**Auditing**

Auditing is an independent examination of financial reports and supporting documents to determine if they:

* comply with levels of quality specified in accounting standards
* provide a true and fair view of the entity’s performance and financial position.

**Why is auditing needed?**

* Required by banks before making loans
* Required for stock exchange listing
* Required by external users who depend on financial reports for decisions

Auditing can be divided into two types:

1. Internal auditing
2. External auditing

**Internal Auditing**

* Its main function is to conduct on-going reviews to make certain that established procedures and policies are followed. Any deficiencies are identified and corrected.
* An efficient internal audit can reduce the time taken for an external audit and produce cost savings.

A full internal audit would include:

1. a review of the efficiency of the internal control system which are procedures to safeguard assets and promote reliability of accounting data.
2. a review of the efficiency of other systems e.g. the supply chain (the steps involved in purchasing and selling inventory)
3. check that the policies of the business are being followed and that the business is complying with all laws, and
4. any other duties set by senior management.

The internal auditor is an employee of the business.

**External Auditing**

**Legal Requirements**

Public companies and large proprietary companies are required to have their annual financial statements audited.

The auditor, a qualified accountant or firm of accountants, must have access to all the company’s financial records so that he can test the systems and ensure that everything is properly recorded.

The role of external auditors is controlled by the Corporations Act.

All auditors must become Registered Company Auditors (RCAs) through being registered with ASIC

RCAs must comply with the Corporations Act 2001 and Auditing Standards as determined by the Auditing and Assurance Standards Board.

**The role of the auditor**

Most stakeholders are not in a position to examine the financial records of a business. The auditor is an independent and qualified person who is given access to examine records on behalf of these stakeholders.

The auditors are required to satisfy themselves that:

1. The company’s records have been kept in accordance with the Act and with Accounting standards and the Framework.
2. The reports based on those records give a true and fair reflection of the financial position at the end of the period and financial performance for the period.

Theauditor’s report must contain, among other things, their opinion on the above and that they have met the independence requirement required by the Act.

**The Auditors report**

Once satisfied on these two points, the auditor signs a report to that effect, which is included with the financial statements and director’s report and sent to shareholders. In this case the report is said to be **unqualified***. (Unqualified = accepted totally without any qualifications or reservations)*

If, for any reason, the auditors find themselves unable to report in this way, they will usually bring any deficiencies to the attention of the company’s management so that they may be rectified.

If this is impossible, or if the company refuses to do so, the auditors must state that their report is a **qualified** one. *(Qualified= not completely positive because of doubts)*

A ‘qualified report’ may occur in such instances:

* The financial statements are presented fairly, except for some deficiencies or weaknesses and the effect on the report is material; in this case an ‘*except for qualification’* is issued.
* The financial statements are not presented fairly and the deficiency or weakness has a highly material effect on the financial reports; in this case an ‘ *adverse qualification*’ is issued
* The auditor is unable to form an opinion, due to lack of evidence or limit placed on the scope of the audit; in this case the lack of evidence is very material.

The Act requires auditors to report to ASIC any contraventions of the Act and any problems the company will not rectify adequately.

They include:

* The company trading while insolvent
* Not complying with accounting standards
* Fraudulent conduct by officers or employees of company
* Not assisting the auditor in his work

**Independence of External Auditors**

Auditors are responsible to shareholders and they are appointed by them at the AGM at which time their remuneration is also voted on.

In practice however the board and senior management have a close working relationship with their auditors and can sometimes lose sight of their ultimate responsibility.

The Act however spells out clearly the need for auditors to be independent and provides for penalties if this requirement is not met. Auditors are required by the Act to notify ASIC if they have been subjected to any attempt to influence their decision.

In order to preserve the independence of auditors the Act contains the ‘5/7 rule’ or time out rule. An auditor who has had a significant role in the audit of a listed company who has served for more than 5 successive financial years is not eligible to continue until he has had at least two successive years of non involvement.

Auditors of companies whose accounts must be audited are required to attend the company’s AGM and shareholders must be given an opportunity to question them.

**Internal Audit and its relationship to external audit**

Internal audit is a continual review of procedures, systems and policies to ensure they are being adhered to and working efficiently and effectively. It monitors, examines and tests the effectiveness of internal control systems.

Its purpose is to detect and correct errors, identify deficiencies in business operations so that improvements can be made.

This function is carried out by internal auditors, who report to management of the entity.

A large organization with several operating divisions and hundreds of employees will need specific control systems, under the supervision of an internal audit committee, which would include representatives from senior management. This committee will also liaise with the external auditors to ensure that the business is meeting the requirement of external regulators. But the external audit is independent of any internal audit process.