

Principles of Auditing

An International Perspective

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Outline

Table of Contents

1. International Auditing Overview
2. The Audit Market
3. Ethics for Professional Accountants
4. Introduction to Audit Process
5. Client Acceptance
6. Internal Control and Its Components
7. Audit Planning
8. Relying on Internal Control in the Audit Process
9. Substantive Testing
10. Completing the Audit
11. External Audit Reports
12. An audit – step by step
13. Auditing beyond 2000

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Chapter 1: International Auditing Overview

A. Introduction

A. Historical background

1. Anthropologists have found records of auditing activity dating back to early Babylonian times (around 3,000 BC).
2. The practice of modern auditing dates back to the beginning of the modern corporation at the dawn of the Industrial Revolution.
3. Management and financial reports: the flow of investor funds to the corporations and the whole process of allocation of financial resources through the securities markets has become dependent to a very large extent upon reports made by management. Management can scarcely be expected to take an impartial view of this process.
4. The role of an auditor: to provide with an independent and expert opinion on the fairness of the financial reports.

B. The Auditor, Corporations and Financial Information

By the audit process, the auditor enhances the usefulness and the value of the financial statements, but he also increases the credibility of other non-audited information released by management.ⁱ

C. Accounting and Auditing Standards

1. Many countries have issued local auditing standards under which companies are audited in their home country.
2. International Accounting Standards: The International Accounting Standards Committee (IASC) has worked for over twenty years to harmonize international accounting standards and its pronouncements, International Accounting Standards (IAS). The IASs have been adopted by many countries which do not have their own national accounting standards or which believe that international comparability is to be preferred.
3. International Auditing Standards: Auditing standards were required by multinational corporations which wanted a world wide, consistent, high quality audit. International auditing standards have existed since the International Federation of Accountants (IFAC) came into being as a result of initiatives put forward in 1973 and approved in 1977. Although ISAs are not required by all countries, we will use them as the basic standards throughout this book because they represent the highest and best international representation of generally accepted auditing standards.
4. A listing of the International Standards on Auditing is given Illustration 1-1.

D. Audit definitions

1. There is no definition of an audit, per se, in the International Standards on Auditing. The definition given in ISA 200 states the *objective of an audit*ⁱⁱ, "The objective on an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework of other criteria.
2. A better, more general definition of auditing is the definition put forth by the American Accounting Associationⁱⁱⁱ, "*An audit is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users.*"
 - a. An audit is a *systematic* approach: the audit follows a structured, documented plan (audit plan).
 - b. An audit is *objectively* conducted: an audit is an independent, objective and expert examination and evaluation of evidence.
 - c. The auditor *obtains and evaluates evidence*. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data.
 - d. The evidence obtained and evaluated by the auditor regards *assertions about economic actions and events*. The basis of evidence gathering objectives, the thing that the evidence must "prove" are the *assertions* of management.
 - e. The auditor *ascertains the degree of correspondence between assertions and established criteria*. The audit program tests most assertions by examining the physical evidence of documents, confirmation, inquiry and observation.
 - f. The goal, or objective, of the audit is *communicating the results to interested users*. The audit is conducted with a view of expressing an informed and credible opinion, in a written report.

E. General Principles Governing an Audit of Financial Statements

1. The financial statements audited under international standards^{iv} are the balance sheets, income statements^v, and cash flow statements^{vi} and the notes thereto. The first International Standard on Auditing, ISA 1 (Subject matter Number 200)^{vii}, discusses the principles governing an audit of financial statements.

- a. ISA 200 (1) states that an auditor could comply with the Code of Ethics for Professional Accountants issued by IFAC, which is discussed later in Chapter 3.
- b. ISA 200 further states that the auditor should conduct an audit in accordance with International Standards on Auditing.
- c. The term “scope of an audit” refers to the audit procedures deemed necessary in the circumstances to achieve the objective of the audit.
- d. An audit in accordance with ISAs is designed to provide reasonable assurance.^{viii}
- e. There are certain inherent limitations in an audit that affect the auditor’s ability to detect material misstatements.
- f. The audit of the financial statements does not relieve management of its responsibilities.

III. Types of Audits

- A. Audits of financial statements examine financial statements to determine if they give a true and fair view or fairly present the financial statements in conformity with specified criteria.
- B. An *operational audit* is a study of a specific unit of an organization for the purpose of measuring its performance.
- C. A *compliance audit* is a review of an organization’s procedures performed to determine whether the organization is following specific procedures, rules, or regulations set out by some higher authority.

IV. Types of Auditors

- A. Internal auditors are employed by individual companies to investigate and appraise the effectiveness of company operations for management.
- B. Independent auditors are certified either by a professional organization. Certified auditors are called:
 1. Certified Public Accountants (CPA);
 2. Chartered Accountants (CA);
 3. Contador Público (CP);
 4. Expert Comptable;
 5. Auditor;
 6. Other titles.

V. The Audit Process Model

- A. Philip Wallage has likened the audit process to the empirical scientific cycle.^{ix}
- B. The audit process begins with a client’s request for an audit of financial statements, is followed by a plan of the audit and tests of evidence, culminating in a judgement or opinion. In this book we will use a four phase standard audit process model based on the scientific empirical cycle.
- C. Phases of an audit are:
 - Phase I: Client Acceptance(pre-planning),
 - Phase II: Planning,
 - Phase III: Testing and Evidence,
 - Phase IV: Evaluation and Judgement.

VI. International Public Accountancy Firms

- A. The Big Six: Arthur Andersen & Co.; Coopers & Lybrand; Deloitte & Touche; Ernst & Young; KPMG; and Price Waterhouse.
- B. The allocation of personnel to an audit:
 1. Staff Accountants (or Junior Assistants then Senior);
 2. Senior Accountants (or Supervisor);
 3. Managers;
 4. Partners/Directors.

VII. Organizations That Affect Auditing

- A. International Federation of Accountants (IFAC): International Standards on Auditing (ISA) are developed by The International Federation of Accountants (IFAC) through its International Auditing Practices Committee (IAPC).
- B. International Accounting Standards Committee (IASC):
 1. Formulate and publish in the public interest accounting standards;
 2. To work generally for the improvement and harmonization of regulations;
- C. The European Union (EU): Has issued a series of accounting standards for the community.

Chapter 2 - The Audit Market

I. Brief history of auditing

- A. Determined by the history of accounting or bookkeeping.
- B. The attitude of profit maximization emerged at the end of the middle ages, with the emergence of large merchant houses in Italy.
- C. Double-entry bookkeeping was first described in Italy.
- D. Another revolution: the Industrial Revolution which started in Great-Britain around 1780. This revolution led to the emergence of large industrial companies, with:
 - 1. Complex bureaucratic structures and, gradually.
 - 2. The need to look for external funds in order to finance further expansion: the separation between capital provision and management.
- E. In 1853, the Society of Accountants in Edinburgh was founded.

II. Theories On The Demand And Supply Of Audit Services

- A. *The demand for audit services has been explained by several different theories:*
 - 1. Policeman Theory
 - a. The most widely held theory on auditing until the 1940s.
 - b. Auditing was focused on arithmetical accuracy and on prevention and detection of fraud.
 - c. Inability to explain the shift of auditing to 'verification of truth and fairness of the financial statements'.
 - 2. Lending Credibility Theory
 - a. Primary function of auditing the addition of credibility to the financial statements.
 - b. The theory as such is unable to explain the various other functions the users of financial statements expect the auditor to assume as part of attestation function.
 - 3. Moderator of Claimants Theory
 - a. Under this theory, it is important that all vital participants in an organization continue to contribute.
 - b. It cannot explain the other attributes of the attestation function, nor does it explain the shift in attention over time.
 - 4. Quasi-Judicial Theory
 - a. The auditor is regarded as a judge in the financial information distribution process.
 - b. This theory cannot be sustained because:
 - an auditor's decisions and decision process are not publicly available,
 - the doctrine of precedence/consistency is not guaranteed in auditing,
 - an auditor's independence differs from a judge's independence because of the different reward systems involved, Porter (1990),
 - 5. Theory of Inspired Confidence
 - a. Developed in the late 1920s by the Dutch professor Theodore Limperg.
 - b. addresses both the demand and the supply of audit services.
 - 6. Agency Theory
 - a. A reputable auditor is appointed not only in the interest of third parties, but also in the interest of management.
 - b. A company is viewed as the result of more or less formal 'contracts', in which several groups make some kind of contribution to the company, given a certain 'price'.
 - c. Agent 'management' has a considerable advantage over the principals regarding information about the company.
 - d. Agency theory can also be used to explain the supply side^x of the audit market. The contribution of an audit to third parties is basically determined by (1) the probability that the auditor will detect errors in the financial statements (or other irregularities, such as fraud or illegal acts) and (2) her willingness to report these errors (e.g., by qualifying her auditor's report), even against the wish of the auditee (auditor independence).

III. Audit Regulation

- A. Although regulation and legislation differ, both the demand and the supply of audit services are currently regulated to some degree in most countries.

IV. Controversies Surrounding The Audit Profession

- A. The development of the auditor's duties is still an object of public debate, often referred to as the '*audit expectation gap*' debate. Two landmark studies that were published in 1992:

1. The Cadbury report

- Cadbury deals with the responsibilities and duties of the executive and non-executive members of the Board of Directors. The report suggests that companies should adhere to a Code of Best Practice, in which these responsibilities and duties are listed.
- In addition, the Cadbury report suggests that the Board should report that they tested the adequacy of the company's *internal control* as well as the company's ability to continue as a going concern.

2. The COSO report envisaged

- harmonizing the definitions regarding internal control and its components.
- helping management in assessing the quality of internal control.
- creating internal control benchmarks, enabling management to compare the internal control in their own company to the state-of-the-art.
- creating a basis for the external reporting on the adequacy of the internal controls.

B. Audit Expectations

The users of audit services can broadly be classified as auditees (the board of directors of the company) and third parties (shareholders, bankers, creditors, employees, customers, and other groups). Expectations were found with regard to the following duties of auditors:

- giving an opinion on the fairness of financial statements;
- giving an opinion on the company's ability to continue as a going concern;
- giving an opinion on the company's internal control system;
- giving an opinion on the occurrence of fraud; and
- giving an opinion on the occurrence of illegal acts.

1. **Opinion On The Fairness Of Financial Statements:** Giving an opinion on the fairness of the financial statements is generally regarded as the auditor's 'core business'.
2. **Opinion On The Company's Ability To Continue As A Going Concern:** If there are serious doubts about this ability, both the financial statements and the auditor's opinion need to express these doubts.
3. **Opinion On The Company's Internal Control System:** The issue of testing and reporting on the quality of a company's *internal control* system has been recognized as one of the focal issues in auditing (see, e.g. the COSO report).
 - The expectation gap surveys show high expectations of the auditor's role in testing whether a satisfactory system of internal control is being operated.
 - The only requirement for internal control reporting in the U.S. so far has come from the US Federal Deposit Insurance Corporation (FDIC) which requires a significant number of deposit taking institutions to report publicly on the effectiveness of their internal control structure with reference to the COSO criteria.
 - The conclusion of the Cadbury Report stressed the importance of internal control reporting to good corporate governance.
 - The Cadbury Report further recommended that the accountancy profession develop criteria for assessing effectiveness, reporting, and audit procedures.
4. **Opinion On The Occurrence Of Fraud:** Both governments and parts of the financial community expect the auditor to find existing fraud cases and report them. The object of an audit may be said to be threefold:
 - The detection of fraud
 - The detection of technical errors
 - The detection of errors of principle

Gradually, the auditor's responsibilities began to change, with fraud no longer being a key priority.

5. Opinion On The Occurrence Of Illegal Acts: As far as the reporting of illegal acts is concerned, most national regulators require the auditor to assess the (potential) impact on the financial statements and determine the consequences of the uncertainty or error in the financial statements for the nature of the opinion.

V. Legal liability to third parties

A. Nearly all national audit professions have some sort of *disciplinary court*. Having heard the arguments of the plaintiff and the defendant, the court makes its judgment and determines the sanction - if any - against the auditor. The sanction may vary from:

1. a fine
2. a reprimand (either oral or written)
3. a suspension for a limited period of time (e.g., 6 months)
4. a life-time ban from the profession. In some countries, the trials of these disciplinary courts are public.

B. In order to hold the auditor successfully legally liable in a civil suit, the following conditions have to be met:

- An audit failure/neglect has to be proven (*negligence issue*). A verdict by the disciplinary court is often the basis for meeting this condition;
- The auditor should owe a duty of care to the plaintiff (*due professional care issue*, see below);
- The plaintiff has to prove a causal relationship between her losses and the alleged audit failure (*causation issue*);
- The plaintiff must quantify her losses (*quantum issue*).

C. Three different standards are used to determine whether the auditor has a duty of care towards a plaintiff:

Chapter 3 - Ethics for Professional Accountants

I. What are Ethics?

Ethics represent a set of moral principles, rules of conduct or values. Ethics apply when an individual has to make a decision from various alternatives regarding moral principles. All recognized professions have developed codes of professional ethics. By establishing a code of ethics, a profession assumes self-discipline beyond the requirements of the law.

II. Ethical Standards Internationally

Ethical standards are a matter of law in some countries such as France and Germany and enforcement involves penalties under the law. The effectiveness of enforcing ethical standards varies from country to country. In many countries an auditor who violates the ethical standard may be disciplined by law or by the professional organization.

A. AICPA CODE OF PROFESSIONAL CONDUCT

The American Institute of Certified Public Accountants (AICPA) has a Code of Professional Conduct that applies to every CPA who is a member. To provide guidelines for the scope and application of the Rules, the AICPA issues Interpretations by the AICPA Division of Professional Ethics. The Principles are a general discussion of six ethical principles required of a CPA. They are: responsibilities, public interest, integrity, objectivity and independence, due care, and scope and nature of services.

III. Fundamental Ethics and Guidelines Applicable to All Accountants

The IFAC Code of Ethics for Professional Accountants offers fundamental principals that are of a general nature and not intended to be used to solve a professional accountant's ethical problems in a specific case.

A. Fundamental principles and guidelines for the Professional Accountant (IFAC Code of Ethics)

To achieve the objectives of the accounting profession, professional accountants have to observe a number of prerequisites or fundamental principles. The fundamental principles are

- 1) **Integrity:** A professional accountant should be straightforward and honest in performing professional services.
- 2) **Objectivity:** The principle of objectivity imposes the obligation on all professional accountants to be fair, intellectually honest and free of conflicts of interest.
- 3) **Professional Competence:** A professional accountant in agreeing to provide professional services implies that he is competent to perform the services.

- 4) **Confidentiality:** Professional accountants have an obligation to respect the confidentiality of information about a client's (or employer's) affairs acquired in the course of professional services.
- 5) **Professional Behavior:** An accountant should act in a manner consistent with the good reputation of the profession. A. Tax Practice B. Publicity
- 6) **Technical Standards:** Professional services should be carried out in accordance with the relevant technical and professional standards.

B. Resolution of Ethical Conflicts

- 1) Review the conflict problem with the immediate superior. If there is no resolution, go to the next higher managerial level.
- 2) Seek counseling and advise on a confidential basis with an independent advisor or the applicable accountancy body to obtain an understanding of possible courses of action.
- 3) If the ethical conflict still exists after fully exhausting all levels of internal review, the accountant as a last resort may have to resign from the employing organization and submit an information memorandum to an appropriate representative of that organization.

When a professional accountant performs services in a country other than the home country and differences on specific matters exist between ethical requirements of the two countries the following provisions should be applied:

- 1) When the ethical requirements of the country in which the services are being performed are less strict than the IFAC ethical guidance then the ethical guidance of IFAC should be applied.
- 2) When the ethical requirements of the country in which the services are being performed are stricter than the IFAC ethical guidance then the ethical requirements of the country where the services are being performed should be applied.
- 3) When the ethical requirements of the home country are mandatory for services performed outside that country and are stricter than set out in (1) and (2) above, then the ethical requirements of the home country should be applied.

IV. Ethics Applicable to Accountants in Public Practice

A *professional accountant in public practice* refers to each partner or person occupying a position similar to that of a partner, and each employee in a practice providing professional services to a client irrespective of their functional classification (e.g., audit, tax or consulting) and professional accountants in a practice having managerial responsibility.

INDEPENDENCE REQUIREMENTS IN DIFFERENT COUNTRIES

Most of the countries we have considered in this book stress both the appearance and the fact of independence. The EEC Eighth Company Law Directive gives discretionary power to member states to determine the conditions of independence for a statutory auditor. U.S. based firms must adhere to the regulations of the Securities and Exchange Commission (SEC) which requires that auditors of publicly held U.S. parent companies assure themselves that foreign subsidiary companies are all audited by persons who meet U.S. definitions of auditor independence.

V. Independence

The Code of Ethics for Professional Accountants, Section 8 discusses the concept of independence as having four components:

- A. financial involvement with clients and appointments in companies;
- B. services to audit clients, personal and family relationships;
- C. fees, goods and services; and
- D. ownership of the capital of an auditing firm.

A. FINANCIAL INVOLVEMENT OR APPOINTMENTS IN CLIENT COMPANIES

Financial involvement with a client will affect independence and may lead a reasonable observer to conclude that independence has been impaired. Financial involvement with a client could take the form of:

- (1) direct financial interest in a client;
- (2) indirect material financial interest resulting from being an administrator of any trust or estate with a financial interest in the client company;
- (3) loans to or from the client or any director or major stockholder in the client company;
- (4) financial interest in a joint venture with a client or employee(s) of a client.
- (5) financial interest in a non-client that has an investor or investee relationship with the client. An *investor* is a parent, general partner or natural person or corporation that has the ability to exercise significant influence on an investee. An *investee* is a subsidiary or an entity subject to the significant influence of an investor.

B. SERVICES TO AUDIT CLIENTS, PERSONAL AND FAMILY RELATIONSHIPS

If an accountant provides services to a client in addition to auditing, they should not perform management functions or make management decisions.

C. FEES, GOODS AND SERVICES

The compromise or appearance of compromise of independence may arise if fees due from a client for professional services remain unpaid for an extended period of time, especially if a substantial part is not paid before the issue of the audit report or attestation. Professional services should not be offered or rendered to a client under a contingent fee basis. Acceptance of goods or services or "undue hospitality" from a client may be a threat to independence.

D. OWNERSHIP OF THE CAPITAL OF A PUBLIC AUDITING PRACTICE

The capital of a practice should be owned entirely by professional accountants in public practice. If all or a proportion of the capital of a practice is owned by others not accountants in public practice, the others could be in a position to influence performance of professional services.

VI. Responsibilities to Clients

Service for a client requires that accountants assume the responsibility to perform such services with integrity and objectivity in accordance with the appropriate technical skills.

A. FEES

Section 9 of the ethics code discusses the responsibilities to clients in pricing auditing services via fees and commissions. Section 9.3 states that professional fees should be computed on the basis of appropriate rates per hour or per day for the time of each person involved in the services.

B. CLIENT'S MONIES

Section 11 of the ethics code discusses *clients' monies*. *Clients' Monies* are any monies - including documents of title to money, e.g., bills of exchange, promissory notes, and documents of title which can be converted into money, e.g., bearer bonds - received by a professional accountant in public practice to be held or paid out on the instruction of the person from whom or on whose behalf they are received.

VII. Responsibilities to Colleagues

Guidance regarding responsibilities to colleagues for professional accountants in private practice includes advise on relations with other professional accountants, advertising, and activities incompatible with practice.

A. RELATIONS WITH OTHER PROFESSIONAL ACCOUNTANTS

Section 12 of the *Code of Ethics for Professional Accountants* describes relations with other professional accountants in public practice. In cases where the client has an existing accountant who is not being superseded and the receiving accountant is providing additional services:

- 1) The receiving accountant should limit the services provided to the specific assignment received, take reasonable steps to support the existing accountant's current relationship with the client, and should not express any criticism of the services of the existing accountant.
- 2) If a receiving accountant is asked by a client to undertake an assignment clearly distinct from that being carried out by the existing accountant or from the assignment originally received, he/she should regard this as a separate request to provide services.
- 3) If the client insists that the existing accountant should not be informed, the receiving accountant should decide whether the client's reasons are valid.
- 4) The receiving accountant should comply with the instructions received from existing accountant or client as long as they do not conflict with relevant legal requirements.

In cases when the appointment will result in another professional accountant in public practice being superseded, the guideline advises: ^{xi}

- 1) A proposed accountant who is asked to replace another must ascertain if there are any professional reasons why the appointment would not be accepted.
- 2) The extent to which an existing accountant can discuss the affairs of the client with the proposed accountant will depend on receipt of the client's permission and the legal or ethical requirements relating to this disclosure.
- 3) The proposed accountant in public practice should treat in the strictest confidence and give due weight to any information provided by the existing accountant.

- 4) Before accepting an appointment involving services that were carried out by another accountant in public practice, the proposed accountant should determine if the existing accountant has been notified by the client and given permission to discuss the client's affairs fully and freely.
- 5) When the existing accountant receives the communication referred to above, he/she should reply, preferably in writing, advising of any reasons why the proposed accountant should not accept the appointment.
- 6) If the proposed accountant does not receive a reply from the existing accountant within a reasonable period of time, further communication should be attempted.
- 7) The existing accountant should promptly transfer to the new accountant through the client all books and papers of the client which are or may be held after the change in appointment.

B. ADVERTISING AND SOLICITATION

Section 13 of the ethics code gives information about advertising and solicitation. Whether *advertising* and *solicitation* by individual professional accountants in public practice is permitted or not is up to the professional accounting organizations in every country.

Advertising activities that are not permitted are those which:

- create false, deceptive or unjustified expectations of favorable results,
- imply the ability to influence any court, tribunal or regulatory agency;
- consist of self laudatory statement that are not based on verifiable facts;
- make comparisons with other professional accountants in public practice;
- contain testimonials or endorsements;
- contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived;
- make unjustified claims to be an expert or specialist in a particular field of accountancy.

C. ACTIVITIES INCOMPATIBLE WITH PRACTICE

Section 10 of the code details some activities incompatible with practice. A professional accountant in public practice should not concurrently engage in any business, occupation or activity which impairs or might impair integrity, objectivity or independence, or the good reputation of the profession.

VIII. LEGAL LIABILITY

Whenever an audited company goes into bankruptcy or experiences a financial reverse, disappointed investors and creditors consider who may be made legally liable for the losses.

There are four major sources of auditors legal liability:

- (1) liability to clients under common law. An example is the client sues the auditor for not discovering a theft of assets (defalcation) during the audit.
- (2) Liability to third parties by common law. For example, a bank sues the auditor for not discovering materially misstated financial statements.
- (3) Liability to third parties under statutory law (government laws and regulations). A combined group of stockholders sue the auditor for not discovering misstated financial statements. and
- (4) Criminal liability. The government prosecutes an auditor for knowingly issuing an incorrect audit report.

Chapter 4 - Introduction to Audit Process

I. The Overall Objective of an Audit

The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.

II. Setting Audit Objectives Based on Management Assertions

A. Management assertions and audit objectives

Management assertions are implied or expressed representations by management about classes of transactions and related accounts in the financial statements. An example of a management assertion is that "the company's financial statements are prepared based on international accounting standards."

B. According to ISA 500, financial statement assertions are assertions by management, explicit or otherwise, that are embodied in the financial statements. They can be categorized as follows:

- **Existence** - an asset or liability exists at a given date
- **Rights and Obligations** - an asset or a liability pertains to the entity
- **Occurrence** - a transaction or event took place which pertains to the entity during the period.
- **Completeness** - there are no unrecorded assets, liabilities, transactions or events, or undisclosed items.
- **Valuation** - an asset or liability is recorded at an appropriate carrying value.
- **Measurement** - a transaction or event is recorded at the proper amount and revenue or expense is allocated to the proper period.
- **Presentation and Disclosure** - an item is disclosed, classified, and described in accordance with acceptable accounting reporting framework.

III. Risk and Materiality in the Audit process

Much of the planning in audits deals with obtaining information to help auditors assess the risks in the audit process. There are two types of risks in conducting an audit:

1. One type of risk is the risk that the auditor or audit firm will suffer harm because of a client relationship, even though the audit report rendered for the client was correct. This is called **risk to the firm**.
2. The other type of risk is **audit risk**, the risk that an auditor may give an inappropriate audit opinion on financial statements, e.g. an unqualified audit opinion on financial statements that are materially misstated.

There are no international standards on auditing for business risk. Business risk is more likely to be considered when planning the audit in countries or circumstances where legal exposure of the auditor is high. If (1) the audit client is in an industry that is experiencing problems, (2) the statements are heavily relied upon, (3) there is a likelihood that the client will experience difficulties after the audit report is issued, or (4) there is a question about management's integrity, additional evidence, experienced personnel and review may be called for.

Materiality deals with the tolerance for errors, or, stated differently, with the inaccuracy the auditor accepts in her audit. Taken together, audit risk and materiality are the determinants of the type and amount of evidence the auditor has to accumulate and hence the audit procedures she has to perform.

A. Audit Risk

Risk in auditing means that the auditor accepts some level of uncertainty in performing the audit function: uncertainty about the competence of evidence, about the effectiveness of a client's internal control structure and, in the end, as to whether the financial statements are fairly stated. Audit Risk Model is presented as

$$\text{PDR} = \text{AAR} / (\text{IR} \times \text{CR})$$

This model illustrates, how the amount of substantive testing that the auditor has to perform (which is a function of PDR = Planned Detection Risk), depends on:

- AAR (Acceptable Audit Risk),
- IR (Inherent Risk),
- CR (Control Risk).

B. Materiality

When planning the audit (Phase II in the Audit Process Model), the auditor considers what would make the financial statements materially misstated. In presenting any accounting information, the concept of materiality is applied in three ways:

- i. If it is material, an item of accounting information is reported in a way that makes it relevant and reliable.
- ii. Material errors from omission or misstatement of accounting information are corrected.
- iii. An immaterial item of accounting information is not reported and an immaterial error is not corrected unless there is a legal requirement or a professional duty to do so.

Three aspects of an item or error are important in determining whether an item or error could influence the economic decisions of users: (1) size; (2) nature, and (3) circumstances.

IV. Standard Audit Process Model

The financial audit is a systematic process which begins with a client's request for an audit of financial statements and culminates in an auditor's opinion in the form of a report.

- A. **Phase I, Client Acceptance:** The client acceptance phase of the audit plan, Phase I, involves deciding whether to accept a new client or continue with an existing one.
- B. **Phase II, Planning the audit:** In Phase II, planning the audit, the auditor obtains more detailed company and industry background information than during the client acceptance phase (including information on (changes in)the internal control structure^{xiii}), obtains legal information and examines the company's previous year's financial statements.
- C. **Phase III, Testing and Evidence:** During Phase III, the auditor performs tests and analyses, in conformance with the assurance required by the audit planning memorandum: tests of controls; substantive tests of transactions; analytical procedures and tests of details of balances. These tests would ordinarily include obtaining evidence through (1) inquiry of personnel, (2) inspection of documents and reports, (3) observation of the application of the control, and (4) reperformance of the control. *Substantive tests* are used to "substantiate" account balances. Three types of substantive tests exist:
 - *Substantive tests of transactions* are performed in order to test whether specific transactions have been properly recorded.
 - *Analytical procedures* consist of the comparison of a value that has to be substantiated to an audited value, i.e. the auditor tests whether an expected relationship between an unaudited and an audited value actually exists.
 - *Tests of details of balances* are an auditor's tests for monetary errors and irregularities in the balances of the year-end general ledger, both for balance sheet and income statement items.
- D. **Phase IV, Evaluation and Reporting:** Phase IV, Evaluation and Reporting, is the phase when the auditor completes the audit and issues an audit report based on the results of the audit. Auditors perform a number of procedures near the end of the audit. Evidence is aggregated and evaluated for sufficiency. Analytical procedures and other reviews are performed to assist the auditor in assessing conclusions reached and for evaluating overall financial statement presentations. Many other procedures and tasks are performed including: procedures to identify subsequent events; wrap-up procedures; report to the board of directors; and prepare Matters of Attention for Partners.

Chapter 5: Client Acceptance

I. Client Acceptance: The First Step on the Journey to an Opinion

Components of acceptance of the client are: acquiring knowledge of the client's business; communication with the *predecessor auditor*; possible use of other professionals (including outside specialist) in the audit; using the work of another auditor; the terms of the *engagement*; the audit *engagement letter*; and assignment of staff.

II. Knowledge of the Client's Business

The knowledge of a client's business is important in establishing the overall audit plan. Furthermore, such knowledge helps the auditor identify areas for special audit consideration, evaluate the reasonableness of both accounting estimates and management representations, and make judgments regarding the appropriateness of accounting policies and disclosure.

A. New Client Investigation

New Client Investigation. Before accepting a new client the auditor will review publicly available information, past company financial statements, reports to stockholders, publicly available government financial reports (e.g., U.S. 10K report), tour the company premises, and have discussions with the previous auditor.

B. Prior Auditor

1. IFAC Code of Ethics for Professional Accountants requires the new auditor to communicate directly with the previous auditor.
2. When the previous accountant receives the communication of the newly proposed auditor, he should reply, preferably in writing, advising of any reasons why the proposed accountant should not accept the appointment.

C. Continuing Clients

1. The continuance of the relationship would depend on:
 - a. If independence is jeopardized if fees due from a client for professional services remain unpaid for an extended period of time.
 - b. If the auditor feels excessive risk is involved, e.g., regulatory conflict or the high risk industry.
 - c. If the client is involved in litigation with the auditor
2. For continuing engagements, the auditor would update and reevaluate information gathered previously, including information in the prior years working papers.

III. Use of Other Professionals in the Audit

The auditor may discover in doing the search for background information that a portion of the client's financial statements will be audited by another auditor or that an outside specialist may be needed to properly audit the client.

A. Using the Work of Another Auditor

The principal auditor:

1. Is responsible for performing procedures to obtain sufficient appropriate audit evidence that the work of the other auditor is adequate.
2. Should obtain written representation from the other auditor of compliance with accounting, auditing and reporting requirements.
3. Should document in the audit working papers the components whose financial information was audited by other auditors, their significance to the financial statements of the entity as a whole, the names of the other auditors, the procedures performed, and the conclusions reached.

B. Using the Work of an Expert

1. The auditor should have a sufficient understanding of the client's business to recognize the need for a specialist, i.e., a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.
2. Situations where an auditor might use an expert are valuations of certain types of assets; actuarial valuation; value of contracts in progress; and legal opinions.
3. The client writes instructions to the expert which cover scope of the expert's work, what the auditors expect the expert's report to cover, intended use by the auditor of the expert's work, and access of the expert to files and records of the client.

IV. Terms of Audit Engagements

According to ISA 210^{xiii}, 'the auditor and the client should agree on the terms of the engagement.' The terms of the engagement include consideration of what is to be done (the objective, scope, and report of the audit) by who (the staff) and for how much (the fee). The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.

A. Establishing and negotiating audit fees

1. According to international ethics, professional fees should be a fair reflection of the value of the professional services performed for the client, taking into account:
 - a. the skill and knowledge required for the type of professional services involved
 - b. the level of training and experience of the persons necessarily engaged in performing the professional services
 - c. the time necessarily occupied by each person engaged in performing the professional services; and
 - d. the degree of responsibility that performing those services entails.
2. Professional fees should normally be computed on the basis of appropriate rates per hour or per day for the time of each person engaged in performing professional services.
3. An accountant can charge a client a lower fee than has previously been charged for similar services, provided the fee has been calculated in accordance with the factors listed in IV B 1.
4. Professional services should not be offered or rendered to a client under a contingency fee and should not take or pay commissions.

B. The Audit Engagement Letter

The Audit Engagement Letter. An *engagement letter* is an agreement between the accounting firm and the client for the conduct of the audit and related services.

C. Contents of Engagement Letter

1. The objective of the audit of financial information.
2. Management's responsibility for the financial information.
3. The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres.
4. The form of any reports or other communication of results of the engagement.
5. The fact that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that even some material misstatement may remain undiscovered.
6. Unrestricted access to whatever records, documentation and other information requested in connection with the audit.

D. Assignment of Staff

1. An audit is to be staffed by persons who have obtained and maintain the skills and competence required to enable them to fulfill their responsibilities on the audit engagement. They must have a degree of technical training and proficiency required in the circumstances.
2. The auditor and assistants with supervisory responsibilities should consider the skills and competence of assistants and there should be sufficient direction and supervision of work at all levels so that the work performed by the audit firm meets appropriate standards of quality.

V. Acceptance by the Client - The Engagement Proposal

The audit organization must have procedures for the preparation of the engagement client proposal and must take care of the coordination of the related activities. Aspects of these proposal procedures may be found in ISA 210, 'Terms of the Audit Engagement' ^{xiv} concerning the acceptance and confirmation of engagements. References to the quality aspects of the client proposal may be found in ISO 9001 ^{xv} which states that the auditing firm shall define and document its policy and objectives for, and commitment to, quality. The international quality control standard (ISO 9004) offers advice on what should be contained in the client engagement proposal (referred to in the standard as 'Design Planning and Objectives')

There are two basic types of audit engagement proposals:

A. Continuing Client Audit Proposal

The continuing client proposal will differ between firms, but generally it discusses the following:

- A review of how the auditing firm can add value
 - Plans for further improvement in value added including discussion of present regulatory trends, audit scope, and any recent changes in the company that may affect the audit.
 - A description of the audit team and any changes in the audit team from the previous year.
 - A detailed fee proposal.
1. A review of how the auditing firm can add value: The introductory part of the client proposal is a discussion of how the proposing firm can benefit the client firm.
 2. Plans for further improvement in value added: This section might identify the client's requirements and discuss how the audit firm meets these requirements. The audit scope and materiality limits may also be discussed.
 3. Audit team: An important part of the proposal is a description of members of the audit team and summary of their work experience.
 4. A fee proposal: The detailed description of the proposed fee is traditionally a separate part of the proposal, presented as a separate document.

B. New Client Audit Proposal

The proposal to a new client may cover the following topics:

- An executive summary
- The client's business and audit expectations
- Strengths of the audit firm
- The audit team
- The audit approach
- The client's internal auditors
- Transition needs and management
- Services audit firm can supply to client
- After service monitoring
- Fee details
- Appendix

1. *The executive summary*: Gives a brief summary of the proposal with special emphasis on client expectation, audit approach, firm selling points, and co-ordination of the audit with staff internal auditors.
2. *The client's business and audit expectations*: The general proposal may begin with a description of client business sectors, technology, financial strengths and divisions.
3. *Strengths of the audit firm*: may explore client service attitudes, technical competency, experience, desire to exceed expectations, and advice and assistance.
4. *The audit team*: This section includes a description of members of the audit team and summary of their work experience.
5. *The audit approach*: The proposal may outline the firm's general audit approach and how it is tailored to this client.
6. *The client's internal auditors*: Their work must be relied upon to a certain extent in all audits.
7. *Transition needs and management*: A discussion of the transition needs of the company may be very important in convincing a new client to switch auditors.
8. *Services audit firm can supply to client*: Might list tax, treasury, management and other services offered by the audit firm.
9. *After service monitoring*: After the audit is complete there are still opportunities for the auditor to offer service to the client.
10. *Fee details*: Traditionally a separate part of the proposal presented as a separate document, details the costs of the audit.
11. *An appendix*: Which might include further information about the audit team, an outline of the audit plan and a list of representative publications.

VI. Summary of Client Acceptance Phase

In the client acceptance phase of the audit, the auditor is primarily concerned with the riskiness of his client and the complexities that can be expected when an audit is performed.

Chapter 6 - Audit Planning

I. Planning - Phase II of the Audit Process Model

Planning means developing a general strategy and a detailed approach for the expected nature, timing and extent of the audit.

II. Obtain Knowledge of Company and Industry

When the planning phase is begun, more in depth review of industry and client background is undertaken. In this section, we will discuss:

- obtaining industry information
- obtaining general background of the client company
- the investigation of the company's legal position.

A. Industry Knowledge

It is important to understand the client's industry because many industries have unique accounting requirements that the auditor must understand to evaluate the client's financial statements.

Industry information can be obtained through discussions with previous year's auditors, auditors currently on similar engagements, and conferences with client personnel.

B. Company Knowledge

Information about the client company not already discovered in the Client Acceptance phase may be obtained by reviewing minutes of meetings of stockholders, board of directors and important committees; from internal financial management reports for current and previous periods; and from previous year's audit working papers and other relevant files. Obtaining the required knowledge of the business is a continuous and cumulative process of gathering and assessing the information at all stages of the audit.

An important source of information on the company is the performance of interviews with client management and personnel and visits to the company's sites:

- Management
- Other personnel
- Audit committee
- Site Visits

C. Investigate Company's Legal Position

Certain legal documents and records should be collected and examined early in the engagement: corporate charter and bylaws, minutes of the board of directors and stockholders meetings, and contracts.

1. Related Parties: ISA 550 uses the definitions of related parties given in IAS (International Accounting Standard) No 24. A *related party transaction* is a transfer of resources or obligations between related parties, regardless of whether a price is charged.
2. Corporate Legal Documents: The *corporate charter* is required by the regulatory body in a specific country or district. It generally gives the name of the corporation, the date of incorporation, the kinds and amounts of capital stock the corporation is authorized to issue, and the types of business activities the corporation is authorized to conduct.

III. Preliminary Analytical Procedures

Analytical procedures are performed at least twice in an audit. Analytical procedures in planning the audit use both financial and non-financial information. In the planning stages of an audit, analytical procedures typically involve current period interim data.

IV. Obtain an Understanding of Accounting and Internal Control Systems

A. Accounting and internal control systems

ISA 400 states: 'The auditor should obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach.' According to ISA 400, the internal control system comprises:

- **the control environment:** Factors reflected in control environment include (1) the functions of the board of directors and its committees, (2) management's philosophy and operating style, (3) the entity's organizational structure and methods of assigning authority and responsibility and (4) management's control system including the internal audit function, personnel policies and procedures and segregation of duties.
- **the control procedures:** those policies and procedures in addition to the control environment which management has established to achieve the entity's specific objectives, including:
 - (1) reporting, reviewing and approving reconciliations,
 - (2) checking the arithmetical accuracy of the records,
 - (3) controlling applications and environment of computer information systems, for example, by establishing controls over (a) changes to computer programs and (b) access to data files,
 - (4) maintaining and reviewing control accounts and trial balances,
 - (5) approving and controlling of documents,
 - (6) comparing internal data with external sources of information,
 - (7) comparing the results of cash, security and inventory counts with accounting records,
 - (8) limiting direct physical access to assets and records, and
 - (9) comparing and analyzing the financial results with budgeted amounts.

B. Procedures to Obtain an Understanding of Accounting and Control Systems

In the planning phase, ISA 400 recommends that the auditor understand and document both the accounting system and the internal control systems. The nature, timing and extent of procedures performed by the auditor to obtain an understanding of the accounting and internal control systems will vary with, among other things:

- The size and complexity of the entity and of its computer system;
- Materiality considerations;
- The type of internal controls involved;
- The nature of the entity's documentation of specific internal controls;
- The auditors assessment of *inherent risk*.

1. Internal Audit Function:

When obtaining an understanding and performing a preliminary assessment of the internal audit function, the important criteria are:

- a. Organizational Status: specific status of internal auditing in the entity and the affect this has on its ability to be objective.
- b. Scope of Function: The nature and extent of internal auditing assignments performed.

- c. Technical Competence: whether internal auditing is performed by persons having adequate technical training and proficiency as internal auditors.
- d. Due Professional Care: whether internal auditing is properly planned, supervised, reviewed and documented.

2. Computer Information Systems

Another significant element of understanding the accounting and internal control systems is the assessment of the client's reliance on the Computer Information Systems (CIS) environment.

V. Set (Planning) Materiality

A. The importance of materiality in the planning phase of the audit

Materiality is defined in the International Accounting Standards Committee's 'Framework for the Preparation and Presentation of Financial Statements', in the following terms: 'Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

1. Size of the Item: the most common application of materiality has to do with the size of the item considered.
2. Nature of the Item: the nature of an item is a qualitative characteristic.
3. Circumstances: the materiality of an error depends upon the circumstances of its occurrence.
4. Cost Benefit: accounting materiality differs from auditing materiality. Accounting materiality is ex post, or after the fact.

VI. Assess Audit Risk

Audit risk is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated:

- *Inherent risk*
- *Control risk*
- *Detection risk*

A. Illustration of Risk

Illustration 6-6 shows a symbolic graphic used by AICPA and later by Guy and Alderman to illustrate how audit risk works.

B. Circumstances Demanding Special Attention

1. **Operating Environment** - A changed regulatory or economic environment can result in increased competitive pressures and significantly different risks.
2. **New Personnel** - A senior executive new to an organization may not understand the organization's culture, or may focus solely on performance to the exclusion of control-related activities.
3. **New or Revamped Information Systems** - Normally effective controls can break down when new systems are developed, particularly when done under unusually tight time constraints - for example, to gain competitive advantage or make tactical moves.
4. **Rapid Growth** - When operations expand significantly and quickly, existing systems may be strained to the point where controls break down.
5. **New Technology** - When new technologies are incorporated into production processes or information systems, a high likelihood exists that internal controls will need to be modified.
6. **New Lines, Products, Activities** - When an entity enters new business lines or engages in transactions with which it is unfamiliar, existing controls may not be adequate.
7. **Corporate Restructuring** - Restructuring may be accompanied by staff reductions and inadequate supervision and segregation of duties.
8. **Foreign Operations** - The expansion or acquisitions of foreign operations carries new and often unique risks that management should address.

C. Audit Risk Model

The audit must be designed to limit audit risk to a low level. Audit risk consists of (a) the risk that an account and its related assertions contain material misstatements (composed of two components: inherent risk and control risk) and (b) the risk that the auditor will not detect such misstatements (referred to as detection risk).

$$\text{Audit risk} = \text{Inherent Risk} \times \text{Control risk} \times \text{Detection Risk}$$

D. Criticism of the SAS model

A disadvantage of the SAS 47 audit risk model is that it suggests a mathematical relationship between the various risk categories, whereas such a relationship is much more complex and not casual as this formula suggests.

VII. Inherent, Control And Detection Risks In Depth

A. Inherent risk

Inherent risk is the risk that an account balance or class of transactions contains a material misstatement, assuming no related internal controls exist.

1. At the Financial Statement Level:

- **The integrity of management.** The integrity of management is fundamental to an auditor's ability to perform an audit and is a key consideration in his assessment of audit risk.
- **Organization and management structure.** The nature of the entity's organization and its management structure may indicate increased audit risk.
- **Pressures on management to report certain financial results.** Pressures may exist to increase management compensation and company performance.
- **The nature of the entity's business.** The nature of the business sometimes indicates increased risk.
- **Factors affecting the industry** in which the entity operates.

2. At the Account Balance and Class of Transaction Level:

- Financial statement accounts likely to be susceptible to misstatement.
- The complexity of the underlying transactions and other events which might require using the work of an expert.
- The degree of judgment involved in determining account balances.
- Susceptibility of assets to loss or misappropriation, for example, assets which are highly desirable and movable such as cash.
- The completion of unusual and complex transactions, particularly at or near period end.
- Transactions not subjected to ordinary processing.

B. Control risk

The auditor assesses control risk based on the perceived effectiveness of the entity's internal control system in preventing and/or detecting material misstatement.

C. Detection risk

In determining detection risk, the auditor should consider:

- The nature of substantive procedures;
- The timing of substantive procedures;
- The extent of substantive procedures.

VIII. Prepare the Audit Planning Memorandum and Audit Program

A. Audit Planning Memorandum

- The final step in the planning process is to prepare an audit planning memorandum and an audit program. An *audit planning memorandum* is a memo detailing the planned audit approach and budget.
- Background information by a brief description of the client company's structure, business, and organization.
- The objectives of the audit showing whether it is an audit for stockholders, the national government filings, or some special purpose audit.
- The assessment of engagement risk and potential follow-up on identified increased engagement risks, identified during the client acceptance phase.
- An identification of other auditors or experts that will be relied upon in the audit and a recap of the instructions provided to them.
- An assessment of materiality.
- Inherent risks, emerging from insight in the client's industry and business, specified for each important combination of financial statement account and audit objective.
- Conclusions regarding the control environment, including the possible reliance on internal auditors.
- Classification of the client's CIS environment and the level of reliance on the client's CIS systems.

- An evaluation of the quality of the accounting and internal control systems, in particular an identification of internal control procedures mitigating the identified inherent risks.
- Summary of the audit approach for addressing each account balance and related audit objective for which an inherent risk has been identified.
- The timing and scheduling of audit work, including determining which procedures may be performed before the balance sheet date. Also considered is what audit work must be done on or after the balance sheet date. Dates are shown for such critical procedures as cash counts, accounts receivable confirmations and inventory observation.
- Audit budget, detailed for each level of expertise available in the audit team.

B. Audit Program

1. How much evidence is required: The 'demand' for audit evidence can be derived from the planning stage.
2. How much audit evidence is provided by a given procedure: This consideration relates to the 'supply of audit evidence. It must be understood that there is no one-to-one relationship between assertions and the procedures applied.
3. What should the timing of audit procedures be : In planning the timing of audit work, crucial procedures should be performed first.

Chapter 7 – Internal Control and Its Components

I. Internal Control Defined

Internal control, 'is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, compliance with applicable laws and regulations and safeguarding of assets against unauthorized acquisition, use or disposition.

II. The Importance Of Internal Control

- A. Defined in ISA 400, 'The term *internal control system* means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, the prevention of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.'
- B. Everyone in the organization has responsibility for internal controls. The chief executive officer is ultimately responsible and should assume 'ownership' of the internal control system, providing leadership and direction to senior managers.
- C. The auditor is interested primarily in controls that relate to reliability of financial reporting. Auditors have significant responsibility for the discovery of management and employee fraud, and, to a lesser degree, certain types of illegal acts

III. Different sides of internal control: Administrative and Accounting Controls

A. Administrative controls are primarily concerned with the promotion of operational efficiency and the adherence to prescribed managerial policies. Administrative controls are related to operational audits and compliance audits.

B. Accounting controls are principally concerned with safeguarding assets and providing assurance that the financial statements and the underlying accounting records are reliable.

Accounting controls are designed to provide reasonable assurance that: (1) Transactions are executed in accordance with management's general or specific organization. (2) Transactions are recorded to permit preparation of financial statements in conformity with IAS. and to maintain accountability of assets. (3) Access to assets is permitted only in accordance with management's authorization. and (4) The recorded accountability of assets is compared with the existing assets at reasonable intervals.

IV. Components of Internal Control

These components are:

- A. Control Environment,
- B. Risk Assessment,

- C. Control Activities / Control procedures,
- D. Information and Communication and Monitoring.

A. Control Environment

1. The control environment means the overall attitude, awareness, and actions of directors and management regarding the internal control system and its importance in the entity.
2. There are potentially many control activities, but they generally fall into five categories:
 - (1) adequate separation of duties;
 - (2) proper authorization of transactions and activities;
 - (3) adequate documents and records;
 - (4) physical control over assets and records; and
 - (5) independent checks on performance.
3. Commitment to integrity and ethical values The effectiveness of internal controls cannot rise above the integrity and ethical values of the people who create, administer and monitor them.
4. Commitment to competence and quality A company's control environment will be more effective if its culture is one in which quality and competence are openly esteemed.
5. Independence, integrity and openness at the board of directors level. An active and involved board of directors possessing an appropriate degree of management, technical and other expertise coupled with the necessary stature and mind set so that it can adequately perform the necessary governance, guidance and oversight responsibilities is critical to effective internal control.
6. Leadership in control by example (management philosophy and operating style). A personal example set by top management and the board provides a clear signal to employees about the company's culture and about the importance of control.
7. An appropriate organizational structure. By understanding the entity's organizational structure, the auditor can discover the management and functional elements of the business and how control policies are carried out.
8. Appropriate delegation of authority with accountability. Responsibility and delegation of authority should be clearly assigned.
9. Appropriate human resource policies and practices. With trustworthy and competent employees, other controls can be absent and reliable financial statements will still result.

B. Risk Assessment

1. If management effectively assesses and responds to risks, the auditor will typically need to accumulate less audit evidence than when management fails to, because control risk is lower.
2. A technique to identify risks. involves identifying and prioritizing high risk activities is:
 - a. identify the essential resources of the business and determine which are most at risk;
 - b. identify possible liabilities which may arise;
 - c. review the risks that have arisen in the past;
 - d. consider any additional risks imposed by new objectives or new external factors; and
 - e. seek to anticipate change by considering problems and opportunities on a continuing basis.

C. Control Activities (Control Procedures)

1. Sometimes referred to as control activities and sometimes as control procedures, they are those policies and procedures which management has established to achieve the entity's specific objectives.
 2. Control procedures entail three fundamental functions which must be separated and adequately supervised: authorization, custody, and recording.
 3. Control procedures are usually considered to fall into five categories:
 - a. adequate segregation of duties;
 - b. proper authorization of transactions and activities;
 - c. physical custody control over assets and records;
 - d. independent checks on performance;
 - e. and adequate documents and records.
- **Ad a. Segregation of duties:** responsibilities for authorizing transactions, recording them and handling the related assets (called 'custody of assets') are divided.

- **Ad b. Proper Authorization of Transactions and Activities.** Appropriate delegation of authority sets limits on what levels of risk are acceptable and these limits determine the discretion of the employees delegated to authorize the main types of business transactions. Authorization may be general or specific.
- **Ad c. Physical Controls.** Only individuals who are properly authorized should be allowed access to the company's assets.
- **Ad d. Independent Checks on Performance.** A careful and continuous review of controls is important because controls may change over time, personnel may forget procedures or become careless
- **Ad e. Adequate Documentation.** Documents and records must be adequate to provide reasonable assurance that all assets are properly controlled and all transactions correctly recorded.

D. Information and Communication.

1. Information must be identified by management as relevant and delivered to people who need it in a form and time frame that allows them to carry out their control and other responsibilities.
2. The information systems used by companies, which are primarily computer information systems (CIS) includes the accounting system; production system; budget information, personnel system; systems software; and information about external events, activities and conditions.
3. The accounting system consists of methods and records established and designed to:
 - a. identify and record all valid transactions, assets and liabilities,
 - b. describe the transactions on a timely basis in sufficient detail to permit their proper classification for financial reporting,
 - c. measure the value of transactions, assets and liabilities in a manner that permits recording their proper monetary value in the financial statements,
 - d. present the transactions and related disclosures properly in the financial statement.
4. As part of the procedures to obtain an understanding, the following should be documented:
 - a. the accounting record, computer files, supporting documents and financial accounts involved in processing transactions,
 - b. the classes of significant transactions,
 - c. how the transactions are initiated,
 - d. the accounting process from initialization of a transaction to its inclusion in the financial statements, including how the data is processed by computer,
 - e. the financial reporting process used to prepare the financial statements, including significant accounting estimates and disclosures.
5. When evaluating the communication system, the auditor will consider:
 - a. Effectiveness with which employees' duties and control responsibilities are communicated;
 - b. Establishment of channels of communication for people to report suspected improprieties;
 - c. Receptivity of management to employee suggestions of ways to enhance productivity, quality or other similar improvements;
 - d. Adequacy of communication across the organization and the completeness and timeliness of information and its sufficiency to enable people to discharge their responsibilities effectively;
 - e. Openness and effectiveness of channels with customers, suppliers and other external parties for communicating information on changing customer needs;
 - f. Timely and appropriate follow-up action by management resulting from communications received from customers, vendors, regulators or other external parties.

E. Monitoring

1. Monitoring is a process that deals with ongoing or periodic assessment of the effectiveness of their design and operation.
2. Monitoring should address whether proper accounting records are being maintained and whether the financial information used within the business and for publication to third parties is reliable.
3. When evaluating the ongoing monitoring the following issues might be considered:
 - a. Extent to which personnel obtain evidence as to whether the system of internal control continues to function.

- b. Periodic comparisons of amounts recorded with the accounting system with physical assets.
- c. Responsiveness to internal and external auditor recommendations on means to strengthen internal controls.
- d. Extent to which training seminars, planning sessions and other meetings provide information to management on whether controls operate effectively.
- e. Effectiveness of internal audit activities.

Chapter 8 - Relying on Internal Control in the Audit Process

Definitions:

- **Internal control** is a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations, reliability of financial reporting, and compliance with applicable laws and regulations. - Committee of Sponsoring Organizations of the Treadway Commission
- **Control risk** is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material individually or when aggregated with misstatements in other balances or classes, will not be prevented or detected and corrected on a timely basis by accounting and internal control systems. (ISA 6)
- **Tests of controls** are audit procedures to test the effectiveness of control policies and procedures in support of a reduced control risk.
- **Substantive procedures** are tests performed to obtain audit evidence to detect material misstatements in the financial statements, and are of two types: tests of details of transactions and balances; and analytical procedures.

I. Overview of an Evaluation of Accounting and Internal Control Systems

The basic audit approach to evaluating *internal controls* involves four broad steps:

- (1) Obtain an understanding of internal control and its components: control environment, risk assessment procedures, control activities, accounting information and communication system and monitoring methods at a fairly detailed level;
- (2) Assess control risk;
- (3) Test of controls;
- (4) Make a reassessment of control risk ; and
- (5) Determine the effect of the control risk assessment on substantive tests.

A. Understanding the Accounting System

The understanding of the accounting system involves knowledge of the ways in which transactions are valued, classified, recorded and summarized in data files, journals, or ledgers.

B. Understanding the Information System

An entity's information system may create many documents, files and reports that are useful for managing the organization, but the auditor needs primarily to understand those outputs that are relevant to the financial statements.

C. Documentation of the Understanding

The auditor will usually only document the aspects of the control environment that she believes are relevant to the financial statement audit. An auditor is not required to document procedures performed to obtain the understanding unless they also help reducing the level of control risk.

II. Assessing Control Risk

Assessing control risk is the process of evaluating the design and operating effectiveness of a company's internal controls as to how it prevents or detects material misstatements in the financial statement assertions.

Assessing control risk follows this process:

- A. Identify Financial Statement Assertions and audit objectives;
- B. Identify Relevant Controls;
- C. Evaluate Weaknesses in Internal Control;
- D. Assess Control Risk at or Below Maximum.

A. Identify Financial Statement Assertions and audit objectives

Assessing control risks starts with the financial statement assertion (e.g. completeness) about significant account balances (e.g., accounts receivable) and transactions.

B. Identify Relevant Controls

The auditor identifies important controls by referring to the types of control activities that might exist, and asking if they do exist (as part of understanding the internal controls).

C. Evaluate Weaknesses in Internal Control

When assessing controls the auditor looks for 'weaknesses' in the controls for two reasons: to determine the nature and extent of the substantive tests she will perform and to formulate constructive suggestions for improvements.

D. Assess Control Risk at or Below Maximum

Control risk should be assessed at the maximum (the greatest risk that a material misstatement that could occur will not be prevented or detected on a timely basis by the internal control structure) for some or all assertions if:

- Policies and procedures are unlikely to pertain to an assertion;
- Policies and procedures are unlikely to be effective;
- Obtaining enough or proper evidence is not efficient.

If internal controls are assessed below the maximum (at medium or low risk) the assessment must be supported by tests of control.

III. Tests of Controls

A. Tests of Controls Defined

Tests of controls are audit procedures to test the effectiveness of control policies and procedures in support of a reduced control risk.

B. Evidence Gathering Techniques for Tests of Control

The nature of tests of controls is that the tests generally consist of one (or a combination) of four types of evidence-gathering techniques:

- 1. inquiry of client personnel,
- 2. observation,
- 3. examination of documents (inspection) , and
- 4. reperformance.

1. *Inquiry*: Inquiry evidence is based on interviews concerning the effectiveness of controls.
2. *Observation*: For controls that leave no documentary evidence, the auditor generally observes them being applied.
3. *Examination of Documents (Inspection)*: Many control activities leave a clear trail of documentary evidence in the form of either written or computer records.
4. *Reperformance*: If content of documents and records is insufficient to assess whether controls are operating effectively, the auditor re-performs the control activity to see if the proper results were obtained.

C. Timing of Tests of Controls

The timeliness of evidential matter considers when the evidence was obtained and the portion of the audit period to which it may be applied.

IV. Reassessment of Control Risk

The auditor's assessment of the components of *audit risk* may change during the course of an audit.

V. Effect of Control Assessment on Substantive Tests

The assessed level of control risk for an assertion has a direct effect on the design of substantive tests. The lower the assessed level of control risk, the less evidence the auditor needs from substantive tests. The auditor's control risk assessment influences the nature, timing and extent of substantive procedures to be performed.

Chapter 9 - Substantive Testing

I. Audit Evidence

Audit evidence is typically obtained from a mix of *tests of control* and substantive procedures.

A. Sufficient Appropriate Audit Evidence

Evidence does not have to be conclusive to be useful. What is sufficient audit evidence is influenced by prior audit experience with the client, the auditors assessment of inherent and control risks, the materiality of the item being examined, the reliability of the available information and whether fraud or error is suspected. The *reliability* of audit evidence along with appropriateness (quality) of the information are equally important.

II. Evidence Gathering Techniques

A. Inquiry

Inquiry consists of seeking information of knowledgeable persons inside or outside the entity.

B. Observation

Observation consists of looking at a process or procedure being performed by others, for example, the observation by the auditor of the counting of inventories by the entity's personnel or by the performance of internal control procedures that leave no audit trail.

C. Inspection (Physical Evidence And Examination Of Documents)

Inspection consists of examining records, documents, or tangible assets. Inspection is the auditor's examination of the client's documents and records to substantiate the information that is or should be included in the financial statements.

- Count of Physical Inventory: ISA 501 discusses the inspection evidence gathering technique for physical Inventory counting. It states^{xvi}, "When inventory is material to the financial statements, the auditor should obtain sufficient appropriate audit evidence regarding its existence and condition by attendance at physical inventory counting."

D. Computation (Reperformance or Mechanical Accuracy)

Computation consists of checking the arithmetical accuracy of source documents and accounting records or of performing independent calculations.

E. Confirmation (Representations By Third Parties)

Confirmation consists of the response to an inquiry to corroborate information contained in the accounting records.

1. Positive and Negative Confirmations:
 - a. The request for confirmation in the positive form asks the recipient (debtor, creditor or other third party) to confirm agreement or to express disagreement with the recorded balance. In a negative form of confirmation letters the reply is requested only in the event of disagreement with the recorded balance or information. A positive confirmation requests the recipient to return the confirmation in all circumstances and a negative confirmation requests that the recipient respond only when the information is incorrect.
2. Accounts Receivable Confirmations:
 - a. The auditor must ordinarily confirm accounts receivable.

F. Analytical Procedures

Analytical procedures consist of the analysis of significant ratios and trends including the resulting investigation of fluctuations and relationships that are inconsistent with other relevant information or deviate from predictable amounts.

1. Extent of Reliance on Analytical Procedures
The application of analytical procedures is based on the expectations that relationships among data exist on a continuous basis unless some condition occurs that alters the relationship. The presence of these relationships provides audit evidence as to the completeness, accuracy and validity of the data produced by the accounting system.
2. Ratio and Trend Analysis

There are five types of analytical procedures:

- (1) those ratios that compare client and industry data,
- (2) ratios that compare client data with similar prior period data,
- (3) ratios that compare client data with client-determined expected results;
- (4) ratios that compare client data with auditor-determined expected results, and
- (5) ratios that compare client data with expected results using non-financial data.

Reliability and Cost of Evidence Gathering Techniques

The most reliable evidence gathering techniques should be used whenever they are cost effective. The quality of internal controls has a significant effect on reliability. A list of the most reliable to the least reliable evidence gathering techniques are in general:

1. computation (reperformance or mechanical accuracy)
2. inspection (physical evidence and examination of documents)
3. confirmation
4. analytical procedures
5. observation
6. inquiry

III. Substantive Procedures

Substantive procedures are tests performed to obtain audit evidence to detect material misstatements in the financial statements.

A. Substantive tests of Balances

Tests of balances are substantive tests that provide either reasonable assurance of the validity of a general ledger balance or identifies a misstatement in the account.

B. Search for unrecorded liabilities

A substantive test usually performed on accounts payable is a search for unrecorded liabilities. This test provides evidence as to completeness and some evidence as to valuation.

Chapter 10 - Completing the Audit

I. The Fourth Phase of the audit process model.

Completing the audit requires the completion of the audit procedures and issuance of an opinion.

The Procedures for this phase of the audit are:

- (1) Perform overall review;
- (2) Perform procedures to identify subsequent events;
- (3) Review financial statements and other report material;
- (4) Perform wrap-up procedures;
- (5) Prepare Matters of Attention of Partners;
- (6) Report to the board of directors;
- (7) Prepare Audit report.

I. Overall Review

The overall review procedures involve obtaining evidence and letters concerning litigation, claims and assessments, and a management representations letter. Evidence gathering involves a review for contingent liabilities and commitments and related parties.

A. Client's Attorney Letter

1. To discover litigation, claims, and assessments that affect the client, the auditor relies on both her own field procedures and a letter from the client's legal counsel.
2. For all litigation, claims and assessments, the attorney letter should request evidence relating to:
 - Existence of conditions or circumstances indicating a possible loss from litigation, claims or assessments
 - The period in which the underlying cause occurred.
 - Likelihood of an unfavorable outcome
 - Amount of potential loss, including court costs

B. Obtain Management Representations Letter.

When management representations relate to matters that are material to the financial statements, the auditor must:

1. seek corroborative audit evidence,
2. evaluate whether the representations made by management appear reasonable and consistent with other audit evidence;
3. consider whether the individuals making the representations are competent to do so.

C. Review for Contingent Liabilities and Commitments

1. *Contingent liability* is a potential future obligation to an outside party for an unknown amount resulting from the outcome of a past event.
Examples are an adverse tax court decision, lawsuit, and notes receivable discounted.
Footnote disclosure is ordinarily required if there are probable losses.
2. *Commitments* are agreements that the entity will hold to a fixed set of conditions, such as the purchase or sale of merchandise at a stated price, at a future date, regardless of what happens to profits or to the economy as a whole.

D. Related Parties

1. Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operation decisions.
2. The auditor should review information provided by the directors and management identifying related party transactions and should be alert for other material related party transactions.
 - review prior year working papers for names of known related parties;
 - review the entity's procedures for identification of related parties;
 - inquire as to the affiliation of directors and officers with other entities;
 - review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a listing of principal shareholders from the share register;
 - review minutes of the meetings of shareholders and the board of directors and other relevant statutory records such as the register of directors' interests;
 - inquire of other auditors currently involved in the audit, or predecessor auditors, as to their knowledge of additional related parties; and
 - review the entity's income tax returns and other information supplied to the regulatory agencies.

II. Review for Discovery of Subsequent Events

Review for subsequent events are the auditing procedures performed by auditors to identify and evaluate subsequent events.

A. Types of Events After the Balance Sheet

Date International Accounting Standard (IAS) 10 identifies two types of events after the balance sheet date:

1. events that provide further evidence of conditions that existed at period end (requires adjustment to the financial statements)
2. events that are indicative of conditions that arose subsequent to period end (if material, requires disclosure).

B. Events Up To The Date Of The Auditor's Report.

The auditor should perform procedures designed to obtain sufficient appropriate audit evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.

C. Events Between The Balance Sheet Date And The Issuance Of The Statements.

The auditor has no responsibility to perform procedures or make any inquiry regarding the financial statements after the date of the auditor's report.

D. Discovery Of Facts After The Financial Statements Have Been Issued.

After the financial statements have been issued the auditor has no obligation to make any inquiry regarding such financial statements.

III. Review Financial Statements and Other Report Material

The final review of the financial statements involves procedures to determine if disclosures of financial statements and other required disclosures (for corporate governance, management reports, etc.) are adequate.

A. Financial Statement Disclosures.

Adequate disclosure includes consideration of all the financial statements, including related footnotes.

B. Corporate Governance Disclosures

A directors report concerning internal financial control should contain as a minimum the following elements :

1. acknowledgment of their responsibility for internal control;
2. that the system can only provide reasonable assurance against material misstatement;
3. a description of key procedures designed to provide effective financial control;
4. confirmation that they have reviewed the effectiveness of the internal control system;
5. information about the weaknesses in internal control that have resulted in material losses, contingencies, or uncertainties which require disclosure in the financial statements.

C. Other Information In Annual Reports

1. ISA 720 'The auditor should read the other information (in documents containing audited financial statements) to identify material inconsistencies with the audited financial statements'.
2. Other information, on which the auditor may have no obligation to report, includes documents such as:
 - an *annual report*,
 - a report by management or the board of directors on operations,
 - financial summary or highlights,
 - employment data,
 - planned capital expenditures,
 - financial ratios,
 - names of officers and directors,
 - selected quarterly data,
 - documents used in securities offerings.

IV. Wrap-Up Procedures

Wrap-up procedures are those procedures done at the end of an audit that generally cannot be performed before the other audit work is complete.

A. Final Analytical Procedures.

Under ISA 520, auditors are required to apply analytical procedures at both the planning and overall review stages of the audit.

B. Working Paper Review

Working papers (or 'work papers') are a record of the auditor's planning; nature, timing and extent of the auditing procedures performed; results of such procedures and the conclusions drawn from the evidence obtained.

C. Evaluating Audit Findings For Material Misstatements

When the audit tests for each item in the financial statements are completed, the staff auditor doing the work will sign off completion of steps in the audit program, identify monetary misstatements in the financial statements and propose adjustment to the financial statements.

D. Client Approval Of Adjusting Entries

1. The senior accountant must obtain client approval for all proposed adjusting and reclassification journal entries before finishing the engagement.
2. The proposed adjusting entries are approved by the manager before being submitted to the client for acceptance.

V. Matters For Attention Of Partners (MAPs)

A. Matters for Attention of Partners (MAPs) is a report by audit managers to be reviewed by the partner or director detailing the audit decisions reached by managers or partners and the reasons for those decisions.

B. The items included in the MAP are:

1. a cover page signed by audit manager and partners stating the basic conclusions of the audit
2. general matters; management comments, comments on results
3. discussions of accounts that required special consideration
4. compliance with statutory laws, ISAs and IASs
5. comments on accounting systems
6. comments on management letters
7. discussion of any matters that were outstanding at that date.

VI. Report to The Board of Directors

A. The Board of Directors has significant influence over accounting and financial policies of the entity. The auditor must communicate their important findings to the Board.

B. Typical areas of discussion in the Long-Form report to the board of directors is information which the client has omitted from its notes and the errors the auditor has found in performing her work.

Chapter 11 – External Audit Reports

DRAFT 17 January, 1998

I. Basic Elements of the Auditor's Report

A. Contents of the Auditor's Report

1. Title,
2. Addressee,
3. Opening or introductory paragraph:
 - a. identification of the financial statements audited,
 - b. a statement of the responsibility of the entity's management and the responsibility of the auditor,
4. Scope paragraph (describing the nature of an audit):
 - a. a reference to the ISAs or relevant national standards or practices,
 - b. a description of the work the auditor performed,
5. Opinion paragraph containing an expression of opinion on the financial statements,
6. Date of the report,
7. Auditor's address, and
8. Auditor's signature

B. Form of an Auditor's Report

The most common type of audit report is the standard unqualified audit report. The form of an auditor's report will generally be the form of the unqualified report - three paragraphs: introduction, scope and opinion, already discussed. Reports can also include a fourth paragraph (after the opinion paragraph) called 'paragraph emphasizing an uncertainty' or 'explanatory paragraph'.

C. International Audit Reports

The basic elements and form of the auditor's report according to ISA, described above, are substantially complied with by United Kingdom, Canada, the United States, the Netherlands, Mexico, Japan and other countries. Other countries diverge from these guidelines.

II. Types of Reports Expressing Audit Opinions

The opinion expressed in the auditor's report may be one of four types: unqualified, qualified, adverse, or disclaimer of opinion.

A. Standard Unqualified Opinion Auditor's Report

In a auditor's report on financial statements an unqualified opinion is issued in a clear and affirmative manner when the auditor is satisfied in all material respects that:

- 1) the financial information has been prepared using acceptable accounting policies, which have been consistently applied;
- 2) the financial information complies with relevant regulations and statutory requirements;
- 3) the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity; and
- 4) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

B. Auditor's Report Containing a Qualified Opinion

An auditor's report containing a qualified opinion is issued when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material as to require an adverse opinion or a disclaimer of opinion.

C. Auditor's Report Containing an Adverse Opinion

An adverse opinion is issued when the effect of a disagreement is so *material* and *pervasive* to the financial statements that the auditor concludes that a qualification of her report is not adequate to disclose the misleading or incomplete nature of the financial statements.

D. Auditor's Report Containing a Disclaimer of Opinion

An auditor's report containing a disclaimer of opinion should be expressed when the possible effect of a *limitation on scope* is so *material* and *pervasive* that the auditor has not been able to obtain sufficient appropriate audit evidence and therefore is unable to express an opinion on the financial statements.

III. Modification of an Auditor's Report Containing an Unqualified Opinion

An auditor's unqualified report is sometimes modified to explain matters that do not affect the auditor's opinion, but should be emphasized to the financial statement user.

A. Emphasis of Matter

Under ISA 700, in certain circumstances an auditor's report may be modified by adding a fourth, *emphasis of matter paragraph*, to highlight a material matter regarding a going concern problem and when there is significant uncertainties, the resolution of which is dependent upon future events which may affect the financial statements.

B. Going Concern Assumption

The *going concern assumption*^{xvii} is one of the fundamental assumptions underlying preparation of financial statements. The going concern assumption is that the enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future.

C. Going Concern Audit Procedures in Order to Arrive at an Opinion

An entity's continuance as a going concern is assumed in the preparation of the financial statements in the absence of information to the contrary. Therefore, assets and liabilities are recorded on the basis the entity will be around long enough to pay the liabilities and fully depreciate the assets.

D. Going Concern Audit Opinions

After the auditor has carried out the additional procedures deemed necessary, obtained all required information and considered the effect of management's plans, she should determine whether the questions raised regarding going concern have been satisfactorily resolved.

IV. Circumstances That May Result in Other Than an Unqualified Opinion.

Based on ISA 700,^{xviii} there are at least two circumstances where the auditor may not be able to express an unqualified opinion: a limitation in scope and a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

A. Limitation on Scope

Scope limitations arise when the auditors are unable for any reason to obtain the information and explanations considered necessary for the audit.

B. Disagreement with Management

The auditor may disagree with management as to:

- a) The acceptability of the accounting policies selected;
- b) The method of policy application, including the adequacy of valuations and disclosures in the financial statements; or
- c) The compliance of the financial statements with relevant regulations and statutory requirements.

If any of these disagreements are material, the auditor should express a qualified opinion. If the effect of the disagreement is so *material* and *pervasive* to the financial statements that the auditor concludes that a qualification would not be adequate to disclose the misleading or incomplete nature of the financial statements, an adverse opinion should be expressed.

V. Uncertainties Leading to Qualification of Opinions

The international standards of IFAC specify qualification of opinions based on limitation of scope and disagreement with management as conditions that lead to an auditor's report containing a qualified or adverse

opinion. However, certain uncertainties may lead to an auditor's report containing a qualification of opinion in many countries.

A. Material Uncertainties

Materiality is an essential consideration in determining the appropriate type of report for a given set of circumstances. An item is material if inclusion or exclusion of the item on the financial statements is sufficiently important to influence a decision made by a reasonable user of financial statements.

B. Accounting Principles Not Consistently Applied

Lack of consistency in the application of accounting principles in the current period in relation to the preceding period may require a modification to an unqualified opinion in many countries based on local standards.

C. Auditor is Not Independent

IFAC's *Guideline on Ethics for Professional Accountants* (see Chapter 3, 'Ethics') stresses the great importance to auditing of independence both in fact and appearance. However, the ISA Auditing standards do not require a qualified opinion or a disclaimer of opinion if the auditor is not independent, although this is the case in most countries.

D. Reports involving other auditors and experts

ISA 620 suggests that when expressing an unqualified opinion the auditor should not refer to the work of an expert in her report as such a reference might be misunderstood to be a qualification of the auditor's opinion or a division of responsibility. If the auditor as a result of the other auditor's or expert's work issues an auditor's report containing other than an unqualified opinion, she may in some circumstances describe the work of the expert.

E. Fraud

ISA 240 states 'In planning the audit the auditor should assess the risk that fraud and error may cause the financial statements to contain material misstatements and should inquire of management as to any fraud or significant error which has been discovered. The auditor is required to communicate factual findings to management as soon as practical if the auditor finds significant error or if she suspects fraud may exist, even if the potential effect on the financial statements would be immaterial. The auditor's duty of confidentiality would ordinarily preclude reporting fraud or error to a third party.'

VI. Finalization of the Audit Report

In order to minimize the auditor's exposure to post balance sheet events, it is an advantage to issue the audit report as soon as possible after financial statement approval by the client.

A. Approval and Signatories

Approval procedures may differ by audit firm, but typically all proposed audit reports are discussed with a second partner, the tax reviewer, and for widely circulated companies, eventually also the Partner in charge of accounting and audit.

B. Draft Reports

Typically the client is sent a draft report before approval. This draft should be clearly marked as such. If an auditor's report containing an unqualified opinion is to be issued, the draft financial statement is usually accompanied by a clearly marked draft opinion or no report.

VII. Long-Form Audit Report

In many countries it is customary for the auditor to prepare a 'long-form' report to the entity's board of directors in addition to the publicly published 'short-form' report discussed in this chapter.

A. Communication With The Audit Committee

The audit committee is a body formed by a company's board of directors to allow the board to focus on issues affecting external reporting and, in some cases, internal control. In general, the board of directors is composed of *outside directors*.

B. Overview of the Audit Engagement

In the overview, the long-form report will discuss nature, scope, organization, level of materiality, new audit work, and work with other auditors and experts.

C. Analysis of Financial Statements

Accounting issues discussed include issues requiring subjective judgment, changes in accounting policies, accounting developments that may affect the client, acquisitions and divestments and their affect on the accounts, financial position, and quality of profits. Also discussed are topics of discussion or disagreement between auditors and management and future client developments and their reflection on the annual report.

D. Risk Management and Internal Control

ISA 250 states 'The auditor should, as soon as practicable, either communicate with the audit committee, the board of directors and senior management, or obtain evidence that they are appropriately informed, regarding noncompliance (with applicable laws and regulations) that comes to the auditor's attention ... If the auditor suspects that members of senior management, including members of the board of directors, are involved in noncompliance, the auditor should report the matter to the next higher level of authority at the entity, if it exists, such as an audit committee or a supervisory board.'

E. Optional Topics

There may be topics not typically addressed that the auditor may feel warrants discussion because of the circumstances of the company, the economy or the audit. These topics may include tax pension, treasury function, and audit related requirements.

F. Reportable Conditions

Major internal control problems (reportable conditions) should be reported to management, and where necessary, the board of directors. In deciding whether a matter is a reportable condition, the auditor considers factors such as the size of the company and its ownership characteristics, the organizational structure, and the complexity and diversity of company activities.

G. Fees

Of course, every client is interested in how much fees they are paying and what services they receive. Typically discussed in the long-form report are an overview of the budget and actual audit costs, costs for related engagements, and service delivery issues. Service delivery issues would include staffing, important changes, quality survey and follow-up.

Chapter 12 – An Audit, Step by Step

(DRAFT 20 December 1999)

I. You are the Audit Manager

One Monday morning the auditor receives a package he has been expecting. It includes several documents and a cover letter from a US office of your accounting firm. This US office wants him to audit some European subsidiaries of their client.

The *Audit Planning Memorandum* incorporates most of the important ideas of the audit. It is put together by your senior audit staff person and approved by you, the manager, and by the partner.

A. GROUP AUDIT INSTRUCTIONS, SECTION A (GENERAL) AND B (SPECIFIC PROCEDURES)

The Instructions start with two sections - one with general information and one with specific procedures. The general information is about subsidiaries and audit standards required. Specific procedures include discussion on: reporting package and deadline, separate report issued information, currency exchange considerations, supplemental statements, details about the Completion Memorandum, potential material weakness in internal control, Management Letter comments, material differences, and specific details of client audited.

B. SECTION C OF THE GROUP INSTRUCTIONS - HOME OFFICE (HO) - THE COMPANY

Section C opens with information about the main client Home Office (HO), the 'Company'. Details are given about the company including when organized, where, products, markets, service, sales force, type of customers and the industry's marketing strategy.

C. SECTION D OF THE GROUP INSTRUCTIONS - AUDIT SCOPE, FEES AND COVERAGE

"Audit scope, Fees and Coverage" It includes subsections on home office participation, audit fees, audit coverage, timing of certain audit procedures, computer assisted auditing techniques, the audit time table, and quarterly reviews.

1. DEADLINES

Deadlines: The audit time table calls for all working papers, reports, and supporting schedules to be received by January 30, 20X2 at BIG overseas. The Audit Planning Memorandum will be due December 12. The auditor highlights that date because that is the most pressing. Most other items required in the Instructions are due Jan 23 and the proof draft of the final management letter is expected by Jan 30.

D. SECTION E, "CRITICAL AND SIGNIFICANT AUDIT CONCERNS"

Section E is called "Critical and Significant Audit Concerns". The auditor feels that this is an important one that points out on which items the auditor will concentrate during the audit. The specific areas of concern are revenue, research and development costs, third party regulation, acquisitions, restructure accruals, management letters, bench-marking, and new accounting standards that need to be applied.

E. SECTION F (MANAGEMENT LETTERS) AND G.(NEW ACCOUNTING STANDARDS)

Management letters are important to BIG. The Instructions convey the suggestions for the management letter be reviewed with Local managers. The auditor also makes sure that your comments are supported in the working papers and typed for inclusion in consolidated management letter.

The final part of the Group Audit Instructions discusses bench-marking and the new accounting standards that apply this year. Local is to be compared to bench-marks developed on several other companies and results are to be discussed with managers.

II. The audit planning memorandum - strategy part

After reading the "Group Audit Instructions", the first order of business is to meet with the audit staff and discuss strategy for the audit. Based on the results of the meeting, your senior staff auditor will write-up an Audit Planning Memorandum which will be reviewed by senior team members.

A. FOLLOW-UP AND INSIGHTS

Since Local is a continuing client, the audit should be started by following-up on last year. Has Local fixed the problems they had last year? How has the situation been improved? If they have improved, what tests will be done to insure this conclusion?

B. INITIAL RISK ANALYSIS

Risk analysis must be done to determine main risks. The auditor and the team made a schedule of risk arranged by process (sales, accounts receivable, and salary) and information source as follows (example):

<u>Process</u>	<u>Information source</u>	<u>Inherent risk</u>	<u>Control risk</u>	<u>Critical Audit Objective</u>
Intangibles	Groot Warnsborn	high	high	valuation
Sales of Software	John Smith	high	high	completeness
Accounts receivable	Patricia Hayward	high	average	valuation
Salary	Robert de Niro	low	low	none

C. CLIENT SERVICE, IMPORTANT CONTACTS, AND AUDIT TEAM

Because auditing is a service for a client and because it is a competitive business, a major concern of BIG is always client service aspects of the audit.

Who does the auditor talk to at Local? The team put together a list of Local's professional advisors and important contacts among Local employees.

The final item in the Strategy Part of the Audit Planning Memorandum is a schedule of the Audit Team including name and experience at client and other professionals at BIG who will probably be called in to help.

III. The audit planning memorandum - plan part

The Plan Part of the Audit Planning Memorandum sets the broad direction for the audit. The Plan Part of the Audit Planning Memorandum summarizes technical matters, client service matters and logistical matters.

A. SIGNIFICANT AUDIT AREAS AND ACCOUNTING ISSUES

Technical matters include further planning of our approach of critical audit objectives and internal control. It expands on the Strategy Part and provides, among other things, an overview of the client company, the industry environment, significant audit concerns, and areas of interest to the audit team.

B. FEES, TIMETABLE AND CONTACTS

Fees and the timetable for the audit are important parts of the audit plan for obvious reasons. The auditor calculates the budgeted hours and related fees for Partner, manager, staff, out of pocket expense.

IV. Audit program

Using BIG's audit software, BIGdealer, the auditor writes the audit program. The auditor use standardized audit procedures suggested by the software that are needed to substantially test the account balances and transactions outlined in the Audit Planning Memorandum.

A. AUDIT CASH BALANCE AND RELATED FLOWS

Only one objective applies to this section. That objective is: "Cash exists and is available to meet the obligations of the entity; cutoff for receipts and disbursements is proper; bank balances reconcile to general ledger balances; and reconciling balances are proper." The audit assertions that this audit objective encompasses are existence, accuracy, ownership, presentation, and disclosure.

B. INVESTMENTS

For investments audit procedures there are three objectives:

- (1) All dividends, interest and other income is recorded; gains and losses on sales and other dispositions are recognized; premiums and discounts and related amortization are recorded. (The financial statement assertions of management are completeness and accuracy).
- (2) Investments exist and are owned by the entity. (The financial statement assertions of management are existence and ownership).
- (3) Valuation methods applied are in conformity with applicable accounting principles consistently applied, and write-down of provision for write-down is recorded when appropriate. (The financial statement assertions of management are evaluation, presentation, and disclosure).

C. AUDITING THE CAPITAL ACCOUNTS

There are two capital audit objectives:

- (1) All capital transactions including dividends are recognized and are those of the entity. (Financial statement assertions are: completeness, existence, accuracy, and ownership).
- (2) Accounting principles applied to capital transactions and the disclosures relative to the capital structure are appropriate and consistent. (Financial statement assertions are: valuation, presentation, and disclosures).

D. EXPENSES AND PAYABLES

Expenses and payables auditing have three audit objectives. For procedure number 3 which we will discuss, the audit objective is: All unpaid amounts due to suppliers or others for goods and services received prior to year-end are included or otherwise accrued. (Financial statement assertions are: completeness, existence, accuracy and, ownership).

E. SALES AND RECEIVABLES

Auditing sales and receivables has seven audit objectives. Here are three of them, numbers 4, 5, and 7:

- (4) Trade accounts receivable represent uncollected sales or other charges to bona fide customers and are owned by the entity. (Financial statement assertions are: existence, and ownership).
- (5) All cash collections are accurately recorded. (Financial statement assertions are: completeness and accuracy).
- (7) Valuation of trade receivables is appropriate (i.e. provision is made for uncollectable amounts). (Financial statement assertions are: valuation, presentation, and disclosure).

F. INVENTORIES

The auditor attends the physical count of the inventory. The auditor reads the count instructions. At the count the auditor makes sure:

- all inventory locations get a "tag" (a description of the item and the quantity and perhaps the item number),
- there are two people counting - one counting the items and the other verifying the count,

- every count team has people from separate departments on the team, e.g., no two people on the same team are from administration accounting; no two persons on a team are from the warehouse, etc.
- there is a pre-numbered count list and that the auditor gets back all the copies of the list,
- every location has a count sheet and the auditor has all sheets returned,
- the auditor takes a random sample of items and make sure they have been counted correctly.

G. ASSETS

Asset auditing has only one audit objective: Amounts prepaid, deferred or capitalized are expected to provide future benefit for matching with expected future income; amounts and related amortization are calculated correctly; write -down or loss provision is recorded. The financial statement assertions are: existence accuracy, valuation, ownership, presentation and disclosure.

H. COMPLETION MEMORANDUM

The first thing the auditor states in the Completion Memorandum is that the audit papers related to critical areas have been reviewed by the engagement manager and partner. This is an essential procedure, because a review by the manager and the partner can uncover weak or incomplete areas of the audit which the audit staff might have overlooked or are not experienced enough to recognize a problem.

I. CRITICAL AUDIT AREAS

The areas the auditor considers critical are allowance for doubtful debts, revenues, and research and development expenditures, so the auditor discusses each in the Completion Memorandum.

J. ACCOUNTING ISSUES

Accounting issues are broadly defined as accounting for Newco, for Design by Local, for Finance Subsidiary (FS) by Local, and for ZAP.

K. FINANCE SUBSIDIARY

This section describes specific items about Finance Subsidiary (FS) cash and cash equivalents, prepaid expenses, and taxation.

L. OTHER MATTERS

Other matters are a round-up of miscellaneous matters including illegal and questionable acts, management letter, summary of audit differences, and the status of statutory financial statements.

M. OUTSTANDING MATTERS

There may be some matters that are still pending because of time limitations or other complications during an audit.

Chapter 13 – Auditing Beyond 2000

I. Trends in Information Credibility (Assurance) Services

Assurance services, according to the International Auditing Practices Committee (IAPC), are professional services, for use by decision makers, designed to enhance the credibility of information that is the responsibility of another party by evaluating that information against suitable criteria..

A. Customer Demands for Information Credibility (Assurance) Services

Assurance services involved four dimensions:

- (1) services that refine raw information into reliable information;
- (2) services that improve decision making by enhancing reliability, relevance and availability of information;
- (3) services that improve decisions by enhancing the decision makers knowledge; and
- (4) services that improve outcomes of the decision process.

One possibility is that corporate accounting information may be placed on the Internet or some computer communication system that can be accessed by financial statement users.

II. Soft Information

Perhaps the largest challenge for auditors in the next century is how to understand, value and quantify 'soft information' such as information about complex financial instruments, valuation of assets, non-financial controls and electronic evidence.

A. Complex Financial Instruments

Derivative financial instruments are financial instruments such as financial options, futures and forwards, interest rate swaps and currency swaps, which create rights and obligations that have the effect of transferring between the parties to the instrument one or more of the financial aspects, as well as the related risks and rewards inherent in the underlying primary financial instrument.

B. Asset Valuation Models

The auditor must consider how asset valuation models like historical cost, current, or fair value accounting will be affected by the realities of the 21st century. Regulations sometimes make an asset unusable or creates special assets (such as an emission right), which are difficult to value under traditional techniques.

1. Historical Cost, Fair Value and Current Cost

The historical cost model of valuation is an important benchmark which will survive into the future because it provides very good evidence of a 'cost' value at a point in time.

2. Environmentally Created Valuation

Government regulations may create new assets which present special valuation problems.

C. Non-financial Internal Controls

Operations of corporations in a global environment will become more and more complex, making corporate governance more difficult. To control the complexity of running such companies, there will be increased emphasis put on internal controls.

1. Reporting on Internal Controls

Public reporting on internal controls may not be widespread for a few years. Until standards are set on internal control reporting, the most important consideration as to public reporting on internal control will most likely be one of cost benefit or lack of uniformity of standards and benchmark reports.

III. Auditing and the Environment

The importance of the environment has created a need for guidance, and IFAC has recently released an International Auditing Practice Statement (IAPS) on Consideration of Environmental Matters in and Audit of Financial Statements.

A. Auditing Practice Statement on Environmental Matters

IFAC has issued an Exposure Draft for a International Auditing Practice Statement (IAPS) on environmental matters, and relates the guidance to various ISAs having an applicability to environmental matters.

1. Laws and Regulations

ISA 250 'Consideration of Laws and Regulations', emphasizes management's responsibility for operating according to the law, including environmental law.

2. Knowledge of the Business

In accordance with ISA 310 'Knowledge of the Business'^{xix}, the auditor needs sufficient knowledge of the client's business to understand the possible impact of environmental matters on the financial statements.

3. Risk

The financial statements of an entity may be materially misstated when the entity fails to recognize, measure or disclose certain environmental matters. This consideration has to form part of the auditor's risk assessments.

4. Substantive Procedures for environmental matters normally include:

- inquiries of management, reading of the minutes of relevant management meetings, and obtaining management representations;
- analytical procedures between quantitative environmental data and related financial information;
- examination of accounting estimates in accordance with ISA 540, 'Audit of Accounting Estimates',^{xx}

5. Using the Work of Others

In order to assess the impact of environmental matters on the financial statements, an expert's involvement may be needed in:

- identifying situations where estimates are required,
- gathering the necessary data on which to base estimates and provide details of information that need be disclosed in the financial statements,
- designing the appropriate remedial action plan and calculating related financial consequences.

Deze samenvatting is samengesteld uit de outlines per hoofdstuk op www.auditingtext.com (draft 24 January, 1998) en gratis te downloaden op www.pentagon.nl.

Notes

- i Such non-financial information might include footnote disclosures, the Management's Report, the Report of the Directors, even the whole annual report.
 - ii IFAC Handbook Technical Pronouncements 1995, *International Standards on Auditing No. 1*, "Objective and General Principles Governing an Audit of Financial Statements", (SMN 200), paragraph 2, International Federation of Accountants, New York, 1995.
 - iii American Accounting Association, A Statement of Basic Auditing Concepts, American Accounting Association, Sarasota, Florida, 1971, p 2.
 - iv One notable gap in International Accounting Standards is a standard dealing with the presentation of financial statements, although IAS 1, 5 and 13 deal with certain aspects. In March 1995 the IASC published a Draft Statement of Principles (Discussion Paper) on financial statement presentations.
 - v IASC, International Accounting Standard 8, "Unusual and Prior Period Items and Changes in Accounting Policies", paragraphs 6, 16, 20, 24,38, 49 and 54; International Accounting Standards Committee (IASC), 1993
 - vi IASC, International Accounting Standard 7, "Cash Flow Statements"; paragraphs 10 and 18; International Accounting Standards Committee (IASC), 1993
 - vii IFAC Handbook Technical Pronouncements 1995, *International Standards on Auditing No. 1*, "Objective and General Principles Governing an Audit of Financial Statements", (SMN 200), International Federation of Accountants, New York, 1995.
 - viii See footnote 3 for definition of reasonable assurance.
 - ix Philip Wallage, "Internationalizing Audit: A study of audit approaches in the Netherlands", European Accounting Review, 1993, No 3, pp. 555-578.
1. The privity standard: the auditor is only liable for *ordinary negligence* to third parties within the bounds of the original contracts. In the USA, this standard is known as the Ultramares doctrine.
 2. The foreseen users standard: Under this standard, the auditor is liable to specific (groups of) people whom the auditor knows or should have known will rely on her audit, e.g. a specific banker or the shareholders (as a group).
 3. The reasonably foreseeable users standard: Under this standard, the auditor is liable to any group of users of audit services, of which the auditor could have reasonably foreseen that they might rely on her services, even though they were not specifically identifiable for the auditor at the moment of expressing her opinion.
- VI. Audit Firms
- A. The Big Six firms: These firms were resulted partially from several major mergers in the late 1980s.
 - B. The non-Big Six firm: These firms can hardly be treated as a homogeneous group.

VII. Audit Quality And Audit Fee Determination

Auditors are evaluated based on *technical* and *functional* quality elements. auditors are evaluated based on *technical* and *functional* quality elements.

A. Technical audit quality addresses the quality of the *outcome* of the audit process: how good is the auditor at finding errors in the financial statements, or at detecting fraud or going concern problems.

B. *Functional audit quality* is defined as the degree to which the process of carrying out the audit and communicating its results meets a consumer's expectations.

- ^{xi} IFAC, "Superseding Another Professional Accountants in Public Practice", Section 12, Paragraphs 12.14 to 12.22, Code of Ethics for Professional Accountants, International Federation of Accountants, New York, July 1992.
- ^{xii} *Procedures to obtain an understanding* are procedures used by the auditor to gather evidence about the design and placement in operation of specific control policies and procedures
- ^{xiii} IFAC Handbook Technical Pronouncements 1995 , *International Standards on Auditing No. 2* (SMN 210), 'Terms of Audit Engagements', paragraph 2, International Federation of Accountants, New York, 1995.
- ^{xiv} IFAC, 'Terms of Audit Engagement', ISA 2 [SMN 210], IFAC Handbook 1995 Technical Pronouncements, International Federation of Accountants, New York, 1995. See also NivRA Opinion Statement 6 and NivRA Standards on Auditing (RC) 2.01.2.
- ^{xv} American National Standard, 'Quality Systems - Model for Quality Assurance in Design/Development, Production, Installation and Servicing', American Society for Quality Control (ASQC), ANSI/ASQC Q91-1987, June 19,1987.
- ^{xvi} IFAC Handbook Technical Pronouncements 1996, *International Standard on Auditing 8*, (SMN 501), "Audit Evidence - Additional Considerations for Specific Items", paragraph 4, International Federation of Accountants, New York, 1996.
- ^{xvii} *Going concern assumption* The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of operations.
- ^{xviii} IFAC Handbook Technical Pronouncements 1995 , *International Standards on Auditing No. 13* (SMN 700), 'The Auditors Report on Financial Statements', paragraph 36, International Federation of Accountants, New York, 1995.
- ^{xix} International Federation of Accountants (IFAC), *International Standards on Auditing No. 30* (SMN 310), 'Knowledge of the Business', IFAC Handbook of Technical Pronouncements 1996, IFAC, New York, 1996
- ^{xx} International Federation of Accountants (IFAC), *International Standards on Auditing No. 26* (SMN 540), 'Audit of Accounting Estimates', IFAC Handbook of Technical Pronouncements 1996, IFAC, New York, 1996