A guide to understanding auditing and assurance:

New Zealand issuers

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CPA AUSTRALIA

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Contents

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Foreword

Auditing and assurance play an essential role in the effective operation of our capital markets and the economy at large, providing confidence to current and prospective shareholders about the information disclosed by companies.

A guide to understanding auditing and assurance: New Zealand issuers explains the value and purpose of auditing and assurance in plain language. This should assist shareholders who are not experts in auditing and assurance to better understand the messages from their company's auditor, and make use of this information in their decision making.

The Guide is an initiative of the External Reporting Centre of Excellence of CPA Australia and I congratulate them on their contribution to a CPA Australia publication that has an important role to play in the promotion of improved financial literacy.

Alex Malley FCPA
Chief Executive Officer
CPA Australia Ltd

A guide to understanding auditing and assurance: Listed companies

Why are audits and reviews required?

Shareholders are often quite separate from those managing and governing the companies they own.[1] They need a reliable source of financial information on which to assess the company, and the performance of management. The same can be said for other stakeholders of companies, such as creditors, lenders, employees, analysts, prospective shareholders, governments and communities. Audits and reviews enhance the credibility of the information contained within the **financial statements**, so that shareholders and other stakeholders can make assessments and decisions with confidence and on a consistent basis.

What does assurance mean?

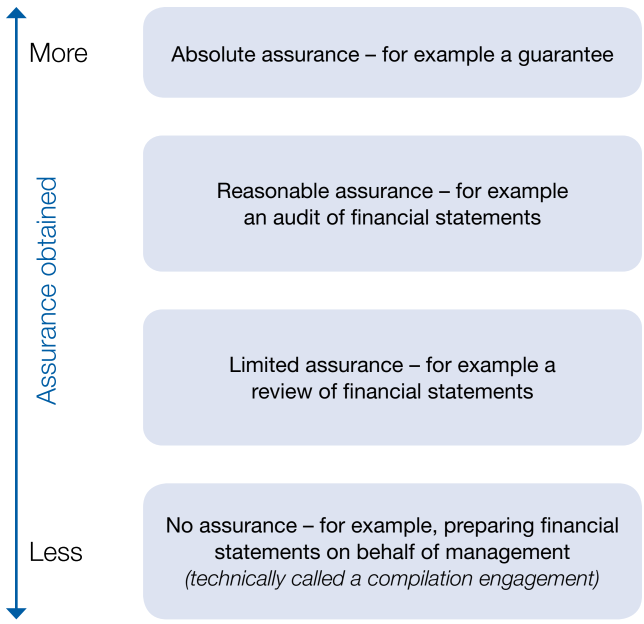
The term **assurance** refers to the expression of a conclusion that is intended to increase the confidence that users can place in a given subject matter or information. For example, an **auditor's report** is a conclusion that increases the confidence that users can place in a company's financial statements.

There are different levels of assurance, which depend on the type of work that the **assurance practitioner** performs, and these different levels also lead to different types of conclusions.

Type of assurance	For example	Nature of key work performed	Example form of conclusion
Reasonable Assurance	An audit of financial statements	Detailed testing, evidence gathering and substantiation to support the conclusion.	"In our opinion, the financial statements *present* a true and fair view".
Limited Assurance	A review of financial statements	Primarily enquiries and analysis, less detailed procedures.	"We have *not* become aware of any matter to cause us to believe the financial statements *do not* present a true and fair view".
No Assurance	Preparing financial statements (compilation)	Preparation of the financial statements	No conclusion provided

1 This guide refers to audits and reviews of listed company financial statements. The concepts of audit and review are also applicable to other types of entity such as groups of companies, trusts and partnerships.

The following diagram illustrates different levels of assurance, in some of the different activities performed by accountants:



What is an audit of financial statements?

An audit of financial statements is a **reasonable assurance** engagement where the auditor provides an opinion about whether the financial statements present a **true and fair** view, and are in accordance with **accounting standards** *(and legislation where appropriate)*.

New Zealand issuer company full-year financial statements are required by law to be audited. Many other types of entities are also required to have their financial statements audited, for example non-listed companies over a certain size threshold, some charities and not-for-profit entities.

While the reasonable assurance obtained in an audit is a high level of assurance, it is not absolute assurance (a certification that the financial statements are completely correct). Obtaining absolute assurance is not possible in financial statement audits for a number of reasons, including:

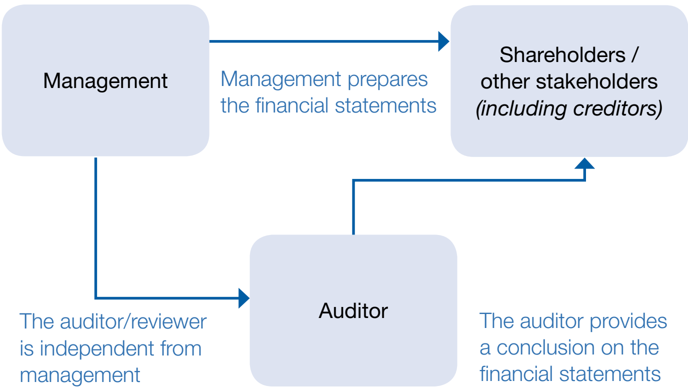
- It would be impractical for the auditor to test and audit every transaction
- Financial statements involve judgements and estimates which often cannot be determined exactly, and may be contingent on future events

What is a review of financial statements?

A review of financial statements is a **limited assurance** engagement where the reviewer provides a conclusion as to whether they have become aware of any matter that causes them to believe the financial statements *do not* present a true and fair view, or *are not* in accordance with accounting standards.

Relationships in financial reporting

The following diagram illustrates the relationship between shareholders and other stakeholders, management[2] and the auditor or reviewer.



A sub-committee of the board of directors called the audit committee usually arranges the appointment of the auditor. The audit committee typically meets with the auditor throughout the year to discuss details such as scheduling, risks, financial reporting issues, the auditors findings and other matters relevant to the audit and financial statements. At the conclusion of the audit, the auditor often provides a more detailed, in-depth confidential report to the audit committee.

2 Unless otherwise specified, the term “management” throughout this guide refers to those charged with the governance of companies including directors and top level executives.

The auditor's report

The auditor's report contains the auditor's opinion on the financial statements, in addition to a range of other information. Appendix 2 contains an illustrative example of an unmodified auditor's report with explanation, and Appendix 3 contains an example of an unmodified **review report** with explanation. An unmodified auditor's report effectively states the auditor believes the financial statements present a true and fair view, and are in accordance with accounting standards and relevant legislation. This is sometimes also called an "unqualified" or a "clean" audit opinion. Unmodified auditor's reports are the most common type you are likely to come across. This is in part because management usually addresses most of the problems or adjustments that auditors discover before the financial statements are issued.

An unmodified review report effectively states the reviewer did not become aware of anything that suggested the financial statements do not present a true and fair view in accordance with accounting standards.

Emphasis of matter and other paragraphs

In some circumstances, the auditor will include additional wording in the auditor's report directing users to information that in their view is fundamental to understanding the financial statements. This may be information included in the financial statements, such as a note (called an "emphasis of matter" paragraph), or information that is included elsewhere (called an "other matter paragraph"). It is important to note that an emphasis of matter or other matter paragraph is not a qualification, limitation or adverse conclusion (for these types of auditor's reports, see *Modified auditor's reports* below).

Type of paragraph	Examples
Emphasis of matter	• There is a significant uncertainty as to the company's ability to continue as a going concern, which has been appropriately disclosed in the financial statements. • The financial statements are not prepared on the basis of applying all accounting standards.
Other matter	There is information included in an annual report that is inconsistent with the audited financial statements (for example, the figures in the operating review are inconsistent with those disclosed in the financial statements).

Modified auditor's reports

Modified auditor's reports are issued when the auditor believes the financial statements contain a **material misstatement**, or when the auditor is unable to obtain enough evidence to form an opinion. The following table sets out the different types of modified auditor's reports that may be issued in these situations.

Type of modified audit opinion	Description	Situations where this type of report may be issued	Examples
Qualified or "except for" opinion	The opinion states the financial statements present a true and fair view, and are in accordance with accounting standards *except* for the effect of a specific matter or matters. The issues are described in a separate paragraph within the report.	A qualified opinion is issued when a specific part of the financial statements contains a material misstatement or adequate evidence cannot be obtained in a specific, material area, and the rest of the financial statements are found to present a true and fair view, in accordance with accounting standards.	The auditor has a different view on the valuation of an asset than that applied by management in the financial statements, but the rest of the financial statements were found to be free of material misstatements.
Disclaimer of opinion	The auditor cannot reach an opinion overall on the financial statements and therefore disclaims any opinion on it.	A disclaimer of opinion is issued when the auditor cannot obtain adequate evidence to form an opinion on the financial statements overall.	The company's financial reporting information system is damaged and key data is lost, meaning adequate evidence is not available to support the disclosures in the financial statements.
Adverse opinion	The opinion states that the auditor believes the financial statements *do not* present a true and fair view, and *are not* in accordance with accounting standards.	An adverse opinion is issued when the auditor believes misstatements are so pervasive that the financial statements do not present a true and fair view, or are not in accordance with accounting standards.	The auditor believes that management has applied an inappropriate financial reporting framework in preparing the financial statements.

How can you tell if the auditor's report is clean or not?

To determine if an auditor's report is clean or modified, you need to look at the "opinion" section. This is usually found towards the end of the auditor's report, before the auditor's name and signature. An unqualified or clean audit opinion will state that the auditor believes the financial statements present a true and fair view, and are in accordance with accounting standards and relevant legislation. A modified auditor's report will contain a qualification to that statement, a disclaimer or an adverse statement (see also "Modified auditor's reports").

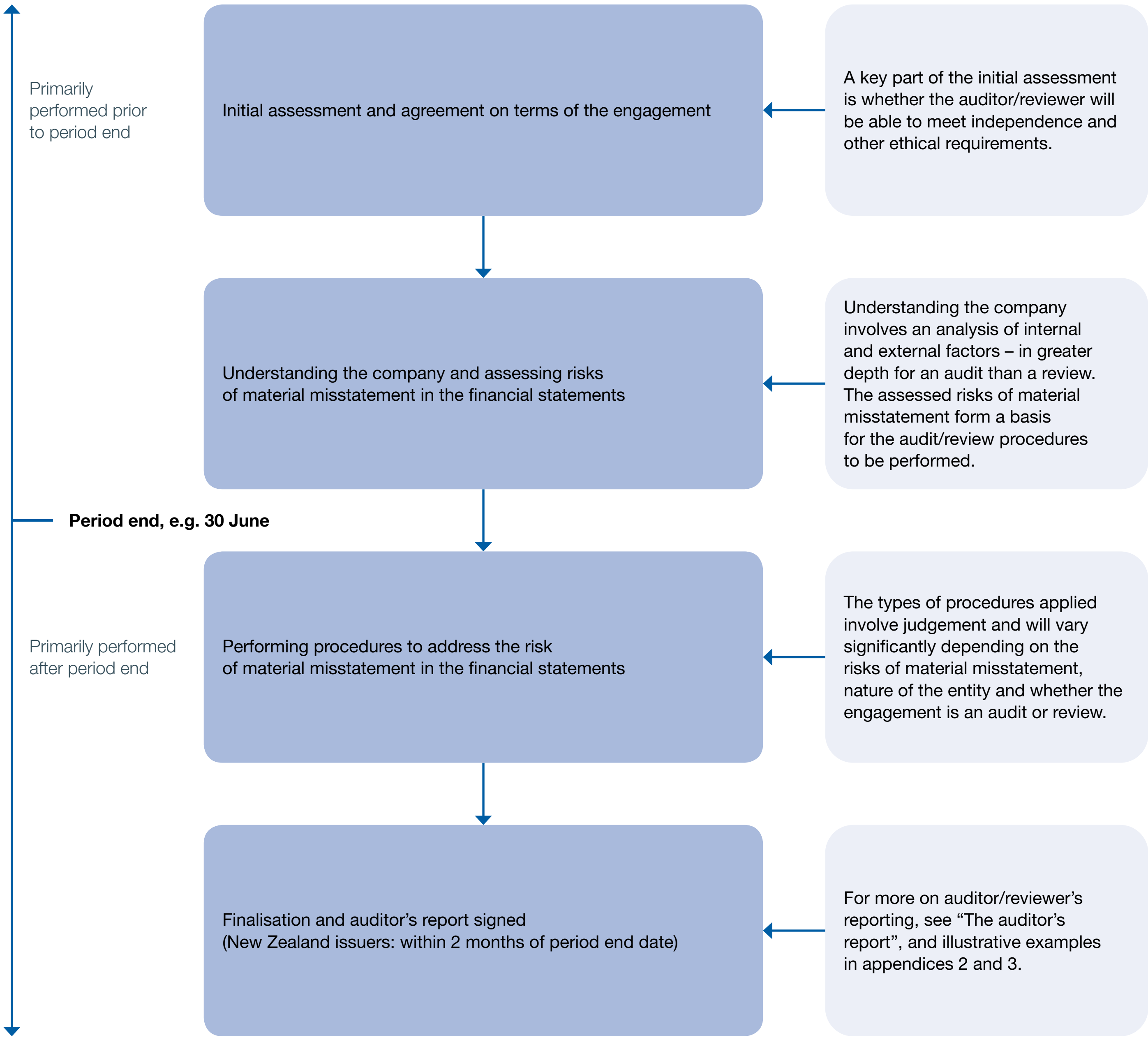
What is auditor independence?

An independent auditor is free from external influence or bias and is therefore able to independently form judgements and conclusions during the audit. Auditors are subject to **professional ethical standards**, including extensive requirements for auditor independence both in mind and in appearance. It is critical that auditors are not only actually independent, but also seen as independent.

What do auditors and reviewers do?

The audit or review of financial statements is a systematic process designed to identify instances of material misstatement in the financial statements. Extensive **auditing and assurance standards** and legislative requirements set the framework and minimum requirements for financial statement audits and reviews.

The following diagram illustrates at a very high level what is involved in financial statement audits and reviews, and the order in which activities usually take place during the year:



What does materiality mean?

As mentioned above, auditors and reviewers are concerned with material misstatements, rather than *any* misstatement in the financial statements. Material misstatements are those that are significant enough to affect the decisions made by the users of the financial statements. This can be in terms of the quantitative or qualitative significance of misstatements.

Quantitative	The quantities or dollar amounts in the financial statements. For example, quantitatively material misstatements could include: • Overstating revenue • Missing/not recording liabilities • Understating expenses
Qualitative	The nature of items in the financial statements. For example, qualitatively material misstatements could include: • Not disclosing certain related party transactions • Not disclosing management's remuneration These disclosures are important in evaluating how the company has been managed, although they may be small quantitatively in comparison to the scale of the company's overall operations.

What do auditors do in regard to fraud?

Auditors consider the possibility that fraudulent activities can result in material misstatement in the financial statements, and take this into account in planning and performing their work. Fraud is defined in auditing and assurance standards as an:

"intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage".

An audit is not an investigation intended to uncover all instances of fraud. However it is reasonable to expect that an audit would detect instances of fraud that result in material misstatement.

What do auditors do in regard to going concern?

The **going concern** assumption is that a company will continue in business for the foreseeable future. This assumption is adopted unless evidence indicates otherwise.

The going concern assumption has a significant impact on how a company's financial statements are presented (see "If going concern doesn't apply").

In preparing the financial statements, management makes an assumption as to whether it believes the company will be able to continue as a going concern. The auditor performs work to assess this assumption as part of the audit.

If going concern doesn't apply

Companies that are not a **going concern** report on a different basis from those that are – for example, assets and liabilities would be recognised at their immediate sale value/liquidation value, rather than their value in future use.

The work of the auditor includes:

- Obtaining evidence that can be used to assess the appropriateness of management's assumptions in regard to going concern.
- Forming a conclusion on whether that evidence indicates any material uncertainties in the ability of the company to continue as a going concern.

The auditor's focus in this assessment is whether the company can continue as a going concern for a 12-month period from the date of signing the auditor's report.

The going concern assumption involves judgements about events taking place in the future, which are inherently uncertain. Where there is significant uncertainty in the company's ability to continue as a going concern and this has been disclosed by management in the financial statements, the auditor includes wording in the auditor's report to direct users to the applicable note in the financial statements. This is called an emphasis of matter paragraph (explained further on page 7). If the auditor ultimately does not agree with management's assumptions in regard to going concern, the result would be a modified opinion (see "The auditor's report").

Does a clean auditor's report mean a clean bill of health for the company?

Auditor's reports are intended to increase the degree of confidence users have in the information in financial statements – not about the state of the company itself or whether it is a safe investment. An unmodified auditor's report means investors or other stakeholders can make an assessment of the company based on its financial statements, with a higher degree of confidence that the information is materially correct and unbiased.

Auditors do perform a role in assessing the appropriateness of the going concern assumptions used by management in preparing the financial statements, but this cannot be taken as a conclusion on the solvency or financial health of the company (see "What do auditors do in regard to going concern?")

Does the auditor sign off on the whole annual report?

The auditor's report is about the financial statements, which are usually included in the annual report. Other information within the annual report may not have been subjected to assurance (for example management discussion and analysis, or an operating review). However, the auditor does consider whether this accompanying information is consistent with the audited financial statements. So for example, the auditor would report if the profit results included in the operating review were inconsistent with those in the financial statements.

Difference between internal and external audit

Internal audit is an appraisal activity established within an entity and functions under the direction of the company's management and board. It is a management tool and forms part of the company's internal control structure. In general, the main focus of an internal audit is to evaluate the adequacy and effectiveness of the company's internal control.

Conversely, an external audit is undertaken by an auditor who is independent from the entity and has been appointed to express an opinion on the financial statements or other specified accountability matter. External auditors act and report in accordance with their mandates, which may be dictated by legislation, regulation or established in a contract.

Other assurance

Assurance is also applicable in a wide and expanding range of other areas aside from financial statements. Some examples include:

- Compliance with regulations
- Sustainability reports
- Greenhouse gas emission statements
- Prospectuses

A wide group of stakeholders increasingly need credible information in regard to the performance and impact of companies in these areas.

Appendix 1 – Glossary

Accounting standards: Mandatory standards applied in preparing financial statements. In New Zealand, these standards are issued by the New Zealand Accounting Standards Board, and internationally by the International Accounting Standards Board.

Assurance: The expression of a conclusion that is intended to increase the confidence of users in subject matter or information (see also "What does assurance mean?")

Assurance practitioner: A professional assurance services provider.

Auditor's report: The final report that sets out the auditor's opinion (see also "The auditor's report", and an example of an auditor's report in Appendix 2).

Auditing and assurance standards: Mandatory standards applied by assurance practitioners in audits, reviews and other assurance engagements. In New Zealand these standards are issued by the New Zealand Auditing and Assurance Standards Board, and internationally by the International Auditing and Assurance Standards Board.

Financial statements: Four primary financial statements for the current and comparative financial period (statement of comprehensive income, statement of financial position, statement of changes in equity, and cash flow statement), plus the notes to the financial statements. Available on CPA Australia's website.

Going concern: An enterprise that is expected to continue in business for the foreseeable future (see also "What do auditors do in regard to going concern?")

Limited assurance: A level of assurance that is meaningful, but lower than reasonable assurance (see also "What does assurance mean?")

Material misstatement: An inaccuracy or omission from the financial statements that is significant enough to affect the decisions made by users of the financial statements.

Professional ethical standards: The ethical standards applicable to the accounting profession, including those applicable to assurance practitioners. In New Zealand, these standards are issued by the New Zealand Auditing and Assurance Standards Board, and internationally by the International Ethics Standards Board for Accountants.

Reasonable assurance: A high but not absolute level of assurance (see also "What does assurance mean?")

Review report: The final report that sets out the review conclusion (see also "The auditor's report", and an example of a review report in Appendix 3).

True and fair: Presenting an accurate and unbiased picture of a company's financial performance and position in the financial statements.

Appendix 2 – Example auditor's report

Independent auditor's report

The report is addressed to the members, or shareholders of the company

To the Shareholders of ABC Company Ltd.

This section sets out the basic details of the engagement – the applicable reporting period, name of the company, what was audited

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company Ltd on pages XX to XX, which comprise the statement of financial position as at 30 June 20X3, and the statement of comprehensive income, statement of changes in equity and cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory information.

The directors are responsible for preparing the financial statements, and for the internal controls in the company

Directors' Responsibility for the Financial Statements

The directors of the company are responsible for the preparation of the financial statements in accordance with generally accepted accounting practice in New Zealand, and that give a true and fair view of the matters to which they relate, and for such internal control as the directors determine is necessary to enable the preparation of financial statements that give a true and fair view and are free from material misstatement, whether due to fraud or error.

Appendix 2 – Example auditor's report

The auditors are responsible for auditing the financial statements – this section also provides a brief description of what auditors do (see also 'What do auditors and reviews do?')

Auditor's Responsibility

Our responsibility is to express an opinion on the financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing (New Zealand). Those standards require that we comply with relevant ethical requirements relating to audit engagements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial report. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the company's preparation of the financial statements that give a true and fair view in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the directors, as well as evaluating the overall presentation of the financial statements.

The auditor confirms their independence

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Other than our capacity as auditor we have no relationship with, or interests in, ABC Company Ltd.

The auditor sets out their overall finding in the opinion. This is an example of an unmodified or 'clean' audit opinion. See also 'The auditor's report' for information on modified opinions.

Opinion

In our opinion, the financial statements on pages XX to XX:

- Comply with generally accepted accounting practice in New Zealand; and
- give a true and fair view of the financial position of ABC Company Limited at 30 June 20X3 and its financial performance and its cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

- We also report in accordance with the Financial Reporting Act 1993. In relation to our audit of the financial statements for the year ended 30 June 20X3:
- we have obtained all the information and explanations we have required; and
- in our opinion proper accounting records have been kept by ABC Company Limited as far as appears from our examination of those records.

audit firm

AUDIT FIRM

Auckland, 28 August 20X3

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