DegreeLive

Bachelor of Commerce (B2001) | Level 3 • Part B Major | Monash University

# Auditing and assurance

Course Code: ACC3600 • Module 1 Notes

# Module 1: The Assurance Framework, Regulation & Professional Ethics

## Chapter 1: Nature, Demand & Governance of Audit and Assurance

### 1.1 The Theoretical Foundation and Economic Demand for Assurance Services

Auditing and assurance services occupy a vital position in modern capital markets and corporate governance. At its core, an assurance engagement is an independent professional service in which an assurance practitioner evaluates an underlying subject matter against established criteria and expresses a conclusion designed to enhance the degree of confidence of intended users other than the responsible party. In the context of financial report auditing, the subject matter comprises the annual or half-yearly financial statements prepared by company management, the criteria are Australian Accounting Standards (AASB standards aligned with International Financial Reporting Standards, IFRS), and the intended users are external shareholders, institutional investors, credit providers, trade creditors, regulatory bodies, and the broader public.

The economic demand for independent external auditing arises primarily from four market characteristics that create pervasive information risk—the risk that financial information distributed to external decision-makers is materially false, misleading, incomplete, or biased:

- **Agency Theory and Information Asymmetry:** In modern corporate enterprise, ownership is widely separated from operational control. Shareholders (principals) delegate decision-making authority to corporate directors and executives (agents). Because management controls day-to-day operations and possesses superior private information regarding commercial realities, conflicting incentives emerge. Managers may face short-term pressures to inflate reported revenues, conceal impairment losses, or smooth earnings to meet executive bonus hurdles, safeguard tenure, or avoid debt covenant breaches. An independent external audit mitigates this moral hazard by monitoring managerial stewardship and verifying financial reporting integrity.
- **Remoteness of Users:** Most company owners, bondholders, and creditors have neither direct access to the corporate general ledger nor legal authority to inspect physical warehouses, inventory counts, and internal database records. They must rely entirely on published annual reports. External auditing acts as an indispensable proxy, deploying qualified professionals to inspect source documents and verify physical and operational realities firsthand.
- **Complexity of Accounting Systems and Transactions:** Contemporary accounting standards involve sophisticated recognition, measurement, and disclosure rules covering derivative financial instruments, lease liabilities, deferred tax assets, share-based payments, and expected credit loss models under AASB 9. The sheer technical complexity of these standards creates substantial risk of unintentional mechanical and conceptual misstatements that unsophisticated readers cannot detect without professional assurance.
- **Economic and Volumetric Significance of Consequences:** In modern capital allocations involving billions of dollars across the Australian Securities Exchange (ASX), economic decisions based on distorted financial statements generate catastrophic capital misallocations, corporate insolvencies, and systemic investor losses. Independent auditing reduces the cost of debt and equity capital by lowering the information risk premium demanded by financial markets.

## 1.2 The Assurance Framework and Engagement Classification

The Auditing and Assurance Standards Board (AUASB) defines assurance engagements under the Framework for Assurance Engagements. Every assurance engagement contains five essential structural elements: a three-party relationship (practitioner, responsible party, intended users); an appropriate underlying subject matter; suitable criteria; sufficient appropriate evidence; and a written assurance report.

Assurance engagements are broadly categorised along two dimensions: the level of assurance provided, and the structural nature of the underlying subject matter evaluation:

| Engagement Dimension | Reasonable Assurance Engagement (Audit) | Limited Assurance Engagement (Review) |
|---|---|---|
| **Objective & Level** | Reduction in assurance engagement risk to an acceptably low level; high (but not absolute) assurance. | Reduction in assurance engagement risk to a moderate level; meaningful assurance to intended users. |
| **Applicable Standards** | Australian Auditing Standards (ASAs, e.g. ASA 200, ASA 315, ASA 500). | Standards on Review Engagements (ASRE 2410, ASRE 2400). |
| **Procedures Undertaken** | Extensive: risk assessment, tests of controls, substantive analytical procedures, detailed tests of details, physical inspection, external confirmation. | Primarily limited to analytical procedures and managerial inquiries; no detailed tests of controls or substantive corroboration unless red flags appear. |
| **Opinion / Conclusion Format** | **Positive Expression:** "In our opinion, the financial report presents fairly, in all material respects..." | **Negative Expression:** "Based on our review, nothing has come to our attention that causes us to believe that..." |
| **Standard Application** | Statutory annual financial report audit under s. 301 of the Australian Corporations Act 2001. | Half-yearly financial report review for disclosing entities under s. 302 of the Corporations Act 2001. |

In contrast to assurance engagements, non-assurance professional engagements—such as agreed-upon procedures engagements (governed by ASRS 4400) and compilation engagements (governed by APES 315)—involve no evaluation against criteria and culminate in a factual findings report or compilation report without expressing any level of assurance or opinion.

## 1.3 The Australian Regulatory and Institutional Environment

Auditing practice in Australia operates within a stringent statutory and co-regulatory institutional architecture designed to safeguard public trust and financial system integrity:

- **The Australian Corporations Act 2001:** Part 2M.3 mandates that public companies, large proprietary companies, registered managed investment schemes, and disclosing entities prepare annual financial reports and have them audited by an independent registered company auditor. Key provisions govern auditor appointment (s. 327B), auditor removal and resignation (s. 329), auditor reporting duties (s. 307 and s. 308), mandatory audit partner rotation every 5 years for listed entities (s. 324DA), and statutory auditor independence declarations (s. 307C).

DegreeLive

- **The Auditing and Assurance Standards Board (AUASB):** Established as an independent statutory agency under s. 227A of the Australian Securities and Investments Commission Act 2001, the AUASB develops and issues Australian Auditing Standards (ASAs). Under s. 307A of the Corporations Act 2001, compliance with AUASB auditing standards carries the full force of federal statutory law. The ASAs are harmonised with the International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB).
- **Australian Securities and Investments Commission (ASIC):** ASIC is the federal statutory regulator responsible for corporate and financial services regulation. Under its Audit Inspection Program, ASIC actively reviews audit engagement files of public and disclosing entities, monitors compliance with independence rules, inspects audit firm quality management systems, registers company auditors under s. 1280, and initiates enforcement proceedings before the Companies Auditors Disciplinary Board (CADB) or federal courts.
- **Accounting Professional and Ethical Standards Board (APESB):** Established by the major accounting bodies (CPA Australia, Chartered Accountants Australia and New Zealand [CA ANZ], and the Institute of Public Accountants [IPA]), the APESB issues binding professional and ethical standards, most notably APES 110 Code of Ethics for Professional Accountants.
- **Australian Prudential Regulation Authority (APRA):** Oversees authorised deposit-taking institutions (ADIs), general and life insurance entities, and registrable superannuation entities (RSEs), imposing specialised prudential auditing requirements (CPS 510, SPS 510) and tripartite prudential reviews.

# Chapter 2: Professional Ethics, Independence & Quality Management

## 2.1 Fundamental Ethical Principles under APES 110

Public confidence in capital markets rests upon the uncompromising ethical integrity of professional auditors. APES 110 establishes five overarching fundamental ethical principles that every professional accountant and auditor must observe at all times:

1. **Integrity:** Obligates an auditor to be straightforward, honest, truthful, and candid in all professional and business relationships. An auditor must not knowingly be associated with reports, returns, communications, or other information where they believe the information contains a materially false or misleading statement, contains statements furnished recklessly, or omits necessary information where such omission misleads.
2. **Objectivity:** Prohibits an auditor from compromising professional or business judgment because of bias, conflict of interest, or undue influence of others. The auditor must remain intellectually impartial and detached from the operational and financial outcomes of the client entity.
3. **Professional Competence and Due Care:** Requires an auditor to attain and maintain professional knowledge and skill at the level required to ensure that a client receives competent professional service, based on current technical and professional standards and relevant legislation. The auditor must act diligently and in accordance with applicable technical and professional standards when providing services.
4. **Confidentiality:** Mandates that an auditor respect the confidentiality of information acquired as a result of professional and business relationships. An auditor must not disclose confidential client information to third parties without proper and specific authority from the client, unless there is a

DegreeLive

legal or professional right or duty to disclose (e.g. reporting corporate misconduct to ASIC under s. 311 of the Corporations Act 2001). Furthermore, confidential information must never be used for the personal advantage of the auditor or third parties (insider trading prohibitions).

5. **Professional Behaviour:** Requires an auditor to comply with relevant laws and regulations, avoid any conduct that the auditor knows or should know might discredit the profession, and refrain from making exaggerated claims for services offered or disparaging comparisons regarding the work of other practitioners.

## 2.2 Auditor Independence: Conceptual Framework, Threats & Safeguards

Auditor independence is the cornerstone of the auditing profession. Independence encompasses two distinct, equally vital dimensions:

- **Independence of Mind (Independence in Fact):** The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity, exercise objectivity, and maintain professional scepticism.
- **Independence in Appearance:** The avoidance of facts and circumstances that are so significant that a reasonable and informed third party, weighing all the specific facts and circumstances, would be likely to conclude that a firm's, or an audit team member's, integrity, objectivity, or professional scepticism has been compromised.

APES 110 operationalises independence through a conceptual framework requiring auditors to identify, evaluate, and address threats to compliance with fundamental principles. Threats fall into five distinct categories:

| Threat Category | Theoretical Nature of Threat | Illustrative Australian Scenario | Appropriate Safeguard / Response |
|---|---|---|---|
| **Self-Interest Threat** | Occurs when a financial or other interest improperly influences the auditor's judgment or behaviour. | An audit partner holds direct shares in an ASX-listed audit client, or total fees from one client represent 25% of the firm's annual revenue. | Mandatory divestment of shares prior to engagement; fee caps; pre-issuance quality review by an independent partner outside the engagement team. |
| **Self-Review Threat** | Occurs when an auditor evaluates the results of a previous judgment made or service performed by the audit firm. | The audit firm prepares the client's source financial accounting entries, valuation models, or designs the internal IT general control infrastructure. | Strict prohibition under APES 110: the audit firm must not prepare accounting records or financial statements for public interest entities (PIEs). |
| **Advocacy Threat** | Occurs when an auditor promotes an audit client's position to the point where subsequent objectivity is compromised. | The audit partner acts as an expert witness or legal advocate defending the client in a taxation dispute against the Australian Taxation Office (ATO). | Prohibition of advocacy services that involve dispute resolution before a court or regulatory tribunal for an audit client. |

| Threat Category | Theoretical Nature of Threat | Illustrative Australian Scenario | Appropriate Safeguard / Response |
|---|---|---|---|
| **Familiarity Threat** | Occurs when, due to a long or close relationship, an auditor becomes too sympathetic to client interests or too accepting of work. | The audit engagement partner has led the statutory audit for 8 consecutive years; the client CFO is the former audit senior manager. | Mandatory partner rotation under s. 324DA (5-year maximum tenure, 2-year cooling-off period); cooling-off periods for former audit personnel joining clients. |
| **Intimidation Threat** | Occurs when an auditor is deterred from acting objectively by actual or perceived pressures, including attempts to exercise undue influence. | Management threatens to dismiss the auditor or withhold non-audit consulting fees unless the auditor signs off on aggressive revenue recognition. | Escalation to the independent Board Audit Committee; consultation with firm technical risk leadership; resignation if intimidation persists. |

### 2.3 Quality Management at the Firm and Engagement Levels (ASQM 1 & ASA 220)

Audit quality cannot rely solely on the conscience of individual practitioners; it requires institutionalised systems of quality management. Under ASQM 1 (Quality Management for Firms that Perform Audits or Reviews), every audit practice must design, implement, and operate a risk-based System of Quality Management (SoQM) addressing eight integrated components:

1. The firm's risk assessment process (identifying quality risks arising from client portfolio and business strategy).
2. Governance and leadership (establishing a culture demonstrating quality over commercial profit).
3. Relevant ethical requirements (monitoring annual independence declarations and conflict-clearing databases).
4. Acceptance and continuance of client relationships and specific engagements.
5. Engagement performance (supervision, review, and consultation on complex technical matters).
6. Resources (technological, intellectual, and human capital recruitment and training).
7. Information and communication (internal quality metrics and external transparency reports).
8. The monitoring and remediation process (annual internal file reviews and systemic root-cause analysis of defects).

At the engagement level, ASA 220 assigns ultimate responsibility for audit quality directly to the engagement partner, who must maintain continuous involvement throughout planning, execution, and final reporting, actively fostering professional scepticism across the audit team.

## Chapter 3: Legal Liability of Auditors & Common Law Duties

### 3.1 Contractual Liability and the Common Law Duty of Care

Auditors operate within an environment of substantial civil legal liability governed by common law contract, the tort of negligence, and Australian federal and state statute law:

Degreelive

- **Liability to the Audit Client in Contract:** The formal audit engagement letter constitutes an enforceable commercial contract between the audit firm and the corporate client. The contract contains express terms (scope of audit, timetable, fee structure) and implied terms under common law and consumer law—specifically that the auditor will exercise reasonable skill, care, and diligence expected of a reasonably competent professional practitioner. If an auditor conducts a substandard audit that fails to detect systemic employee embezzlement or inventory theft due to negligent omissions, the company can sue the auditor for breach of contract to recover direct financial damages.
- **Liability to the Client in Tort (Negligence):** Under the tort of negligence, the client can concurrently sue the auditor for damages. To succeed in an action for professional negligence, the plaintiff must establish three fundamental legal elements:
  1. The auditor owed the plaintiff a legal duty of care;
  2. The auditor breached that duty of care by failing to attain the standard of care of a reasonably competent auditor; and
  3. The plaintiff suffered quantifiable financial loss directly caused by the auditor's breach (causation), and the loss was not too remote.

## 3.2 Landmark Common Law Cases and Evolution of Third-Party Liability

While an auditor's duty of care to the audit client company is universally established by contract, whether an auditor owes a common law duty of care to external third parties (such as potential investors, prospective acquirers, or bank lenders) has been the subject of extensive common law litigation:

| Legal Case & Jurisdiction | Key Facts & Circumstances | Core Legal Principle Established |
|---|---|---|
| **Donoghue v Stevenson [1932] AC 562** (UK) | Decomposed snail in ginger beer bottle consumed by plaintiff. | The foundational "neighbour principle": a person owes a duty of care to persons so closely and directly affected by their act that they ought reasonably to have them in contemplation. |
| **Hedley Byrne & Co Ltd v Heller & Partners [1964] AC 465** (UK) | Bank provided negligent credit reference for a client upon which an advertising agency relied. | Established liability for pure economic loss resulting from negligent misstatement where a "special relationship" exists, characterised by reasonable reliance by the plaintiff and known assumption of responsibility by the defendant. |
| **Caparo Industries plc v Dickman [1990] 2 AC 605** (UK) | Caparo purchased shares and launched a takeover bid in reliance on audited accounts showing a profit, which in reality was a loss. | House of Lords established the three-stage test: foreseeability, proximity, and fairness/justice/reasonableness. Crucially held that statutory financial statements are prepared for the collective shareholders to exercise governance, not to guide individual investment or takeover decisions. No duty of care owed to individual potential investors. |

| Legal Case & Jurisdiction | Key Facts & Circumstances | Core Legal Principle Established |
|---|---|---|
| **Esanda Finance Corp Ltd v Peat Marwick Hungerfords (1997) 188 CLR 241** (High Court of Australia) | Esanda loaned funds to Excel in reliance on Excel's audited accounts. Excel collapsed, and Esanda sued the auditor for negligence. | **The Definitive Australian Precedent:** High Court held that mere foreseeability that a third party might rely on audited accounts is insufficient to establish a duty of care. For an auditor to owe a duty of care to a third party for pure economic loss, the plaintiff must prove that:<br>• The auditor knew, or reasonably ought to have known, that the audited financial report would be communicated to the plaintiff;<br>• The communication was for a specific purpose or transaction; and<br>• The auditor intended to induce the plaintiff to act, or refrain from acting, in reliance upon the audited report.<br>Because Esanda failed to show the auditor intended to induce Esanda to lend to Excel, the auditor owed no duty of care to Esanda. |

## 3.3 Statutory Reforms: Proportionate Liability and Professional Standards Legislation

Historically, common law applied the doctrine of "joint and several liability". Under joint and several liability, if multiple parties (e.g. fraudulent company directors, negligent internal accountants, and the external auditor) contributed to an investor loss, the plaintiff could recover 100% of total damages from the external auditor alone—frequently targeted as the only "deep-pocket" defendant carrying extensive professional indemnity insurance.

To rectify this severe economic distortion, Australian jurisdictions enacted coordinated statutory tort reforms:

- **Proportionate Liability:** Introduced into Part 9.10A of the Commonwealth Corporations Act 2001 and state civil liability acts (e.g. Victorian Wrongs Act 1958, NSW Civil Liability Act 2002). Under proportionate liability, in any claim involving economic loss or property damage arising from misleading or deceptive conduct or negligence, an auditor's financial liability is strictly limited to the proportion of damages for which the auditor is held blameworthy by the court. If fraudulent management is found 80% responsible and the auditor is found 20% responsible for failing to exercise due care, the auditor pays strictly 20% of the plaintiff's proven loss.
- **Professional Standards Schemes:** Operating under state Professional Standards Acts, professional bodies (CA ANZ and CPA Australia) maintain government-approved Professional Standards Schemes. These statutory schemes cap an audit firm's maximum civil liability to a statutory monetary ceiling (typically scaled according to firm fee revenue and entity size, ranging from \$2 million to \$75 million), provided the firm complies with mandatory professional indemnity insurance, quality management, and continuing professional education standards.

DegreeLive

# Chapter 4: Overview of the Modern Financial Statement Audit Process

## 4.1 The Four Sequential Audit Phases

A systematic financial statement audit progresses logically through four distinct, interrelated operational phases:

| Audit Phase | Key Professional Objectives | Primary Standards & Deliverables |
|---|---|---|
| **Phase 1: Pre-Engagement & Planning** | Client acceptance and continuance evaluation; ethical conflict clearing; engagement letter execution; obtaining an understanding of entity and environment; identifying business risks; establishing overall materiality; formulating overall audit strategy. | ASA 210, ASA 220, ASA 300, ASA 315, ASA 320. *Deliverables:* Signed Engagement Letter, Strategy Memorandum, Materiality Calculations. |
| **Phase 2: Internal Control & Risk Assessment** | Detailed evaluation of entity-level and transaction-level internal controls; evaluating IT general controls (ITGCs); performing walk-throughs; designing and executing Tests of Controls (ToC) to assess control operating effectiveness. | ASA 315, ASA 330, ASQM 1. *Deliverables:* Control Risk Matrices, Walkthrough Documentation, Tests of Controls Working Papers. |
| **Phase 3: Substantive Testing & Evidence Gathering** | Executing substantive analytical procedures; performing detailed substantive tests of transactions and balances (vouching, tracing, external confirmation, inventory observation, valuation recalculations); addressing financial statement assertions. | ASA 500, ASA 501, ASA 505, ASA 520, ASA 530, ASA 540. *Deliverables:* Substantive Audit Programs, Bank and Accounts Receivable Confirmations, Lead Schedules. |
| **Phase 4: Audit Completion & Reporting** | Reviewing subsequent events; evaluating going concern viability; obtaining management representation letter; aggregating unadjusted misstatements; formulating final audit opinion; communicating Key Audit Matters (KAMs) to Governance. | ASA 450, ASA 560, ASA 570, ASA 580, ASA 700, ASA 701, ASA 705. *Deliverables:* Final Audit Summary Memorandum, Audit Committee Report, Independent Auditor's Report. |

## 4.2 Summary of Chapter Key Concepts and Definitional Matrix

| Term / Concept | Definitional Authority | Operational Role in Assurance Practice |
|---|---|---|
| **Information Risk** | Auditing Theory | The probability that published financial statements are materially misstated, creating capital misallocation. |
| **Reasonable Assurance** | ASA 200.11 | High, but not absolute, level of assurance expressed as a positive audit opinion. |

DegreeLive

| Term / Concept | Definitional Authority | Operational Role in Assurance Practice |
|---|---|---|
| **Professional Scepticism** | ASA 200.13 | An attitude that includes a questioning mind, being alert to conditions indicating possible misstatement, and critical evidence evaluation. |
| **APES 110 Independence** | APES 110 (s. 120 & 290) | Dual requirement of independence of mind and independence in appearance to preserve public credibility. |
| **Proportionate Liability** | Corporations Act s. 87CD | Statutory liability regime capping defendant liability to their proportionate degree of fault. |

\

# Chapter 5: The Audit Expectations Gap, Regulatory Inquiries & Non-Audit Services

## 5.1 Deconstructing the Audit Expectations Gap

A persistent challenge confronting the assurance profession globally and within Australia is the "audit expectations gap"—the difference between what external financial statement users expect auditors to achieve and what an audit actually delivers under the governing legislative and professional standard framework. Humphrey, Moizer, and Turley (1993) and the Porter framework deconstruct this expectations gap into three distinct operational components:

- **The Reasonableness Gap:** Represents the divergence between what the public expects auditors to achieve and what auditors can reasonably be expected to accomplish within the boundaries of practical economics. Many unsophisticated users expect an independent audit to guarantee 100% absolute accuracy of every single dollar in the balance sheet, certify that the company is entirely immune to future commercial bankruptcy or managerial mismanagement, and guarantee that no fraud of any kind has occurred anywhere within the enterprise. However, because auditors operate under statutory deadlines, sample testing, and inherit inherent limitations of internal accounting estimates, providing absolute assurance would require evaluating every single physical transaction at economically prohibitive cost.
- **The Performance Gap:** The gap between what society can reasonably expect auditors to do and what auditors actually deliver in practice. The performance gap is further subdivided into:
  1. *Deficient Standards:* Where existing auditing standards fail to encompass duties that society reasonably expects auditors to perform (such as early warning signals on impending liquidity collapse or climate transition risks).
  2. *Deficient Performance:* Where individual audit engagement teams fail to comply with existing auditing and professional standards due to inadequate technical competence, lack of supervision, compromised independence, or commercial fee pressures.
- **The Knowledge Gap:** Arising from broad misunderstanding among the general investing public regarding the true legal and statutory purpose of an audit under the Corporations Act 2001. Public investors frequently confuse the role of the independent external auditor with that of a forensic

Degreelive

fraud investigator or an investment advisor endorsing the commercial wisdom of management's strategic capital deployment.

## 5.2 Australian Corporate Governance Inquiries: Ramsay Report, CLERP 9 & Parliamentary Joint Committee (PJC)

The Australian auditing regulatory architecture is not static; it has evolved dynamically through landmark regulatory inquiries following major corporate collapses:

- **The Ramsay Report (2001) and CLERP 9 (2004):** Following the dramatic insolvencies of HIH Insurance (a \$5.3 billion collapse representing the largest corporate failure in Australian history), One.Tel, and Harris Scarfe in 2001, public outrage prompted the Commonwealth Government to commission Professor Ian Ramsay to review auditor independence. The Ramsay Report's recommendations formed the bedrock of the Corporate Law Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004 (CLERP 9). Key legislative enactments included:
  - Mandatory statutory auditor independence declaration under s. 307C of the Corporations Act 2001.
  - Statutory restriction on employment relationships (a former audit partner cannot serve as a director or officer of a former client within two years of retiring from the audit firm).
  - Mandatory rotation of lead and review audit partners after five successive financial years for listed entities (s. 324DA).
  - Giving AUASB auditing standards the full force of statutory law under s. 307A, enforceable by ASIC.
  - Mandating that the auditor attend the company's Annual General Meeting (AGM) and be available to answer shareholder questions regarding the conduct of the audit and accounting policies (s. 250RA).
- **The Parliamentary Joint Committee (PJC) on Corporations and Financial Services (2019–2020):** Initiated to examine the regulation of auditing in Australia, focusing on audit quality, multi-disciplinary accounting firm structures, fee transparency, and ASIC inspection findings. The PJC Inquiry explored whether large multi-disciplinary partnerships face inherent structural conflicts between low-margin statutory audit practices and high-margin management consulting, advisory, and technology implementation services. The inquiry reinforced rigorous enforcement of non-audit service prohibitions and advocated for expanded operational separation of audit practices within the major accounting networks.

## 5.3 Strict Restrictions on Non-Audit Services (NAS) under APES 110

To eliminate self-review and self-interest threats that arise when audit firms provide commercial consulting services to statutory audit clients, APES 110 enforces stringent rules, particularly for Public Interest Entities (PIEs, including all ASX-listed corporations, banks, and large insurance companies):

1. **Prohibition on Accounting and Bookkeeping Services:** An audit firm must not prepare accounting records, post journal entries, calculate depreciation schedules, or generate financial statements for an audit client that is a PIE. Management must maintain complete ownership and responsibility for source ledgers.

DegreeLive

2. **Prohibition on Internal Audit Outsourcing:** Audit firms cannot provide internal audit outsourcing services related to the internal accounting controls, financial systems, or financial statement amounts for statutory audit clients. Performing internal audit creates an irreconcilable self-review threat when the external audit evaluates those same internal controls.
3. **Valuation Services and Tax Planning:** An audit firm cannot perform valuation services if the valuation will have a material effect on the financial statements and involves a significant degree of subjectivity. Similarly, aggressive tax avoidance schemes or acting as an advocate before taxation tribunals is strictly prohibited.
4. **Fee Dependency Safeguards:** Under APES 110, if the total gross fees generated from an audit client represent more than 15% of the total gross fees received by the audit firm for two consecutive years, the firm must disclose this dependency to the Board Audit Committee and undergo pre-issuance or post-issuance reviews by an independent professional body or external practitioner outside the firm.

## Chapter 6: Landmark Australian Case Law & Practical Ethical Decision Scenarios

### 6.1 Centro Properties Group: ASIC v Healey [2011] FCA 717

The landmark Federal Court of Australia decision in *ASIC v Healey* (commonly known as the Centro case) provides crucial jurisprudence regarding the respective governance responsibilities of company directors versus independent external auditors under the Corporations Act 2001. In 2007, Centro Properties Group and its associated syndicates published audited annual financial reports that failed to disclose approximately \$1.5 billion in short-term interest-bearing bank debt, misclassifying the liabilities as non-current debt, and failed to disclose an additional \$1.75 billion in post-balance-date guarantees.

The financial statements had been prepared by management and received an unqualified audit opinion from PricewaterhouseCoopers (PwC). When Centro subsequently faced a catastrophic liquidity freeze during the 2008 Global Financial Crisis due to maturing debt that could not be refinanced, ASIC initiated civil penalty proceedings against the non-executive and executive directors for breaching their statutory duty of care and diligence under s. 180(1) of the Corporations Act 2001.

The directors argued that they were entitled to rely entirely upon the professional advice and competence of their management accounting personnel and the external auditors who had audited the accounts without objection. Justice Middleton firmly rejected this defence, establishing foundational governance principles:

- **Non-Delegable Duty of Financial Literacy:** Directors cannot act as mere rubber stamps. While directors may delegate tasks, each director is required by law to take a diligent and intelligent interest in the information available to them, read the financial statements carefully, and apply an inquiring mind to whether the disclosures correspond with their own knowledge of the company's financial affairs.
- **Interrelationship with the External Auditor:** The existence of an independent external audit does not absolve corporate directors from their primary statutory obligation under s. 295 to declare that the financial statements comply with accounting standards and give a true and fair view.

Degreelive

External auditing operates as an additional layer of assurance, not a substitute for director oversight.

- **Auditor Liability Consequences:** Following the judicial determination of director liability, class action litigation was initiated against PwC by aggrieved investors, culminating in a historic \$200 million settlement, highlighting the severe civil exposure confronting audit firms when material misclassifications escape detection.

## 6.2 Practical Ethical Dilemmas: APES 110 Identification & Resolution Scenarios

In professional practice, assurance practitioners encounter complex overlapping threats that require disciplined application of the APES 110 conceptual framework. Consider three operational scenarios confronting an Australian registered audit firm:

| Case Scenario | Threat Classification | Regulatory Analysis & Mandatory Action |
|---|---|---|
| **Scenario A:** The Chief Financial Officer of an ASX-listed retail audit client was, until 8 months ago, the audit senior manager leading the statutory audit engagement team at the firm. | **Familiarity & Self-Review Threat** | Under Corporations Act s. 324CK and APES 110 s. 524, a former audit partner or key audit personnel cannot serve as an officer of the audit client without satisfying a mandatory 2-year cooling-off period. Even for non-partner managers, close personal relationships create severe familiarity threats. *Mandatory Action:* Restructure the audit team immediately; ensure no former colleagues supervise the audit; conduct an independent pre-issuance quality review by a partner uninvolved with the engagement. |
| **Scenario B:** An audit client offers the audit engagement team a contingent audit fee structure: a base fee of \$100,000, with an additional \$50,000 bonus if the company successfully completes an initial public offering (IPO) on the ASX. | **Self-Interest Threat** | Under APES 110 s. 410.10, contingent fees for assurance engagements are strictly prohibited. The auditor's remuneration must never depend upon the outcome of a financial transaction, reporting result, or corporate event, as it creates an immediate financial incentive to overlook accounting misstatements. *Mandatory Action:* Flatly reject the contingent fee arrangement; establish a fixed-fee schedule based strictly on estimated professional hours and skill requirements. |
| **Scenario C:** A mining client requests that the audit firm's corporate finance team assist in negotiating a syndicated loan facility with an Australian commercial bank, including making representations regarding future cash flow forecasts. | **Advocacy & Self-Review Threat** | Under APES 110 s. 605, acting as an advocate or negotiating on behalf of an assurance client with external credit providers directly compromises objectivity. Furthermore, if the debt covenants rely on forecasts evaluated during subsequent going concern reviews, self-review is breached. *Mandatory Action:* Decline the financing negotiation engagement; advise the client to retain an independent debt advisory specialist. |

Degree Live