as a result of their substantive procedures.

*Chapter 10: Substantive testing and balance sheet accounts.* This chapter provides an overview of the types of substantive procedures commonly used in practice when testing the contents of a client's balance sheet. The relationship between risk for a significant account and the extent and timing of substantive procedures for that account is described. The procedures commonly used by auditors when testing balance sheet accounts are then explained. Specifically, the procedures used by auditors when testing cash; trade (accounts) receivables; inventory; property, plant and equipment; and payables are described in detail in this chapter. An overview is then provided of how substantive testing is used for

other balance sheet accounts before an explanation is provided of the processes used by auditors when assessing the results of their substantive procedures to determine whether additional substantive tests are necessary.

*Chapter 11: Substantive testing and income statement accounts.* This chapter provides an overview of the types of substantive procedures commonly used in practice when testing the contents of a client's income statement. The relationship between an auditor's overall risk assessment for a client and the consequent extent and timing of substantive procedures when testing income statement accounts is explained. These procedures are compared and contrasted to the procedures outlined in chapter 10 when testing balance sheet accounts. The procedures commonly used by auditors when testing income statement accounts are then explained. Specifically, the procedures used by auditors when testing revenue, cost of sales and significant expense accounts are described in detail in this chapter. Finally, an overview is provided of how the results of these substantive procedures are used by auditors to determine whether additional substantive tests are necessary.

*Chapter 12: Completing and reporting on the audit.* This final chapter of the text marks the conclusion of the audit. An explanation of the procedures performed by an auditor as part of their wrap-up, including gathering and evaluating audit evidence, is provided. The going concern concept is revisited in the context of finalising the audit. Subsequent event testing is explained. The procedures used by auditors when evaluating material misstatements uncovered during their audit are outlined. A description is provided of how auditors evaluate the conclusions drawn throughout the audit in relation to evidence gathered and their impact on the overall opinion formed on the financial report. The form and content of the audit report is outlined and possible *Corporations Act 2001* breaches are described. Finally, a description is provided of the reports an auditor will provide to their client's management and those charged with governance at the conclusion of the audit.

## Structure of each chapter

Each chapter commences with an overview of the *learning objectives* addressed in the chapter. These learning objectives are highlighted throughout the chapter as the discussion unfolds. After each learning objective is covered in the text, three *before you go on* questions are set for students to confirm they recall the main issues covered. As these questions come directly from the text, it is straightforward for students to check their understanding of the key concepts covered before progressing to the next learning objective (section) in the chapter. Specific learning objectives are also linked to end-of-chapter professional application questions. This approach means that tutorial questions can be set to ensure coverage of the learning objectives considered most important.

Following the learning objectives listed at the beginning of each chapter is a summary of the *Australian and international assurance standards* discussed in each chapter. The listed standards are incorporated in the discussion within each chapter. Pronouncements and guidance statements are listed with the standards and discussed where applicable.

The summary of standards is followed by a diagram of the *overview of the audit*. This figure aids in understanding the structure of the textbook, which mirrors the process generally used when conducting an audit. The diagram highlights the stage to be covered in the current chapter, which aids in understanding what has come before and what is still to come.

Following the overview diagram is an *audit process in focus* section, which includes a brief overview and outline of each chapter. Key terms are highlighted throughout the chapter and their definitions appear at the end of chapter, which aids studying and revision.

The Cloud 9 case study appears throughout each chapter. Students can choose to incorporate Cloud 9 in their reading of each chapter or to go back and read through the case study after reading the main text. As Cloud 9 is easily distinguishable from the main text, either approach can be adopted when studying a chapter.

Descriptions of the *professional environment* in which auditors operate appear in each chapter. These vignettes provide some details of the auditing profession and various challenges faced by auditors.

Each chapter concludes with a summary, list of key terms used and end-of-chapter questions. The summary provides a brief recap of each learning objective covered in a chapter. The end-of-chapter questions include multiple-choice questions, review questions, professional application questions, a Cloud 9 case study question and a research question. Solutions to multiple-choice questions appear at the very end of each chapter, so students can use these as part of their independent study. The review questions test student understanding of the key concepts covered in the chapter. The professional application questions are problems designed around the learning objectives set for the chapter. Each question is graded as basic, moderate or challenging and indicates the learning objective(s) covered. A selection of the professional application questions are based upon problems set by Chartered Accountants Australia and New Zealand as part of their chartered accountants program. The Cloud 9 case study builds from one chapter to the next and is based on the information provided in each chapter, in the case study at the end of each chapter and in the appendix. The use of a case study in this text aids in the appreciation of how each topic covered fits into the context of an audit as a whole. Together with the practical approach used in the body of the text, this allows a deeper understanding of how audits are conducted in practice. Research questions provide an opportunity for students to gain a deeper appreciation for the role of academic research in providing greater insights into audit practice.

*Robyn Moroney, Fiona Campbell, Jane Hamilton*  
May 2016

## CHAPTER 1

# Introduction and overview of audit and assurance

### LEARNING OBJECTIVES

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After studying this chapter you should be able to:

- 1.1** describe an assurance engagement
  - 1.2** discriminate between different types of assurance services
  - 1.3** discriminate between different levels of assurance
  - 1.4** categorise different audit opinions
  - 1.5** discriminate between the different role of the preparer and the auditor, and discuss the different firms that provide assurance services
  - 1.6** justify the demand for audit and assurance services
  - 1.7** compare the different regulators and regulations surrounding the assurance process
  - 1.8** categorise the audit expectation gap.
-

## AUDITING AND ASSURANCE STANDARDS

### AUSTRALIAN

### INTERNATIONAL

*Framework for Assurance Engagements*

*International Framework for Assurance Engagements*

*APES 110 Code of Ethics for Professional Accountants*

*Code of Ethics for Professional Accountants*

*APES 210 Conformity with Auditing and Assurance Standards*

*ASA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*

*ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*

*ASA 210 Agreeing the Terms of Audit Engagements*

*ISA 210 Agreeing the Terms of Audit Engagements*

*ASA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of a Financial Report*

*ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

*ASA 610 Using the Work of Internal Auditors*

*ISA 610 Using the Work of Internal Auditors*

*ASA 700 (Revised) Forming an Opinion and Reporting on a Financial Report*

*ISA 700 (Revised) Forming an Opinion and Reporting on Financial Statements*

*ASA 701 Communicating Key Audit Matters in the Independent Auditor's Report*

*ISA 701 Communicating Key Audit Matters in the Independent Auditor's Report*

*ASA 705 (Revised) Modifications to the Opinion in the Independent Auditor's Report*

*ISA 705 (Revised) Modifications to the Opinion in the Independent Auditor's Report*

*ASA 706 (Revised) Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

*ISA 706 (Revised) Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*

*ASRE 2410 Review of a Financial Report Performed by the Independent Auditor of the Entity*

*ISRE 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity*

*ASAE 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information*

*ISAE 3000 Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*

*ASAE 3410 Assurance Engagements on Greenhouse Gas Statements*

*ISAE 3410 Assurance Engagements on Greenhouse Gas Statements*

*ASAE 3500 Performance Engagements*

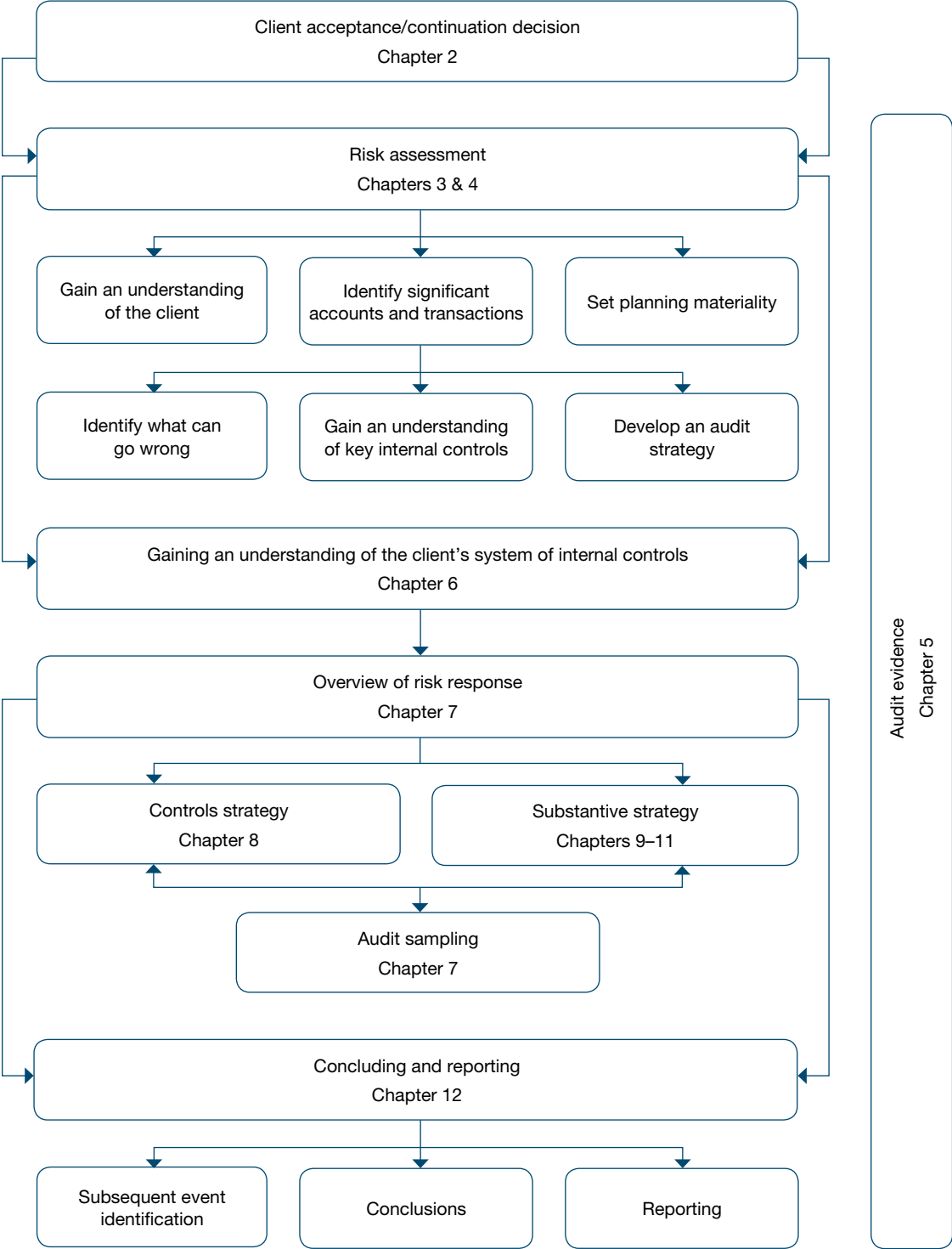
*ASQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Reports, Other Financial Information, and Other Assurance Engagements*

*ISQC 1 Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

*Regulatory Guide 230 Disclosing non-IFRS financial information*



**Overview of the audit process**  
**Chapter 1**



This text is designed to provide students with the opportunity to learn about auditing by using a practical, problem-based approach. Each chapter begins with some information about an audit client — Cloud 9 Pty Ltd (Cloud 9). The chapter then provides the underlying concepts and background information needed to deal with this client's situation and the problems facing its auditor. As students work through the chapters, they gradually build up their knowledge of auditing by studying how the contents of each chapter are applied to Cloud 9. The end-of-chapter exercises and problems also provide students with the opportunity to study other aspects of Cloud 9's audit, in addition to applying the knowledge gained in the chapter to other practical examples.

Cloud 9 Inc., a listed company in the United States (US), is looking to expand. McLellan's Shoes was seen as a potential target.

In 1980, Ron McLellan starts a business in Sydney manufacturing and retailing customised basketball shoes. Ron calls his business McLellan's Shoes. Ron borrows from the bank to start the business, using his house as security, and over the years he works very hard to establish a profitable niche in the highly competitive sport shoe market. Ron is able to repay the bank in 1993, just before the recession. As he watches interest rates soar above 20 per cent, he vows to never borrow again.

As the business grows, Ron's wife and three adult children start to work for him, with responsibility for administration, marketing and sales, production and distribution. By the early 1990s, Ron's business employs 20 people full time, most of whom work in production. There are also several casual employees and part-time staff in the retail outlet, particularly during busy periods.

In February 1995, Ron receives a call from Chip Masters, the senior vice-president of Cloud 9 Inc. Chip expresses an interest in buying McLellan's Shoes. Ron is getting tired, and his children are starting to fight amongst themselves about who is going to take over from their father. Ron has had enough, but he does not want Chip to know that. He asks if Chip is ready to talk about the price. Chip said he is, but first he needs to see the audited financial reports for McLellan's Shoes.

Ron asks for some time. He tells Chip that he needs to talk to his family and will get back to him. When Ron puts the phone down he immediately rings his friend from the golf club, Ernie Black, who is a chartered accountant. For years, Ernie has been quietly suggesting to Ron that his business affairs need attention. Ron is good at making deals and working hard, but he has never bothered with sophisticated financial arrangements. He is still running his business as a sole trader (not a company), and his wife does all the tax returns. Ron is in a panic — he wants to sell McLellan's Shoes, but what is he going to do about Chip's request for audited financial reports?

## Audit process in focus

The purpose of this chapter is to provide an overview of audit and assurance services. While the focus of this text is the audit of financial reports, in this chapter we define assurance engagements and differentiate between different types of assurance engagements. The assurance engagements explained in this chapter include financial report audits, compliance audits, performance audits, comprehensive audits, internal audits and assurance of corporate social responsibility disclosures. We also provide an overview of the different levels of assurance that can be provided when conducting assurance procedures. The levels of assurance discussed in this chapter include reasonable, limited and no assurance engagements.

Next we provide a brief overview of the different audit reports that an auditor can issue after completing their audit. Auditors can issue either an unmodified or a modified audit report. Four modifications to an audit report are: the inclusion of an emphasis of matter paragraph, a qualified opinion, an adverse opinion or a disclaimer of opinion. These concepts are explained further in this chapter.

The roles of the financial report preparer and auditor are explained and contrasted. An overview is then provided of the different firms that provide assurance services. That section contains details of both

accounting and consulting firms and the different services that they provide. The factors that explain why there is a demand for audit and assurance services are then described before an overview is provided of assurance regulators and their regulations. The audit expectation gap is explained in the last section of this chapter.

## 1.1 Auditing and assurance defined

**LEARNING OBJECTIVE 1.1** Describe an assurance engagement.

### CLOUD 9

Chip Masters has asked Ron McLellan for audited financial reports of McLellan's Shoes. Ron has never had an audit and is not sure what it involves. He has heard about tax audits, environmental audits, efficiency audits, as well as financial report audits. Are they all the same thing? Ernie explains to Ron that there are several services that people call 'audits' that are different to financial report audits. However, all these services, including financial report audits, can be defined as assurance engagements.

An **assurance engagement** (or service) is defined as 'an engagement in which an assurance practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria' (*Framework for Assurance Engagements*, para. 10; *International Framework for Assurance Engagements*, para. 7).

An assurance practitioner may be, for example, an auditor working in public practice providing assurance on financial reports of publicly listed companies or a consultant providing assurance about environmental disclosures. Intended users are the people for whom the assurance provider prepares their report (for example, the shareholders). The responsible party is the person or organisation (for example, a company) responsible for the preparation of the subject matter (for example, the financial reports). While the audit of a company's financial reports is the most common assurance engagement and the focus of much of this text, it is not the only type of assurance. The next section of this chapter provides a description of different types of assurance services.

### BEFORE YOU GO ON

- What are two examples of assurance providers?
- What might an assurance provider express a conclusion about?
- What is a responsible party?

## 1.2 Different assurance services

**LEARNING OBJECTIVE 1.2** Discriminate between different types of assurance services.

In this section we provide an overview of the different types of assurance services that an assurance practitioner can provide. The most common types of assurance engagements are financial report audits, compliance audits, performance audits, comprehensive audits, internal audits and assurance on corporate social responsibility (CSR) disclosures. Each will now be explained in turn.

### 1.2.1 Financial report audits

According to ASA 200 (ISA 200) *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Australian Auditing Standards*, the objective of a **financial report audit** is for

the auditor to express an opinion about whether the financial report is prepared in all material respects in accordance with a financial reporting framework (ASA 200, para. 11; ISA 200, para. 11). Within an Australian context, this means that the financial report has been prepared in accordance with Australian Accounting Standards and interpretations and any relevant legislation such as the *Corporations Act 2001*. Where a fair presentation framework is applicable, which is generally the case for financial reports, the opinion required by the Australian Auditing Standards is on whether the financial report is presented fairly, in all material respects, or gives a true and fair view (ASA 200, para. A13; ISA 200, para. A13).

#### CLOUD 9

Ron is not running a company; he operates his customised basketball shoe business as a sole trader. He is aware that big companies have to be audited, but because he is not affected by the Corporations Act he does not believe that he has to have an audit. Ernie agrees that Ron does not have to follow the same rules, but also tells him that Australian Auditing Standards apply to an audit of a financial report for any purpose. This means that although all the attention is usually on companies, sole traders can have their financial reports audited too.

A financial report and a directors' report must be prepared annually by disclosing entities, public companies, large proprietary companies and registered schemes (s. 292 of the Corporations Act). Under sections 295(4)(c) and 295A of the Act, directors of the reporting entity must declare whether the reporting entity will be able to pay its debts as and when they become due, whether the financial records have been properly maintained, whether the financial report and notes comply with Australian Accounting Standards including interpretations, and whether the financial report and notes give a **true and fair view** (this concept is discussed in more detail in section 1.5 of this chapter). A true and fair view refers to the consistent and faithful application of accounting standards in accordance with the financial reporting framework when preparing the financial report (ASA 200, para. 13; ISA 200, para.13). Australian companies must prepare their financial report in compliance with accounting standards (s. 296 of the Corporations Act). If compliance with accounting standards does not give a true and fair view, a company should provide additional information in the notes to the financial report (s. 295(3)(c) of the Corporations Act). Regulatory Guide 230 (ASIC, 2011) provides information for company directors and financial report preparers regarding the disclosure of information other than in accordance with accounting standards. Section 301 of the Act requires that the financial report be audited. It is part of the auditor's responsibility to form an opinion on the truth and fairness of the financial report. In fulfilling their role, the auditor must be independent of the company they audit, exercise due professional care, and comply with Auditing and Assurance Standards (APES 210, para. 1.2).

#### CLOUD 9

Ron believes that his business has good, reliable financial records. Ron's wife helps him keep tight control of the cash and other assets, and together they prepare some simple reports on a regular basis. Ron believes he knows exactly what is happening in the business and monitors the business's cash flow and profit very closely. However, he has not prepared financial reports that comply with Australian Accounting Standards. Is this a problem? Ernie explains to Ron that some businesses must apply the accounting standards, even if they are not companies. It all depends on whether it is reasonable to expect the existence of users dependent on the reports for information that will be useful to them in making and evaluating decisions about the allocation of scarce resources (Statement of Accounting Concepts 1 (SAC1) *Definition of the Reporting Entity*, para. 40). Ron is a bit worried now — how does he know if he has these 'users'?

## Limitations of an audit

A financial report audit is conducted to enhance the reliability and credibility of the information included in a financial report. Yet it is not a guarantee that the financial report is free from error or fraud.

The limitations of an audit stem from the nature of financial reporting, the nature of audit procedures and the need for the audit to be conducted within a reasonable period of time and at a reasonable cost (ASA 200, ISA 200).

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

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

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

### 1.2.2 Compliance audits

A **compliance audit** involves gathering evidence to ascertain whether the person or entity under review has followed the rules, policies, procedures, laws and regulations with which they must conform. There are a number of examples of compliance audits. A tax audit is used to determine whether an individual or company has completed their tax return in accordance with the *Income Tax Assessment Act 1936* and the *Income Tax Assessment Act 1997*. Within an organisation, management may specify that certain processes be followed when completing a function. For example, a company may have policies and procedures for the hiring of new staff. In that case the organisation's internal auditors may be called upon to check whether employees are following the specified processes appropriately.

### 1.2.3 Performance audits

**Performance audits** are concerned with the economy, efficiency and effectiveness of an organisation's activities (ASAE 3500 *Performance Engagements*, para. 12). Economy refers to the cost of inputs, including wages and materials. Efficiency refers to the relationship between inputs and outputs. Specifically, efficiency refers to the use of the minimum amount of inputs to achieve a given output. Finally, effectiveness refers to the achievement of certain goals or the production of a certain level of outputs. From an organisation's perspective it is important to perform well across all three dimensions and not allow one to dominate. For example, if buying cheap inputs results in an inefficient production process, efficiency may be seen to be sacrificed to achieve economic goals.

Performance audits are generally conducted by an organisation's internal auditors or they may be outsourced to an external audit firm. Performance audits are sometimes referred to as value for money audits, operational audits or efficiency audits.

## 1.2.4 Comprehensive audits

A **comprehensive audit** may encompass elements of a financial report audit, a compliance audit and a performance audit. For example, an auditor may report on whether an entity has met its efficiency targets. Comprehensive audits most commonly occur in the public sector where compliance with various regulations is examined when completing a financial report audit.

## 1.2.5 Internal audits

**Internal audits** are conducted to provide assurance about various aspects of an organisation's activities. The internal audit function is typically conducted by employees of the organisation being audited, but can be outsourced to an external audit firm. As such, the function of internal audit is determined by **those charged with governance** and management within the organisation. While the functions of internal audits vary widely from one organisation to another, they are often concerned with evaluating and improving risk management, internal control procedures and elements of the governance process. The internal audit function often conducts performance audits, compliance audits, internal control assessments and reviews. Many internal auditors are members of the Institute of Internal Auditors (IIA). The IIA is an international organisation, with more than 180 000 members, that provides guidance and standards to aid internal auditors in their work. When conducting the financial report audit, the external auditor will consider and often rely on the work done by the internal auditors (ASA 610 (ISA 610) *Using the Work of Internal Auditors*).

## 1.2.6 Corporate social responsibility (CSR) assurance

**Corporate social responsibility (CSR)** reporting is voluntary and is becoming more widespread (see section 1.6.4 of this chapter for a discussion of the demand for assurance in a voluntary setting). CSR disclosures include environmental, employee and social reporting. Some organisations choose to have their CSR disclosures assured by an independent assurance provider. The assurance of CSR disclosures is currently carried out by either auditors or specialist **consulting firms**. As these disclosures include non-financial as well as financial information, the skill set required to conduct these assurance services is quite broad. Whether a company chooses to provide additional voluntary environmental disclosures or not, an auditor must consider the impact of environmental issues on their clients' financial report when conducting the financial report audit.

ASAE 3000 (ISAE 3000) *Assurance Engagements Other than Audits or Reviews of Historical Financial Information* provides some guidance for auditors when assuring CSR and similar reports. ASAE 3000 (ISAE 3000) provides guidance on the client acceptance decision, quality control, the role of professional scepticism and professional judgement, planning and performing the assurance engagement, steps in evidence gathering, and forming an opinion based on conclusions drawn from the evidence gathered. An example of an assurance report relating to a CSR report is provided in figure 1.1.

### CLOUD 9

Ron is not concerned about internal audits — his business is too small for a separate internal audit function. He is also not worried about CSR reporting or compliance and performance audits. His priority at the moment is to close the deal with Chip Masters, and he still does not know what he has to do about the audit.



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## Independent Limited Assurance Report in relation to Telstra Group's 2014 Corporate Responsibility Reporting

To the Management and Directors of Telstra Group

We have carried out a limited assurance engagement in order to state whether anything has come to our attention to suggest that the agreed environmental, human resource and community data as reported in the Telstra Group's ('Telstra') 2014 Annual Report and Bigger Picture Sustainability Report (collectively referred to as 'the Report') has not been presented in accordance with the criteria listed below.

### Subject Matter

The Subject Matter for our limited assurance engagement for the year ending 30 June 2014 is the 31 metrics and related performance disclosures included in the Report (refer to Attachment A for a list of the 31 metrics) and an assessment of Telstra's sustainability materiality assessment process.

### Criteria

The following Criteria have been applied to the Subject Matter described above:

- ▶ The principle of materiality in the context of the Global Reporting Initiative ('GRI') framework
- ▶ *National Greenhouse and Energy Reporting Act 2007*
- ▶ *National Greenhouse and Energy Reporting Regulations 2008*
- ▶ *National Greenhouse and Energy (Measurement) Determination 2008*, including the *National Greenhouse and Energy Reporting (Measurement) Amendment Determination 2013 (No. 1)* (the 'Measurement Determination')
- ▶ National Greenhouse Accounts Factors, July 2013 for scope 1, 2 and 3 greenhouse gas emissions (the 'NGA Factors')
- ▶ UK Department for Environment Food and Rural Affairs (DEFRA) – 2013 greenhouse gas conversion factors for company reporting
- ▶ Telstra's reported criteria as detailed in the Glossary document at [www.telstra.com/sustainability/report](http://www.telstra.com/sustainability/report) for:
  - Certain scope 3 greenhouse gas emissions
  - Carbon emissions intensity (CO<sub>2</sub>-e/TB)
  - Network related emissions
  - Energy and emission savings
  - Air travel
  - Waste recycled
  - MobileMuster (mobility device recycling)
  - Paper consumption
  - Water consumption
  - Sensis – Yellow and White Pages metrics
  - Human resources and community metrics

### The Responsibility of Management

The management of Telstra is responsible for the preparation and presentation of the Subject Matter in the Report in accordance with the above Criteria, and is also responsible for the selection of methods included in the Criteria. No conclusion is expressed as to whether the selected methods used are appropriate for the purpose described above. Further, Telstra's management is responsible for establishing and maintaining internal controls relevant to the preparation and presentation of the Subject Matter that is free from material misstatement, whether due to fraud or error; selecting and applying appropriate criteria; maintaining adequate records and making estimates that are reasonable in the circumstances.

**FIGURE 1.1** Example of an assurance report