Chapter 1

AUDITING AND THE AUDIT PROFESSION

This chapter provides an introduction to the role and function of auditing and considers the structure and regulation of the auditing profession.

This chapter covers syllabus areas 1(a), (b), (c), 2(a), 2(b)(i) and (ii).

CONTENTS

1 The nature of an audit
2 The purpose of the external audit
3 The structure of the external audit
4 The accounting and auditing profession
5 International Standards on Auditing
6 The relationship between auditing and accounting

LEARNING OUTCOMES

At the end of this chapter, you should be able to:

• explain the nature, purpose and structure of an audit
• appreciate the distinction between external and internal audit
• appreciate the main mechanisms which currently regulate the auditing profession
• explain the role of both auditing and accounting standards.

1 THE NATURE OF AN AUDIT

1.1 WHAT IS AN AUDIT?

Whilst it is, of course, important to have a sound grasp of the meaning of the subject which you are studying in Paper 8 you are not likely to be assessed directly on the definition of the word audit. It is therefore more important to grasp an appreciation of the ideas involved in the audit concept than to attempt to learn a definition word for word.
Look at the ideas brought out by the following:

One possible definition of an audit is:

**Definition** The independent examination of evidence from which the financial statements of an enterprise are derived in order to give the reader of those statements confidence as to the 'truth and fairness' of the state of affairs which they disclose.

An alternative view is presented by ISA 200 – this is an International Standard on Auditing Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing. The objective of an audit 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’. This framework might be International Accounting Standards, or the national standards of a particular country. The phrases used to express the auditor’s opinion are that the financial statements ‘give a true and fair view’ or ‘present fairly in all material respects’. These phrases, which are equivalent terms, are used in many countries, including the UK and the US.

What can we see as the essential features of an audit from a combination of these definitions and explanation?

- An audit involves an examination of financial statements – the auditor is not responsible for the preparation of financial statements.
- The end result of an audit is an opinion to assist the user of the financial statements – auditing therefore relies heavily on professional judgement, not merely facts.
- The auditor’s opinion makes reference to true and fair, or fair presentation – but true and fair is again a matter of judgement – it is not precisely defined for the auditor.
- In order for the user of the information to feel confident in relying on the audit report, the auditor should be independent of the enterprise subject to audit – independent essentially means that the auditor has no significant personal interest in the enterprise. This allows an objective, professional view to be taken.

You will note that this is a wide concept of an audit which can be applied to any enterprise, not just to limited companies. However we are concerned here primarily with the annual audits of the financial statements of limited companies (often known as statutory or external audits). Any other audit applications will be clearly indicated for you in the text.

This paper does require that you have a general appreciation of other types of audit, not just the external audit referred to above. A later chapter of this text looks at this in more detail, but at this introductory stage, we should make a brief reference to the concept of internal audit and the internal auditor.

An internal audit function is (usually) a department set up within an enterprise, staffed by employees of that enterprise to provide a permanent audit presence which will generate benefits for the enterprise. An external audit carried out by independent professional accountants from outside the enterprise is a statutory requirement for many enterprises – but most do not have to have an internal audit function. Where such an internal audit department exists, its role and activities in most enterprises are dictated by the management of the organisation – whereas the external auditors face strict regulation by legislation and the auditing and accounting profession.

### 1.2 HISTORICAL BACKGROUND TO EXTERNAL AUDITING

The role of the auditor goes back many hundreds of years. There are records from ancient Egypt and Rome, showing that people were employed to review work done by tax collectors and estate managers. In fact the word audit is a Latin word meaning let it be heard i.e. the auditor is requiring responsible managers to explain their
transactions. In medieval Britain, an independent auditor was employed by the feudal Barons to ensure that returns from tenant farmers accurately reflected revenues received from the estates. Originally, the emphasis was very much on the detection of fraud and other irregularities. Over time this emphasis has changed as we shall see later and the role of the auditor has become much broader.

1.3 THE DEVELOPMENT OF MODERN EXTERNAL AUDITING

Modern auditing owes its origins to the development of a number of ‘fiduciary’ relationships, the most important for our purposes being the relationship between company directors and shareholders.

Definition A ‘fiduciary’ relationship is a relationship of ‘trust and good faith’ such as that between a trustee and a beneficiary, and between directors and shareholders.

It was recognised many years ago that whenever a fiduciary relationship with financial implications existed – think of the relationship between company directors and the shareholders in the company – there was a need for an outsider (what we would now refer to as an independent auditor) to review the accounts reflecting financial transactions and to express an opinion as to their honesty (we would now say truth and fairness) or otherwise.

These relationships in the context of companies can be shown as follows:

The relationship shown here is often described as depicting the **divorce of ownership from control**.

The shareholders own the company, but a different group, the directors, manage and control the company on behalf of the shareholders. The auditor acts as an independent referee, reporting to the shareholders on the financial statements prepared by the directors.
Company legislation in most countries now requires auditors to express an opinion on the truth and fairness of the statement of comprehensive income and the statement of financial position, both of which should be prepared by directors and presented to the shareholders. In addition, it is generally required that auditors should possess a recognised professional qualification and detailed provisions can be laid down regarding their duties, powers and responsibilities.

1.4 THE DETECTION OF FRAUD AND ERROR

In the early days of external audits, the generally held view was that a major role of the auditor was the detection of fraud (in simple terms, deliberate errors to produce a personal gain) and other (unintentional) error in accounts. However, modern auditing takes a different view of the role of the external auditor in connection with fraud and error.

This change in view was formalised by the UK courts in the Kingston Cotton Mill case of 1896 which was seen to be a leading case in defining the modern role of the auditor. Here the judgement was that the auditor's role should be that of a watchdog rather than a bloodhound, i.e. the auditor should act with such reasonable care and skill appropriate in the circumstances in order to have a reasonable chance of detecting major frauds and other errors. However, the auditor should not be expected to detect every fraud or error in financial statements.

The current position, in general is that there is no statutory duty for auditors to seek out fraud. The auditor’s duty under Company Law is usually confined to expressing an opinion as to whether the financial statements show a fair presentation of the company's results and position, and comply with relevant legislation.

Professional practice, as set out in ISA 240 The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements requires that auditors should plan and perform their audit work so as to have a reasonable expectation of detecting misstatements arising from fraud or error which are material to the financial statements.

Unfortunately, the general public still seem to take the view that the detection of fraud is the main role of the auditor. In recent years, auditing has been suffering from an expectations gap – the fact that the general public have a view of the role of the auditor which differs significantly from the view taken by the profession and by legislation.

ACTIVITY 1

Explain what is meant by an audit and the current view of the role of the auditor in relation to fraud.

For a suggested answer, see the ‘Answers’ section at the end of the book.

2 THE PURPOSE OF THE EXTERNAL AUDIT

2.1 INTRODUCTION

As described above, the need for an external audit centres around the requirements of the users of the accounts who are primarily, but not solely, the shareholders in the case of company audits. There are also many other outside parties who use the financial statements as a basis for making decisions regarding a company. Bankers, suppliers and lenders as well as potential investors, customers and employees all have an interest in the state of the company's financial affairs. The independent audit requirement fulfils the need for a professional opinion on whether those financial statements are objective, free from bias and manipulation and relevant to the needs of the users.
2.2 ADVANTAGES OF AN AUDIT

As we have seen, the need for an external audit in the case of companies arises primarily from the existence of divorce of ‘ownership from control’. There are however, certain advantages in having financial statements audited even where no statutory requirement exists for such an audit – in the case of a sole trader, partnership, club or society for example.

These advantages can be summarised as follows:

(a) Any audit will give assurance to readers of the accounts (e.g. current investors, potential investors, senior managers of the business) that the accounts have been properly drawn up and give a fair presentation of the financial position of the business. For example, the members of a sports club might choose to have the club’s accounts audited each year, to give assurance to the members that their subscription paid had been used properly as set out in the published financial statements.

(b) Disputes between stakeholders may be more easily settled. For instance, a partnership which has complicated profit-sharing arrangements may require an independent examination of those accounts to ensure as far as possible an accurate assessment and division of those profits.

(c) Major changes in ownership may be facilitated if past accounts contain an independent audit report, for instance, where two sole traders merge their business to form a new partnership.

(d) Applications to third parties for finance may be strengthened by the submission of audited accounts, as it adds credibility to the figures. However, do remember that a bank, for instance, is likely to be far more concerned about the future of the business and available security, than by the past historical accounts, audited or otherwise.

(e) The audit is likely to involve an in-depth examination of the business and so may enable the auditor to give constructive advice to management on improving the efficiency of the business.

2.3 DISADVANTAGES OF AN AUDIT

Like most things in life, audits are not entirely without their disadvantages. There are two main points to make here:

(a) The audit fee! Clearly the services of an auditor must be paid for. It is for this reason that few partnerships and even fewer sole traders are likely to have their accounts audited.

(b) The audit involves the client’s staff and management in giving time to providing information to the auditor. Professional auditors should therefore plan their audit carefully to minimise the disruption which their work will cause.

3 THE STRUCTURE OF THE EXTERNAL AUDIT

Auditing is essentially a practical task, especially as far as Paper 8 is concerned. The auditor always needs to reflect the nature of the circumstances of the enterprise under audit – it is unlikely that any two audit assignments will ever be identical. It is however possible to identify a number of standard stages in a typical external audit. These are represented diagrammatically below.

All this will be covered in detail later in the text – this is just an overview at this stage to give you a flavour of what an audit may involve.
Stages of the audit

Notes (refer to numbers on diagram)

The auditor will make a preliminary evaluation of the enterprise's control systems:

1. If the controls appear to be operating effectively and therefore are likely to lead to a true and fair set of financial statements the auditor will test those controls.

2. If they appear weak he will not 'rely' on the controls (there is no point!) but carry out extensive testing of the transactions and balances which appear in the financial statements; such tests are known as substantive procedures.

3. If the controls are operating effectively, the auditor can reduce the amount of substantive testing described above and adopt a reliance approach.

4. If not the auditor will be forced into a substantive approach.

Finally the auditor will always review the financial statements as a whole and formulate the audit opinion.

You will note from the above diagram that there are a number of different paths available for the auditor to follow in order to reach an opinion as expressed in the audit report. The path followed will be based on the auditor's judgement on key aspects of the circumstances of the enterprise – notably, the risks to which the enterprise is exposed and the controls in place to manage those risks. The concepts of risk assessment and control are central to modern auditing – as you will see later in the text.
ACTIVITY 2

A sole trader has just started a business and has asked you to explain whether his business will have to undergo a statutory audit and, if not, what benefits he may derive from having an audit performed on a voluntary basis.

Outline the main points which you would make in reply to his enquiry.

For a suggested answer, see the ‘Answers’ section at the end of the book.

4 THE ACCOUNTING AND AUDITING PROFESSION

The organisation and structure of the accounting and auditing profession will, of course, vary from country to country. A knowledge of how the profession operates in any given country is clearly beyond the scope of this paper.

There are a number of internationally recognised accountancy bodies, of which ACCA, although UK based, has a major international presence. There are also international auditing bodies, of which more later!

There are continuing moves to harmonise the accounting standards in use across the world. In particular, all companies listed in the European Union have been required to use International Financial Reporting Standards (IFRSs) when preparing group accounts since January 2005. There are also moves to harmonise auditing standards and the International Auditing and Assurance Standards Board (IAASB) has developed a high quality suite of auditing standards intended to improve current procedures and to try to ensure consistency of audit practices and procedures worldwide.

ACTIVITY 3

Carry out a short research project to identify the main bodies involved in the accountancy and auditing profession in your own country.

There is no feedback to this activity.

5 INTERNATIONAL STANDARDS ON AUDITING

5.1 INTRODUCTION

International Standards on Auditing (ISAs) are issued by the International Auditing and Assurance Standards Board (IAASB) which is based in New York. The IAASB functions as an independent standard setting body under the responsibility of the International Federation of Accountants (IFAC). The aim of the IAASB is to develop and issue high quality auditing standards to improve uniformity of practice by accountants throughout the world, thereby strengthening public confidence in the audit process globally. Until 2002 the IAASB was known as the International Auditing Practices Committee (IAPC). IAASB pronouncements are developed following a process that includes input and consideration by the General Public, IFAC member bodies and their members, and a Consultative Advisory Group that represents regulators, preparers, and users of financial statements.

The IAASB issues standards and statements on auditing and related services in order to improve the degree of uniformity of auditing practices and related services throughout the world.
The IAASB works closely with its members and national standard setters in order to gain acceptance of International Standards on Auditing (ISAs). It expects its members to have due regard for ISAs in setting national standards. Member bodies have increasingly sought to align the national position with the international position as IFAC and the IAASB have gained influence and recognition. Standard setters increasingly refer to the international position in their consultative documents as authoritative support for a particular view.

International auditing and accounting standards do not at present override local regulations. Neither IFAC nor the IAASB can currently compel any organisation to comply with international standards; nor are there specific IFAC sanctions where organisations claim to have complied with international standards, but have not done so. However, this situation will change as more and more countries adopt international standards rather than imposing their own domestic standards. For example, all listed European companies have been required to adopt international accounting standards since 2005, and the UK and Ireland have required all audits to be carried out in compliance with ISAs since December 2004.

In 2004, the IAASB began a project to update the ISAs. These new ‘clarified’ ISAs became effective for audits beginning on, or after, 15 December 2009. In response, ACCA has incorporated these ISAs in to this paper. We will only be looking at these new ‘clarified’ ISAs in this text.

IAASB pronouncements fall into a number of categories:

- **IFAC Code of Ethics for Professional Accountants**
- **International Standards on Quality Control (ISQCs)**
- **Audits of historical financial information**
- **International Standards on Auditing (ISAs)**
- **International Auditing Practice Statements (IAPSs)**
- **Other documents**
- **Other engagements**

The **IFAC Code of Ethics** sets standards of conduct for professional accountants and states the fundamental principles that should be observed.

The **International Standards on Quality Control (ISQCs)** provide guidance to auditors in their responsibilities to maintain good quality control over their audit engagements.

The **International Standards on Auditing (ISAs)** provide guidance to auditors in carrying out their audit engagements. The basic principles and essential procedures (identified in each ISA in bold lettering) are mandatory guidance. Other guidance is only advisory in status.

The **International Auditing Practice Statements (IAPSs)** provide practical assistance to auditors in interpreting and implementing standards and promote good practice. They are not intended to have the authority of standards.
5.2 DEVELOPMENT OF INTERNATIONAL STANDARDS ON AUDITING

The stages are similar to those in developing accounting standards:

- an Exposure Draft is issued with a request for comments by a specified date
- the comments are reviewed and, where appropriate, the draft amended
- the ISA is issued with a specified implementation date.

6 THE RELATIONSHIP BETWEEN AUDITING AND ACCOUNTING

Auditing and accounting are closely connected but separate activities. The directors of a company are responsible for establishing records which will accurately record transactions and which are used for preparing the annual financial statements. It is similarly the responsibility of the directors to adopt consistent and appropriate accounting policies in order to prepare the financial statements. For the purposes of this exam, we assume that the financial statements have to comply with legislative requirements and International Accounting Standards (IASs) and International Financial Reporting Standards (IFRSs). The International Accounting Standards Board (IASB) assumed responsibility for setting these accounting standards from 1 April 2001. There is also a conceptual accounting framework in issue (the Framework) which sets out the concepts that underlie the preparation and presentation of the financial statements for users.

Auditors are primarily concerned with the end result of this work i.e. do the financial statements show a 'true and fair' view? In order to arrive at their conclusion the auditors must have a deep knowledge and understanding of accounting (including applicable accounting standards) and, in practice, the directors will consult with the auditors as to appropriate accounting policies to follow.

CONCLUSION

This chapter gives you a basis for studying the detail of audit regulation and procedures which are dealt with in later chapters.

As a result of studying the contents of this chapter you should have gained a general understanding of the role and structure of an audit.

You should note that most of what follows is dealing with the statutory (external) audit. The overriding objective of this is for an independent professional accountant to establish and be able to report whether the financial statements present a true and fair view.

We have also introduced the idea of internal audit, which is becoming increasingly widely used by businesses as a means of monitoring and controlling their activities. This will also be dealt with more fully later in the text.

KEY TERMS

Audit – The independent examination of evidence from which the financial statements of an enterprise are derived in order to give the reader of those statements confidence as to the 'truth and fairness' of the state of affairs which they disclose.

Internal audit – A department set up within an enterprise, normally staffed by employees of that enterprise, to provide a permanent audit presence which will generate benefits for the enterprise.
Fiduciary relationship – A relationship of ‘trust and good faith’ such as that between a trustee and a beneficiary, and between directors and shareholders.

International Standards on Auditing (ISAs) – Statements containing basic principles and essential procedures for the auditor to follow together with related guidance in the form of explanatory and other material.

International Financial Reporting Standards (IFRSs) – Pronouncements issued by the International Accounting Standards Board providing guidance in respect of the treatment and disclosure of accounting items in the financial statements.

SELF TEST QUESTIONS

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PRACTICE QUESTION 1

KID BROTHER

Your younger brother has written to you stating that he is contemplating following your footsteps into the accountancy and auditing profession. However, he is finding difficulty in understanding the nature and purposes of an audit and he has asked for your assistance.

Write an appropriate letter, in language that a layperson can understand, describing an audit, with particular emphasis on its nature and purposes.

(Use fictitious names and addresses. Marks will be awarded specifically for style as well as for content.)

(20 marks)

For a suggested answer, see the ‘Answers’ section at the end of the book.

PRACTICE QUESTION 2

(a) Give a definition of an audit, and explain the significance of the terms therein.

(10 marks)

(b) What is the role of the IAASB?

(5 marks)

(Total: 15 marks)

For a suggested answer, see the ‘Answers’ section at the end of the book.