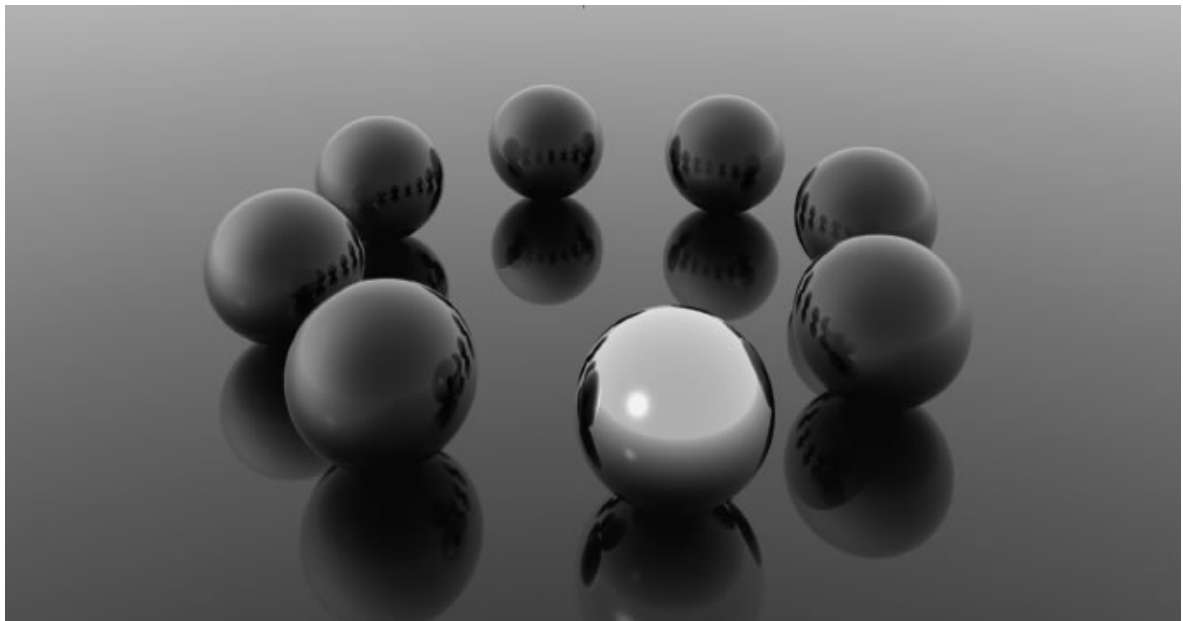


The Audit Process
4th Edition
Principles, Practice and Cases

ISA Edition

Students' self-assessment solutions



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Chapter 1

Why are auditors needed?

- 1.1 A number of people in the list would, on the face of it, be *competent* to carry out the audit of a small limited company in your local town - the members of ACCA, ICAEW and ICAS. Although the Wirtschaftsprüfer would be a competent auditor he or she might not possess the knowledge of local conditions to enable him or her to carry out the job properly. The ACCA member who is chief accountant of the company lacks independence and would, therefore, be rejected. The ICAS member is employed by a Building Society, does not appear to be in practice and may therefore lack recent audit experience. On the whole the best person (of the qualified accountants) to be the auditor would seem to be the member of ICAEW, a partner in the firm of Chartered Accountants.

All the other people (even if they were competent to carry out the work of an auditor) would seem to have an interest in the company in one way or another and would not be suitable. You may have said in your answer that the independence of the ordinary shareholder owning 1% of the shares would not be threatened and that he or she could, therefore act as auditor. In this case, bear in mind that 1% might represent a large part of personal wealth and that he or she is likely therefore to lack sufficient independence.

- 1.2 The simple answer to this question is 'all of them'. Let us go through the list one by one and justify this answer:
- (a) The shareholders are the providers of capital and they are entitled to know how successfully the directors have been running the company. The accounts should also aid them to some extent in the decision to hold onto or to sell their shares, although in practice they would be wise to seek further advice before doing so.
 - (b) The employees are intimately connected through their employment and rate of pay is likely to be dependent on the success of the company. It would seem, therefore, that they too have an interest in properly prepared accounts.
 - (c) These people are potential shareholders and they want to make a decision as to whether to buy shares or not. One of the sources of information available to them will be the company's accounts so they are clearly interested in those accounts being properly prepared. Again, it would be wise to seek further information about the company before doing so.
 - (d) The starting point of the tax computation of taxable income is the accounting profit before taxation. The inspector is clearly interested in properly prepared accounts.
 - (e) British Telecommunications plc is an important UK company. Its success or failure has a vital bearing on the success of the UK economy and in view of this, all residents of the UK are concerned in the proper preparation of accounts by the company. (If you are not a resident of the UK, take an example from important companies in your own economy).
 - (f) Suppliers of goods to a company are interested in the health of that company; in the short term they wish to be paid for goods supplied; in the longer term to know if the customer is a valuable long-term business partner. The same kind of considerations apply to customers and to competitors, all members of what the Corporate Report refers to as 'the business contact group').
 - (g) The Government of any country is concerned with the success or failure of the component parts of the economy. In addition, in so far as governmental statistics are often based on accounting information, it will also be interested in the validity of that information.
 - (h) BT is a public limited company and as published accounting information has a direct bearing on the quoted price of shares, the stock exchange has a very clear interest in valid accounting information.

Students should refer to the Corporate Report published by the Accounting Standards Steering Committee in 1975 for a discussion of these matters.

1.3 This is a question that is designed to start you thinking about the audit process. Andrew has stated that the motor expenses amount to £4,000; the duty of the auditor would be to prove that the assertion was a valid one. The first step would be to consider the types of expenditure that would be included under this heading. Suggestions are:

- (a) Vehicle licence fee
- (b) Insurance
- (c) Petrol
- (d) Servicing

Vehicle licence fee and insurance would be quite easily dealt with. An inspection of the relevant invoice, policy or tax disc would readily provide information about the charge to the profit and loss account and the amount of prepayment, if any. If there has been servicing of the lorry during the six-month period, an inspection of invoices would reveal the amount. It is to be hoped that Andrew has kept the invoices, although his system for recording income would not give us much reason to suppose that he has done this in all instances. This may be particularly the case with regards to petrol. We would have to question Andrew about distances travelled and miles per gallon. Experienced auditors would probably be able to determine whether the figure appeared reasonable or not, although, without more information, it is difficult to say whether they would be able to report that the motor expenses figure was acceptable. However, the above suggestions do give an idea as to how auditors might proceed.

1.4 Companies whose employees operate dangerous machinery are required by law to have proper safety procedures in force. In this case the audit helps to ensure compliance with the law and identifies hazards that aid the protection of employees.

Audit objectives would include:

- ensuring that the company has proper rules concerning the use of the dangerous machinery
- ensuring that the company has training schemes for employees in the operation of the machinery and in the understanding of safety measures, such as protective screens
- ensuring that staff are aware of the procedures to be adopted in the case of accident
- being satisfied that the incidence of accidents is at a minimum.

Chapter 2

An overview of the postulates and concepts of auditing

- 2.1 Whether managers actually prepare a list of assertions that they make about figures in the financial statements or on the quality of internal controls is perhaps doubtful. However, there are many implied assertions made by management when they include balances or figures in the financial statements. Thus, management is implying in relation to trade debtors that:
- a) Balances are genuine, that is, they represent amounts legally due to the company for goods in respect of which property has passed or for services rendered before the balance sheet date.
 - b) The amounts stated as due to the company in respect of trade debtors will be received in full, the implied assertion here being that full provision for bad and doubtful debts has been made.
 - c) All debtors' balances are reflected in the debtors figure in the financial statements.

The value to the auditor of identifying the assertions is that the evidence search can be conducted with specific objectives in mind. Thus, in respect of a) above, the auditors will direct their attention to proving that credit sales are completely and accurately recorded. This work would include obtaining assurance that sales and stock cut-off is accurate to ensure that debtors represent amounts due at the balance sheet date. Specific tests would include a debtors' circularisation. The evidence search in respect of collectability would start from the assumption that amounts recorded are legally receivable. The objective in this case would be to prove that the valuation of debtors is valid. To this end, the auditor will examine debtors' ageing statements and look at the past record of payment by debtors. Other procedures would include examining payments by debtors after the balance sheet date and testing for adherence to properly determined credit limits.

The above argument leads to the conclusion that the statement is valid. Basically, identification of assertions is important from the point of view of both the effectiveness and efficiency of the audit process.

- 2.2 The Auditors' Code suggests that the principle of integrity means that auditors fulfil their responsibilities with honesty, fairness, candour, courage and confidentiality. The problem with words like integrity, honesty, fairness, candour, courage and confidentiality is that they are all intangible qualities and therefore difficult to assess. In practice, the only way that we can assess whether, for instance, people are honest and fair is to observe their behaviour. We might conclude that some circumstances hinder honesty in the performance of an auditor's duties. Such circumstances might include the holding of shares in the company or being a personal friend of the managing director.

This means that apart from highlighting integrity as an important personal quality of the auditor, it is necessary to back up the principle by giving guidance to auditors on how integrity can be achieved. The question of appearance is a very important one and the profession has recognised for some time that being seen to be independent is just as important as being independent. The same applies to integrity. It can be argued, of course, that auditor reputation is so important that auditors will strive to maintain their integrity and independence as a matter of course. Integrity is certainly a quality that a profession would expect to see in its members and it could be argued that by publishing the principle of integrity APB is merely emphasising a general professional requirement.

- 2.3. You will have noted that the Auditors' Code says that auditors assess critically the information and explanations obtained in the course of their work and such additional evidence as they consider necessary for the purposes of their audit. The word 'critically' is in fact the important word in helping us to understand what is meant by professional scepticism. The expression does not mean that auditors should approach their work with undue suspicion, but that they should not accept statements by management or documentation at face value.

By way of example, let us assume that you are auditing a publishing company and that you have noted that the warehouse contains 20,000 unbound copies of one particular book. You raise the matter with management and they inform you that 15,000 copies have been sold to wholesalers after the balance sheet date, showing you orders from the wholesalers to support their assertion. You should not assume that management is misrepresenting the position to you, but as auditor you would need to look for evidence to prove their assertion. One important point to emphasise is that audit work does not take place in a vacuum. If you have already concluded that management quality and trustworthiness is high and that there are no indications that the company might be in financial trouble, the audit work would be carried out in a different context than if you had not formed these conclusions.

- 2.4 This matter is covered by the principle of Association. The directors appear, on the face of it, to be misleading the readers of the Directors' Report and there certainly seems to be conflict between the profit shown in that report and the loss shown in the Financial Statements. The readers would probably be very confused in the case cited and this might cause them to form the opinion that the auditor has not been competent. The auditors would ask the directors to change the Directors' Report, and if they refuse they would have to refer to the matter in the Audit Report, probably as an emphasis of matter.

Chapter 3

The meaning and importance of auditor independence, factors affecting independence and measures to attain it

- 3.1 a) In this case, the fees are less than 15% of gross practice income, but they are far in excess of the 10% and you would no doubt not wish to lose this income. ES4 certainly suggests that this situation might threaten independence. You might feel yourself that you are professional person and could maintain your independence, but you should remember that it is the perception of independence that is just as important as actual independence. There are two important matters in relation to the scenario outlined, namely, that the audit client is not a small entity, but your firm has less than three partners and cannot fulfil the requirement that an ethics partner should perform a hot review of the audit procedures, documentation and conclusions before the audit report is finalized. However, you should certainly discuss the key issues affecting the audit of your client with your fellow-partner, and perhaps even ask an outside firm to perform the hot review for you.

You should also inform those charged with governance of the audit client of the significance of the fee issue, and you might even consider giving up some of the non-audit work, if any, particularly if the fees are likely to rise above 15% of your gross practice income

- b) The problem here is that losing this client might mean that the office would lose its viability and your objectivity might be threatened in consequence. The threat to your independence would be particularly grave if your remuneration was based, at least to some extent, on the fees generated by your office. This is clearly a situation where the matter should be referred to the ethics partner. However, as your remuneration is based to some extent on the fees of this client this looks as if your firm might have to consider resigning from the audit of this client, unless your firm can assign this client to another part of the firm. See paragraph 25 of ES4 in this connection.
- c) You are clearly spending a great deal of time with the client in question, and your objectivity might be threatened because of the closeness of the relationship, that is, there may well be a familiarity threat. Although the fee income is below the limits specified in ES4 and though your own remuneration is not affected specifically by the fees received from this client, your firm would have to have policies and procedures in force to ensure that the familiarity threat was countered. The matter should be referred to the ethics partner, who might perform a hot review of the audit procedures, documentation and conclusions, considering in particular the key inherent and control risks facing the client. Consideration should also be given to the period of time that you have been involved with the client and in the circumstances it might be wise to consider rotation even if your period of engagement does not exceed the limits specified in ES3 (5 years for a listed company client and 10 years for a non-listed client).
- 3.2 The first and indeed seminal academic work on auditing appeared in 1961 when Mautz and Sharaf published 'The Philosophy of Auditing' which included a considerable section on independence, some of which we have introduced in this chapter. Since then, there has been considerable academic interest in auditing and we have introduced you to some of their work in this chapter, that of Goldman and Barlev and of Shockley in particular. These writers identified some years ago the risks to independence that find a place in the Statement. Shockley even went so far as to say that his work would be an aid to legislators. By legislators we include not merely legislators in parliament but those members of the profession and others who are responsible for issuing guidance to members of the auditing profession, including the IFAC Code and the APB Ethical Standards. We discussed this matter in the text and

believe therefore that the Statement has indeed been influenced by academic work in the past.

- 3.3 You might think that holding 1,000 shares from 100,000 would be a matter of little importance as it represents only 1% of the total. However, holding of shares in the auditee company is one particular risk to integrity, objectivity and independence that ES2 regards as an insurmountable self-interest threat. You might regard yourself as a fairly lowly member of staff and that, as your work is reviewed and controlled by others, there would be no threat as far as your audit firm is concerned. However, being senior in charge, you are likely to have an influence on the conduct and outcome of the audit and you should inform the audit partner of your holding. The likely action by your firm is concerned would be to remove you from the audit, and, if you have already been engaged in some audit work, to have this work subjected to independent review. This is because there are no safeguards to counter a financial interest of this nature (see paragraph 8 of ES2. You could, of course, dispose of your shares if you wish to continue as senior on the assignment, but even then, you might be excluded temporarily (see paragraph 13 of ES2.
- 3.4 The general rule is that accounting services should not be provided to listed company clients (see paragraph 117 of ES 5). However, this is clearly an emergency as contemplated in paragraph 121 and one that might have unfortunate consequences for Randerston plc, if it meant that it missed filing financial statements on a timely basis, or if obtaining further lines of credit was dependant on timely preparation of those statements. In these circumstances you could accede to the request of Randerston's chief accountant, but you have to warn him that the two members of staff seconded to the company would not be able to take any part in the audit engagement. You might suggest that two other members of staff with IT and accounting backgrounds could perform the work instead. You should also say that the help that the audit firm's staff would be of a technical nature and that they should not take part in any activity which would be the province of management, such as making decisions on such matters as stage of completion and any profits or losses to be taken up.

Chapter 4 Audit regulation

4.1 (a) *False*

CA 1985 s. 385(3), allows directors to appoint the first auditors and s. 388(1) allows the directors to fill a casual vacancy in the position of auditor.

(b) *True*

CA 1985 s. 390A(1), states that the remuneration may be fixed in such a manner as the company in general meeting may determine. In addition, s. 390A(2) permits the directors or the Secretary of State to fix remuneration where auditors have been appointed by them.

(c) *True*

CA 1985, s. 391(3), states that where an auditor is removed under s. 391(1), nothing is to be taken as 'depriving a person removed ... of compensation or damages payable to him in respect of the termination of his appointment as auditor or of any appointment terminating with that as auditor'.

(d) *False*

Auditors are allowed under CA 1985 (s. 391A(3)) to make representations to the shareholders. However, they are not allowed to make *any* representations. If the court is satisfied that the right to make representations is being abused to secure needless publicity for defamatory matter, they need not be communicated to the shareholders (CA 1985 s. 391A (6)).

4.2 (a) You will have seen from your reading of CA 1985 s. 221(3), that accounting records required to be kept by a company dealing in goods must include all statements of stocktakings relating to the year-end stocks figure appearing in the financial statements. If stock sheets cannot be relied upon, it can be argued the company has not kept proper accounting records. However, provided the auditors can satisfy themselves by other means that the stock figure in the accounts is reasonable, they may be able to avoid mentioning it in their report.

(b) Janet Helmsley has certain rights under CA 1985 s. 391(A), if the directors decide not to put her name forward for reappointment at the general meeting at which her period of office expired. These are:

(i) The directors must give special notice, that is at least 21 days notice, for a resolution at a general meeting...appointing as auditor a person other than a retiring auditor.

(ii) On receipt of (the) ... intended resolution ... the company shall ... send a copy of it...to the person proposed to be ... removed

(iii) The auditor proposed to be removed may make representations of reasonable length which the company shall send to shareholders and refer to those representations in the notice of the resolution. Note:

- that if the representations are received too late or if the company does not for some other reason send the representations out to shareholders, the retiring auditor may require that they are read out at the meeting;
- that if the court is satisfied that the rights to make representations are being abused to secure needless publicity for defamatory matter, then the representations need not be sent or read out;

- (iv) auditors proposed to be removed have the right to be heard at any general meeting at which it is proposed to fill the vacancy caused by their removal.
- (c) The question of Janet's fees is covered by CA 1985 s. 391 (3) which makes clear that the compensation payable to her in respect of her term of office is due to her.
- (d) The actions you would take assuming you were a member of a body of professional accountants are clearly stated in the rules of professional conduct. The answer below is based on the guidance provided by the ACCA in their Code of Ethics and Conduct on changes in professional appointments:
 - (i) The prospective auditor should inform the client that they have a professional duty to communicate with the previous auditor, Janet Helmsley. The prospective auditor should request that the client give Janet Helmsley written authority to discuss the client's affairs with the prospective auditor.
 - (ii) Assuming this permission is obtained you should write to Janet Helmsley asking her 'to provide known information on any facts or circumstances that, in the existing accountant's opinion, the prospective accountant should be aware of before deciding whether to accept the engagement.' This is not just professional courtesy, but also to ensure that there is no professional reason why you should not accept the appointment.
 - (iii) Where the outgoing accountants/auditors has been refused permission to discuss the client's affairs with the prospective auditor they should inform the latter of this fact and the prospective auditor should refuse the appointment.
 - (iv) Where permission is obtained the existing auditors should inform the prospective auditor of the nature and details of any matters that the latter should be aware. If there are not any matters that they believe should be brought to the attention of the prospective auditor they should state that fact. It is recommended that any communication should be in written form but where it is given orally then each party should keep their own written record of the conversation that took place. The prospective accountants/auditors would have to consider carefully the information received before accepting appointment. In the case cited of Janet Helmsley and Skiplam Ltd you may have doubts about the wisdom of accepting the appointment.
 - (v) If no reply were received from Janet Helmsley, you must make every effort, such as by telephoning, to contact her. If this fails you should send a letter by registered post or recorded delivery, saying that if no reply is received within (say) 7 days you will assume there are no matters that should be brought to your attention. Where no reply is received the prospective auditor should obtain information on the client by other means, for example, through third parties and background investigations. You should note that if no reply is received then the prospective auditors may complain to their accounting body that the existing auditors failed to respond to their enquiry.

The case in point is an audit matter concerning inadequate accounting records. If, on the other hand, Helmsley had resigned because she had suspicions that the client was guilty of an unlawful act, but has no proof, she would have to be very careful before communicating these suspicions to you.

4.3 You should advise the two partners that converting a partnership to a limited company brings with it onerous duties as well as certain advantages. You should warn them that limitation of liability can be more apparent than real, as banks frequently require personal guarantees from directors as well as charges on company assets to secure loans and overdrafts made by them. Specific duties imposed upon companies and directors of companies include:

- (a) Proper accounting records as defined in CA 1985 s 221(1) to (3) and penalties if they are not kept s 221(5) and (6);
- (b) Duty to prepare accounts that show a true and fair view (s. 226);
- (c) Preparation of a directors' report with significant disclosure requirements (s.234, 234ZZA and 234ZZB). There are certain exemptions from the disclosure requirements for small and medium sized entities;
- (d) Penalties for not laying accounts before the company in general meeting (s. 241(2)) and the penalties for producing accounts which are approved by the directors and do not comply with the requirements of the Act (s. 233(5)). You should also note the implications of having to revise defective accounts (s. 245, 245A, B and C).

The basic audit requirements are laid down in CA 1985 s. 235 and s. 237. These requirements are that:

- (a) The auditors must state whether the financial statements give a true and fair view of what they purport to show and that they comply with the provisions of CA 1985.
- (b) The auditors must satisfy themselves that:
 - (i) proper accounting records have been kept and by the company and proper returns adequate for their audit have been received from branches not visited by them;
 - (ii) the financial statements are in agreement with the books and records;
 - (iii) they have received all the information and explanations they think necessary for the purpose of their duties;
 - (iv) the information given in the directors' report is consistent with the financial statements themselves. If they are not so satisfied they must state that fact and describe the inconsistency in their report. See ISA 720 (revised) Section B The auditor's statutory reporting responsibility in relation to directors' reports.
 - (v) the information requirements of the CA in respect of emoluments and benefits of the directors is complied with in the annual accounts. Where this is not the case, the auditors should include in their report so far as they are reasonably able to do so details of the required particulars.
- (c) The auditors have the right of access to the company's records *at all times* (but most auditors will interpret this reasonably) s. 389A(1).

4.4 (a) *True*

See 4.3 (c) above

(b) *True*

Directors commit an offence (which may result in imprisonment and/or a fine) if they 'knowingly or recklessly' make a statement to the company's auditors which is required by the auditors in course of their duties and is misleading, false or deceptive in a material particular (see s. 389B(1)). The second part of the statement is somewhat more problematic. 'Not striving anxiously to tell the truth' sounds like an easy way to avoid the requirements of s. 389A. But do not forget that the directors have full responsibility for preparing accounts that give a true

and fair view and comply with CA 1985. The directors are also required to include a statement in their report that This amendment to the Companies Act 1985 was brought in by in The Companies (Audit, Investigations and Community Enterprise) Act 2004. In respect of each director they are not aware of any relevant information that the auditors are unaware of and that each director has taken steps to make himself or herself aware of any relevant audit information and that the auditors are aware of such information. Furthermore, the directors have a general duty to act in good faith and honestly in their dealings. Not giving all the facts in relation to an auditor's query may, therefore, not allow directors to escape liability even if they have not told a direct falsehood. The Companies (Audit, Investigations and Community Enterprise) Act 2004 strengthened the auditor's position by making it an offence for directors and other **employees** to withhold information that the auditors required from them. The act also widened the scope by making it clear that employees came within its scope as well as company officers. The auditor should of course ask specific and not general or vague questions.

(c) *False*

Notes to the accounts are really extensions of documents that *are* to be included in company's accounts, comprising, among other things, profit and loss account and balance sheet. They are, therefore, properly the subject of the auditor's report.

(d) *True*

This is an area of law which was changed in 2005. A statutory instrument issued in 2005 amended section 235(3) of the Companies Act 1985. It now provides that 'the auditors must state in their report whether in their opinion the information given in the directors' report for the financial year for which the annual accounts are prepared is consistent with those accounts.' We will visit this topic again in Chapter 16 when we discuss auditors' reports.

(e) *False*

If you refer to Figure 4.5 you will see that the auditors' period of duty runs from the general meeting at which they are appointed to the general meeting at which the accounts for the accounting reference period are laid before shareholders.

(f) *True*

The accounts of a private company must be laid before the company in general meeting within 10 months of the accounting reference date. 31 August 2008 is exactly 10 months after 31 October 2007. When the 2006 Act comes into force, 31 July 2008 would be the appropriate date.

Chapter 5

The risk-based approach to audit: audit judgement

5.1 Case Study 5.5 Cosmetics Company: Fine Faces Plc

Activity 1

We are sure that you will have seen that the cosmetics industry is in the fashion industry and that a major problem is the difficulty of assessing future fashion trends so that what sold well in the past may not do so in the future. For the auditor this can be problematic. At the extreme, if the company gets future fashion trends wrong, the whole company might be at risk of losing its going concern status. Even if this risk does not exist, the auditor might be worried that the company has stocks on hand that will prove to be unsaleable.

Activity 2

The most obvious control that the company would introduce and we expect you will have noted this, is market research to establish current fashion trends and to determine if planned company ranges are likely to go down well with a somewhat fickle public. The auditor would wish to find out from management how they conducted market research and how often. This might involve face to face interviews, questionnaires, and soundings with fashion leaders, the results of which should be subjected to analysis by company staff and a record made of the decisions taken. As changes in fashion may happen quickly, the company would have to ensure that it is kept informed of trends. The auditor will wish to determine that the process has been satisfactory and will examine the market research reports, minutes of market research committee meetings and directors minutes. A review of the trade press might also reveal whether the company had got it right or not. You would also be influenced by how successful Fine Faces plc management had been in forecasting fashion trends in prior years, and also if sales analysis enables them to determine trends. Remember that your prime objective is to determine if the control is working properly - with the objective of reducing control risk, but you might also be interested in advising management on critical matters.

At this stage, you are aware of the major business/inherent risk and the main control in force. However, being a good modern auditor you adopt an attitude of professional scepticism and ask management how they keep track of how well products are performing in the market place. You discover that the company prepares projections of sales and production at the beginning of the year, keeps monthly records of sales budgets per line and makes monthly comparisons of budgeted with actual sales. It is sometimes difficult to say what comes first - the chicken or the egg. Auditors might in practice make a comparison themselves for planning purposes to decide if inherent risk was high, but also to determine if controls in force were adequate. The audit programme might read: 'Obtain the budgets for year to date and compare with actual sales.' Any significant discrepancy between the two might reveal timing differences (sales turning up later than expected or vice-versa) but more seriously might reveal that the anticipated sales had failed to materialise.

Activity 3

Your immediate reaction might have been to go to the chief accountant and raise the matter with him or her. However, one of the basic rules of auditing is to be sure of your ground before you take any matter further. Here are some suggested procedures you might adopt:

1. Review the market research report again to confirm the company's view that this particular type and colour of lipstick would achieve good sales in the current year.
2. Examine the production reports to confirm that the product has been put into production.

3. Take a look at the stock records to confirm that the finished stock of this lipstick has been received in the stock room.
4. Confirm that the stock on hand agrees with the stock records.

At this point you can go to the chief accountant with information that backs up your previous concern that one of the products might turn out to be unsaleable. When you raise the matter, it will be almost certain that the chief accountant already knows about it. You may be somewhat concerned that you have not been told about it, knowing that integrity of management is important to the auditor. However, at this point it will be important for you to discover the background to the problem and what action the company is intending to take.

Activity 4

The main concern would be that you had failed to detect the problems in the buying and receipt of goods areas of the company, before you stumbled on it as the result of detection procedures in another part of your audit. There was, of course, failure also of company control systems in respect of purchasing and the inspection of goods on receipt. The worry would be whether this had implications for other production lines as well.

Audit actions as a result of identifying the control risks discussed above would be an expansion of audit procedures to ensure that detection risk was low, bearing in mind high inherent risk at the boundary (between the company and the outside world) and the high control risk at the same boundary. There are, of course, also internal boundaries, such as those between raw material store and the factory floor. Examples of procedures might include tests on quality of raw materials and finished goods, examination of correspondence between suppliers, customers and the company. The extent of your tests would depend on your judgment as to whether the breakdown in controls was a one-off breakdown or something more serious.

Apart from the audit risk matter that we have discussed we have also seen that the company's controls have failed to reduce the impact of an important business risk - that products manufactured will fail to meet the standard expect, thus ensuring that the company is failing to meet at least one of its objectives - an acceptable level of profitability. You have also discovered that management has failed to inform you of this important matter, so much so, that at the extreme you might wonder if you should seek reappointment as auditor. This means that we have come across another reason for adopting a business risk approach - to aid you in the decision as to whether you should accept appointment or to extend it.

5.2 a) *True*

The important thing is that both auditors and client are aware of, indeed have a full understanding of, the nature of the assignment and the rights and duties under it. The statement is, of course, only partially true. The fact is that both directors and auditor should sign the letter, the auditor at the time of sending the letter and the directors or their representative, at the time of returning it. There is no reason why the client should not send the letter in the first place, but normally it is better that it be drafted by the professional firm. It would, of course, be necessary to discuss it in detail with the directors before it is finalised.

b) *False*

There is much discussion about the auditor's duty with regard to detection of fraud and other errors and we shall discuss this in detail in Chapter 17. Basically, the auditor is required to focus on areas where there is risk of material misstatement because of fraud, including management fraud and to maintain an attitude of professional scepticism throughout the audit. However, The primary responsibility for the prevention and detection of fraud rests with both those

charged with governance of the entity and with management. (See paragraph 13 of ISA 240 - The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements).

c) *True*

The basis of charging fees must be such that the auditor is, and is seen to be, independent. The preferred basis for charging fees is time taken and grade of staff engaged. Recently there has been much more openness in setting fees with large firms tendering at fee levels considerably less than only a few years ago.

d) *True*

To some extent inherent risks, which form one component of audit risk, are similar to business risks in that they need to be subjected to management controls to alleviate their impact. Business risks are those risks that may make it difficult to achieve management objectives. For instance, an hotel might have a preferred room occupancy rate to achieve desired levels of profitability. We have already seen in this chapter that management may introduce management information systems on such matters as rooms currently unoccupied and peaks and troughs of occupancy. This information is a form of control and would be used to inform potential customers whether rooms are available and to enable them to put in a strategy to increase room occupancy at less busy times. For auditors, knowledge about how the company controls business risk in this area, would be an important element in work designed to prove that accommodation income appearing in the profit and loss account was true and fair in the context of the financial statements taken as a whole. However, inherent risk approaches are more limited than business risk approaches as they are directed to the financial statements in the context of the auditors' opinion on the financial statements. However, business risk approaches are designed to aid management in achieving business objectives, of which the preparation of fairly presented financial statements would only be one. Thus, it is true to say that a business risk approach by auditors is wider than the audit risk approach.

5.3 We described the role of the individual members of the audit team engaged on the audit assignment, including those providing specialist services such as tax advice, and administrative services, such as secretarial and typing services. The engagement team is defined in ISA 220 as 'all personnel performing an audit engagement, including any experts contracted by the firm in connection with that audit engagement. It is interesting to note that 10 people in John Gunn and Co are engaged in one way or another with the assignment, out of a total of 67 staff. You should re-read the pages referred to, but as you are doing so, remember that the whole activity must be organised to produce the professional service when it is required. It is quite likely, for instance, that there will be a partner in charge of the computer/IT services and of the taxation services. In preparing the audit plan, approaches will have to be made to the specialist services to ensure that their staff will be available when required. It will also be desirable that the person in charge of the typing services is aware of deadlines and other reporting requirements (for instance, complicated diagrams and layouts) on a timely basis.

5.4 Typical income in a company publishing a newspaper:

- Sale of newspapers: Office sales, Newsagent sales, Street sales
- Sale of advertising: Classified advertising, Block advertising (Prominent advertising of commercial and official material)
- Sale of photographs
- Games and competitions entered by the readership

Typical expenditure of a company publishing a newspaper:

- Newsprint
- Inks of various colours
- Sundry printing costs, including repair and maintenance of printing machinery
- In a company using the latest technology, we would expect to find both capital and revenue costs associated with the technology
- Salary and wage costs of: Editorial staff, Reporters, Photographers, Copy readers, Delivery people. Advertising department staff (including classified advertising staff dealing direct with the public, and designers and setters of larger advertisements), Administration staff
- Expenses connected with obtaining stories and photographs
- Distribution costs, including delivery van costs (petrol, servicing, depreciation of vans etc.)
- Payments to free-lance writers
- Payment of prizes to the winners of games and competitions.

Possible problem areas for management and auditor:

- Reporting on circulation of the newspaper to government or independent bodies. The average sales over a period of time represent actual sales (not print runs), so it is important to reconcile print runs with recorded sales. Typical reasons for differences between print run and quantities sold will be: copies given to editorial and other staff, free copies given to libraries and other organisations, copies not sold, either by own staff or newsagents. There should thus be control over copies returned for pulping. The auditor would have to find out if it is company policy not to charge newsagents for returned copies.
- Maintenance of circulation. This normally has a correlation with advertising and the auditor would find circulation and advertising statistics produced by management for their own purposes, useful sources of evidence.
- Control of advertising to the newspaper. Classified advertising consists of many hundreds of transactions each time the newspaper is produced. The control of advertising is complicated by the fact that there are often special rules where an advertisement is placed several times in the paper: 'One free for every three placed', for instance. Management will have to institute tight systems of control, not only to ensure that the advertisement appears in the correct form and in the desired issue of the paper, but also that the income has been completely and accurately recorded. The auditor will investigate the operation of the control system, but, like management, should be able to substantiate total advertising revenue on a global basis. Each page of classified advertising should be valued for each issue and reconciled to revenue. The auditor can do this sort of check on a test basis.
- Control over expenses of reporters, photographers and other members of staff will require the drawing up of detailed rules and internal checks to ensure that the rules are adhered to. The auditor would test the system of control to ensure it is working properly and check a selection of expense reports to ensure the expenditure has been incurred by the staff member, that the amounts are in accordance with predetermined rules and that they have been agreed by responsible officials.

This review of newspaper income, expenditure and management and control problems has touched upon typical matters and is not intended to be complete. What is important for the auditor is to understand how to approach audit assignments, even in unusual industrial and commercial sectors.

- 5.5 a) Failure by control systems to detect material misstatements in the accounts subject to audit will of course increase audit risk, but audit risk is affected not only by control risk, but also inherent and detection risk. The statement in the question was designed to help you to understand the nature of audit risk. As we made clear in the text, audit risk is a concept that has been receiving greater notice in recent years and it is important that you should understand its

significance. The statement is therefore incomplete. Control systems should be designed to mitigate inherent risk and the auditor should review control systems to ascertain whether they are likely to detect material error and irregularity deriving from inherent risk. Review and evaluation of control systems is necessary to determine detection risk.

- b) Cumulative client knowledge is all the continuing useful information about the Client Company, collected by the auditor during association with the company. Much of this information will be included in working papers and correspondence files, but some of it will be in the minds of people. Typical useful knowledge will include:
- Key personnel: details of position, experience and background; personality and management style
 - History of company, its position in the industry/commercial sector and its strategy to meet the problems of the industry
 - Products and their nature, major customers and suppliers
 - Particular audit problem areas and how the problems were solved in the past
 - Details of systems in use and the number of transactions they process during an average week/month/year.

All audit firms try to keep permanent records of cumulative client knowledge, by, for instance, requiring the senior to copy all matters of permanent interest from the current year's working file and correspondence files to a permanent file. Correspondence between the client company and the bank on new and stringent arrangements for control of the bank overdraft would be a typical item to be kept permanently. It must be said that keeping the permanent file up to date and uncluttered with irrelevant material needs considerable discipline on the part of the auditor, although this is probably easier where the audit firm is using computerised audit files. It is human nature to move to the next assignment without dotting the i's and crossing the t's on the previous one. That cumulative client knowledge is important is not to be doubted. To acquire knowledge is an expensive business, and if you are collecting the same knowledge year after year, you not only run the risk of upsetting the client staff, you also make the audit process much less efficient and profitable than it should be.

The other matter of importance is the question of effectiveness. The *raison d'être* of the external auditor is the professional one of giving an opinion on the truth and fairness of financial information. In attaining the professional objective, the auditor has to obtain sufficient, appropriate (relevant and reliable) information. If the audit firm has not maintained cumulative client knowledge properly in previous years it is likely that the auditor will be less effective in the current year.

- c) If the client does not understand the letter of engagement and can prove that the auditor did not explain it properly to them, the letter might indeed be said to be of little value. A court might well take the view that the auditor had merely produced a document to protect him or her and that the client had a legitimate expectation that the auditor had not fulfilled.

The letter of engagement should be seen as the document setting the scene for the future relationship between auditor and management. It should be relevant to the company being audited and should be discussed paragraph by paragraph with the client before signature. The client should have the opportunity to suggest amendments and to have any matter explained that is not understood. The statement in the question should be rejected.

Chapter 6

The search for evidence explained

6.1 a) *True*

The statement is true in itself, although it is incomplete. Auditors must clearly have enough evidence to form their conclusions. For instance, management might claim that the credit control department has checked all sales orders to ensure that the customer is likely to pay for goods and services ordered. Auditors may wish to satisfy themselves on this point and will test enough sales orders for evidence of credit control to ensure that the risk they have not been checked appears low. However, sufficiency of evidence is only one aspect. It is necessary also that it be relevant and reliable. It certainly appears to be relevant to ensuring within reason the credit worthiness of customers.

b) i) *True*

The dates that the chief accountant goes on holiday may well be relevant. For instance, if he or she exercises an important control function, care must be taken to ensure that, when on holiday, proper cover exists. The auditor might wish to test the holiday period in greater detail.

ii) *True*

The purchasing officer needs a file of recognised suppliers, when deciding who should supply goods and services to the company. As the list would need to be accurate for this purpose, the auditor would find it reliable in determining whether all liabilities have been reflected in the accounts. A typical audit question might be: 'I see that Runcorn Ltd is on your list of suppliers of Product X, but this company does not appear in the purchases record this year. Do you owe this company any money at the year-end?' Clearly, the list would be relevant as well as being reliable evidence.

iii) *False*

We have suggested that the statement is false and to the extent that the chief accountant went on holiday to one seaside resort last year and to another this year, it would not be particularly relevant. If, on the other hand, the holiday was more expensive and the chief accountant's general standard of living higher than salary would appear to justify, the auditor might wish to consider whether he or she might be misappropriating funds from the company.

iv) *True*

Debtor's credit limits may be very relevant evidence. If limits are much exceeded, for instance, this might indicate that credit control is inadequate and that more work will be required to prove that the debtors are collectible.

c) *False*

While vetting by company directors may add to the reliability of evidence (for instance, directors' comments on a legal claim against the company), care should be taken in accepting it too readily. Evidence originating from directors or controlled by them is not as reliable as evidence obtained from independent third parties or created by the auditor himself. It may, of course, be substantiated by evidence from other sources.

d) *True*

The written evidence from the bank manager is good evidence and is reliable because it comes from an independent and professional source. However, the bank manager might not be aware of all bank accounts owned by the company if they had been made secret by putting them in the name of a specified individual.

e) *False*

While written evidence from within the company is not of itself reliable because it comes from a dependent source, it comes from a very well informed source and if it is derived from sound systems, it can also be very reliable.

f) *True*

Consistency is the basis for upgrading audit evidence, as evidence corroborated by other evidence is strengthened. For instance, the signature of an employee in a personnel record will provide evidence that a payroll entry bearing the same signature is accurate, each signature adding to the value of the other. This, of course, would be dependent on the personnel record being held by individuals other than those preparing the payroll. This is an example of synergy or a situation where $2 + 2$ may equal 5. Conversely inconsistent evidence may result in evidence previously collected not being accepted as of value. Thus, if the company's lawyer suggests that on the basis of previous case law, the company has a good chance of defending successfully a case brought against it, this apparently good evidence may be nullified if a second lawyer contradicts the first view. The auditor would then have to seek further evidence to confirm or refute either view.

g) *True*

If the auditor physically inspects the fixed asset, quite clearly this will prove that it exists. The question of ownership, cost and value can only be answered by looking for other kinds of evidence, such as original invoice for the asset, its entry in the fixed asset register and valuers' reports.

6.2.a)

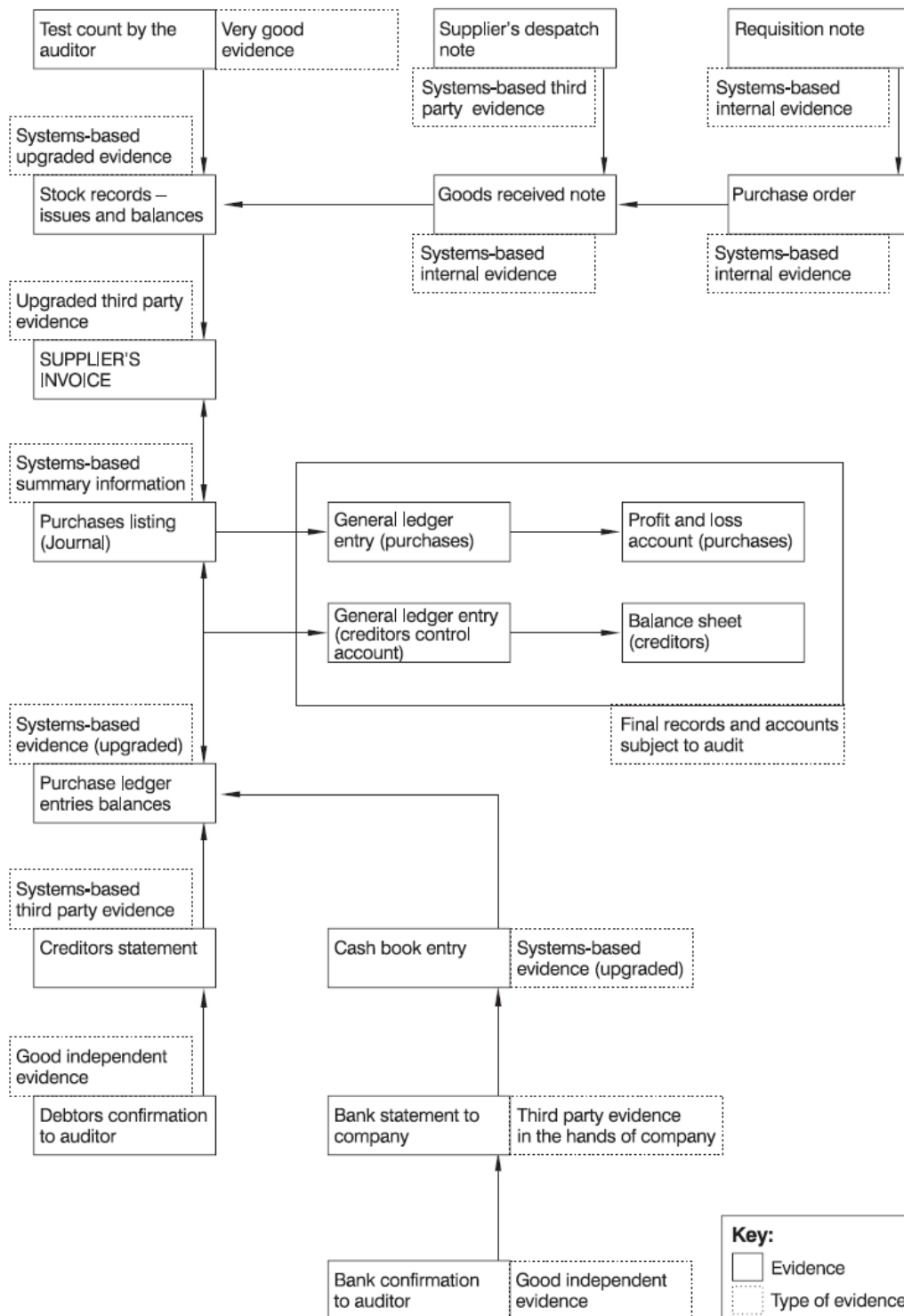


Figure 6.4 Oakshaw Ltd purchases and related creditors

- b) Figure 6.4 showing the Oakshaw purchases and creditors audit trail indicates the upgrading process and you should study it carefully. Remember the various rules we discussed in the text, to which you should refer if you have any difficulty.
- c) The brief answer to this question is that the auditor obtains satisfaction from a number of different sources. If the systems for controlling purchase transactions

is proved to be sound, this will give some confidence that the purchases figure is valid. Similarly, if the review of the accounts reveals nothing that is strange in relation to what the auditor knows about the company (that is, all the figures appear consistent with each other), this work can also support the purchases figure. Detailed matters of significance are as follows:

Systems: We are told that different people control the purchase and creditors records. We shall see later in this book that this is a very important control feature. Also the auditor's work has revealed that the records are carefully and properly controlled. Both of these conclusions will help the auditor to conclude that the purchases figure is acceptable

Review of accounts: The gross profit percentage in 2007 is 30% compared with 29% in 2006 and the auditor would discuss this trend in the company with management to determine if demand for the company's products is inelastic enough to allow increases in selling prices unaccompanied by increases in costs. The auditor should supplement this work by comparing the company's margins with those of competitors. If the increase in margin appears to make sense in the light of this work, the auditor would be more inclined to accept the figure of purchases, although other more detailed tests on the purchases figure would be necessary.

- 6.3. a)
- i) The chief accountant is a well-informed officer of the company. For this reason, evidence emanating from him or her is good evidence. However, he or she is internal to the organisation and the auditor would seek corroborative evidence that the statement is acceptable. For instance, if the auditor finds that sales forecasts indicate a higher level of sales in the coming year than in the year just ended, this might help to prove the chief accountant's statement.
 - ii) The storeman is again internal to the organisation and his statements should perhaps be viewed with caution. However, such officials are frequently a very useful source of evidence as they may be very well informed about a small segment of the company's activities and may, indeed, be much better informed about them than the chief accountant. For instance, the chief accountant may believe that stock control officials check physical stock against stock records at regular intervals, whereas the storeman knows that this is not the case. On the other hand, it must be said that often people in organisations are not aware of the whole picture so that care must be taken in evaluating statements made by them. For instance, stock control officials may carry out stock counts at night when the storeman is not on duty. It would therefore be necessary to corroborate the statements made by the storeman.
 - iii) An invoice from a supplier of electricity is a document in the hands of the company emanating from a third party. It may be regarded as a particularly reliable document for the following reasons:
 - Electricity invoices are normally issued at regular intervals during the year and can be easily compared with previous electricity invoices, although there is a possibility that they may be forged.
 - The electricity usage will be metered and meter readings can easily be tested by the auditor.Electricity charges may be corroborated in general terms by assessing general levels of activity.
 - iv) Invoices of the Telephone Company will support the telephone charges and these invoices are as reliable as the electricity invoice referred to above. The explanations for the charges being lower this year depends upon

whether they appear reasonable in the light of what the auditor knows about the company. For instance, if company sales are much lower because of a downturn in economic activity, telephone charges may be lower if they are correlated to sales. Analytical review of activity levels could thus help to corroborate telephone charges. Your view of the trainee accountant's ability may also affect the credence given to his statements.

- v) The letter from the lawyer would be regarded as good evidence in itself because it comes from an independent professional person and has been sent direct to the auditor. The main problem for the auditor is identifying which legal advisors the company had used. In particularly difficult cases involving perhaps complex legal matters, the auditor might wish to corroborate the opinions of the company's legal advisor(s) by seeking a second opinion.
- vi) The letter from the debtor is also good evidence, coming as it does from an independent third party direct to the auditor. We would be inclined to regard it as less reliable than that from the lawyer, however, for the reasons outlined in the text. Confirmations from debtors would not normally be the sole evidence sought by the auditor in confirming debtors balances and sales invoices. Other corroborative evidence would include all the supporting evidence detailed in Figure 6.2.
- vii) Most qualified auditors will have knowledge of taxation, although it is an area in which one may get rapidly out of date. Assuming that the auditor is a tax expert or has called upon expert help from within his firm, the computation of tax charge and liability would be reliable evidence for the auditor, especially if the computation is checked by others within the firm. Although the computation has been done by the auditor, it would be necessary to ensure that management was in agreement with it.
- viii) Stock count sheets are prepared as a result of a physical count carried out by company staff. If the system that the company has established to control the stock count is good and the auditor's observation has confirmed that the count has been properly carried out, the stock count sheets may be regarded as good evidence, particularly if supported by the auditors own count sheets (that would serve to corroborate the company's figures). Remember that stock count sheets prepared by the company are internal documents and may therefore be subject to manipulation.
- ix) The company requires the order book for its own planning purposes and in the normal course of business. Such evidence is better than evidence prepared on an ad hoc basis and may be used by the auditor for testing such matters as the saleability of stock. Provided that the auditor can corroborate its accuracy by reference to correspondence from customers, salesmen's' records etc., the order book may be good evidence.
- x) The estimate of useful life is a more difficult matter as it relates to the future and the future is notoriously cloudy. In itself the estimate by the production director is poor quality evidence, but it may be upgraded on the basis of past experience, manufacturer's specifications, experience of others in the industry and so on. Remember also that, within the company, the production director may be the best qualified to estimate the useful lives of production plant. The auditor should certainly discuss the matter with him or her.

- 6.4 i) The term '**interim examination**' is used for that part of the audit carried out prior to the year-end. Normally, the interim will be used to review and test the operation of systems and to test the accuracy and completeness of the recording of transactions. The results of this work and the conclusions drawn therefore will be used during the final examination in planning and in supporting conclusions on the final work. In the case of large assignments, there may be more than one interim examination, and indeed for very large engagements, auditors may be present in the company and its various locations throughout the year.
- ii) '**Final examination**' is the term given to the work on the accounts after the year-end. Note that in the case of small assignments, the systems, transaction testing and work on the final accounts are likely all to be carried out in the same period.
- iii) '**Inconsistent audit evidence**' is evidence that does not support other evidence, thereby downgrading it and rendering it of less value. It may reveal that the auditor has initially formed a view that is not sustainable. For instance, let us assume that you are auditing a roofing company, which makes provision for customer claims on the basis of 3% of turnover per annum. The auditors may have satisfied themselves that 3% is adequate on the basis of past experience, but a recent article in the trade press has suggested that rate of claims is likely to rise because of problems in the use of new materials. In this case the reliability of evidence based on past experience would be reduced because it is inconsistent with more up-to-date evidence.
- iv) '**Systems-based evidence**' is evidence that has been produced or influenced in some way by the accounting and control system in use by the company. For instance, a supplier's invoice which has been checked by company officials and stamped to indicate agreement with purchase order and goods received note has been checked by the system. A sound system of control tends to make such evidence more reliable.
- v) '**Third party evidence**' is evidence emanating from persons or organisations external to the company and therefore possesses the important quality of independence. It is usual to distinguish between third party evidence coming from:
- Professional people such as lawyers or other accountants
 - Non-professional people such as customers and suppliers
 - Third party evidence coming direct to the auditor such as a letter from a bank manager confirming a bank balance, and third party evidence in the hands of the company, such as the suppliers invoice referred to above.

On the whole third party evidence is reliable as far as the auditor is concerned.

- vi) The use of the term 'persuasive' in relation to audit evidence indicates that often (normally) the evidence collected by the auditor is not conclusive. For instance, if the auditor checks 10 items of stock on hand with the stock count sheets and finds that the sheets are correct in each case, this may well persuade the auditor that the stock count is being properly conducted and that the stock sheets are reliable. Auditors would, however, be very unwise to draw the conclusion that the stock count was 100% correct on the basis of their test. They may of course obtain sufficient confidence on the basis of the persuasiveness of the evidence in the context of tolerable error.

Chapter 7

Systems work: basic ideas 1

- 7.1 The definition of internal control shows why it is of importance to the organization. It is the process designed and affected by those charged with governance, management, and other personnel to provide reasonable assurance about the achievement of the entity's objectives with regard to reliability of financial reporting, effectiveness and efficiency of operations and compliance with applicable laws and regulations. It follows that internal control is designed and implemented to address identified business risks that threaten the achievement of any of these objectives.

Note its aims:

- (a) To ensure within reason that financial reports are valid and reliable
- (b) To ensure within reason, that operations are effective and efficient
- (c) To ensure within reason that applicable laws and regulations are adhered to
- (d) To address identified business risks that may threaten the objectives in (a) to (c) above.

The main elements (or components) of internal control are:

- (a) The control environment.
- (b) The entity's risk assessment process.
- (c) The information system, including the related business processes, relevant to financial reporting, and communication.
- (d) Control activities.
- (e) Monitoring of controls.

The reason that the auditor is interested in the effectiveness of internal control and its components is that good control systems reduce audit risk by mitigating the impact of inherent risk. The auditor's main interest, of course, is in determining that the financial statements give a true and fair view, and the existence of strong internal control within the organization will increase the likelihood that financial reporting is valid and reliable. If control risk is low the auditor will be able to reduce the amount of detailed substantive testing.

- 7.2 We saw in the text that the control environment can only be effective if integrity and ethical values permeate the organisation. However, they CAN be just meaningless words unless management makes sure that staff know what integrity means in the context of the organisation. For instance, management of an electrical retailer would effectively be saying to customers that goods purchased were safe to use. This would mean that statements about safety would have to be properly backed up by a proper testing regime. If not, the company would expect to suffer loss of reputation and to incur damages as the result of court cases. An example like this can show us that integrity and ethical values have a practical significance and are not just meaningless words.

As far as auditors are concerned, they have to decide if they can rely on company systems in achieving their own objectives, the main one of which is to give an opinion on the truth and fairness of the financial statement. Management is responsible for putting in systems and creating a control environment that will ensure that all of their objectives will within reason be met, including preparing financial statements that truly and fairly represent the results of the organisation and its state of affairs. If management possesses integrity and ensures that company staff are aware of the ethical values needed in the context of the company, the auditor will be more confident that the control environment and associated detail controls can be relied on. In this connection, there have been a number of well-publicised case of whistle-blowing by people internal to organisations, who have objected to the way that the organisations behave. Very often these objections are legitimate and organisations should have a

stated policy in respect of whistle-blowing, including a system that enables employees to discuss their misgivings to independent people within the organisation.

7.3 You might have preferred not to start from here, but rather to have been involved when the decisions were made to install the computer system. The key risks would be as follows:

- a) Physical risks affecting the microcomputers, the network server and the people operating systems. You might suggest to the managing director that he should ensure that physical equipment should only be used by authorised people and be kept secure particularly outside working hours. It might be useful to employ someone with basic computer skills to help staff when problems arise and to make sure that the server is working properly when needed. It might also be desirable to shut down the server out with normal working hours. This person might usefully draw up a code of conduct for computer users, including a restriction in the time that people sit at the keyboard.
- b) Risk that the system has not been developed properly in the first place. You should ask the managing director to see the documentation prepared at the time the system was developed, including any feasibility studies, documentation concerning the desired characteristics of the systems, and testing that was carried out, and by whom, prior to putting the system into use. You would be particularly interested in discovering if the bought-in software performs in the way expected, for instance, whether appropriate information/audit trails are recorded. Is double entry properly carried through in all cases? You should also ask what kind of training staff received at the time the system was introduced and what kind of ongoing training is provided. For instance, was staff informed of the need to respond to error messages, to keep passwords private, and to report bugs in the system.
- c) Risks of loss of programs and data. The managing director might be particularly concerned about loss of (say) debtors, creditors and stock records, and information used to manage the business. We are not told much about the system but we would recommend simple security measures, such as keeping back up copies of programs and data outside the operating areas, supported by the use of grandfather, father, son and dumping systems as appropriate. You should advise the managing director to establish degrees of access to data if this has not been done already, supported by the use of appropriate passwords. You might also suggest that one person keep master copies of programs and of back-up copies of data in a computer library, together with a booking in/out system.
- d) Risk that the company does not observe appropriate organisational controls. For instance, does the company have a system for allocating responsibility? Are duties appropriately segregated? You might reassure the managing director that in a small company where there is little computing knowledge among staff and where systems analysts and programmers are not employed there is a lower risk that people will interfere with the proper operation of programs.

Chapter 8

Systems work: basic ideas 2

8.1 a) *True*

ICQs are questionnaires designed to help the auditor to understand how an accounting and internal control system operates, as well as aiding evaluation. They are not always useful in complex systems.

b) *True*

This statement is also true. ICQs are not merely used to record the operation of systems; they are also used to evaluate the systems. ICQs are usually designed so that 'No' answers will indicate a weakness in the systems in use.

c) *False*

ICEQs, unlike ICQs, are not used to **record** the systems in use, but to **evaluate** using key questions, supported by subsidiary questions.

d) *True*

Accounting systems do not have to be sophisticated if the demands of the business do not require it. In the case of a small trading company, it is possible that the only records required will be an analysed cash book and invoice and bank statement files. You should not forget that the more complicated the accounting system, the greater the degree of expertise required to operate it. Many small businesses cannot afford to employ a trained accountant and rely on professional accountants to prepare accounts for them.

e) *False*

While it is true that sound systems of internal check based upon segregation of duties is often not possible in small companies, the internal controls may be good because of supervisory controls exercised by proprietors or owner directors. There may be problems for the auditor, however, as there may be no certainty that directors are not overriding controls.

f) *True*

In modern computer systems many actions are occurring electronically within the company's systems, which do not result in a flow of documents, so it is more useful to show how data flows through the system. Auditors use the diagram to prove the audit trail and to identify control points. This does not mean that document flow charts do not have a role, as documents are still produced both and after the computer.

8.2 As Ann Paterson is an established customer of the company, she would be able to identify herself and authenticate her status as a valued customer. She might already have given her credit card number and expiry date and an identifying word to the sales clerk before the order was processed. The clerk would either complete a hardcopy form or a form called up on the monitor screen. If the latter is the case, important controls would be (a) form design enabling easy completion (b) non-acceptance unless all fields on the form were complete. Further controls would be procedures to ensure that the clerk knows if the books are available and when they would be despatched, that calculated the amount of the invoice and compared Ann's credit limit with the outstanding balance, adjusted for the new transaction. The clerk would be prompted to inform Ann whether the order had been accepted, and if accepted, to read the terms of the order and amount of the invoice to her. The system should send a copy of the

accepted order to her, and, if not accepted, a letter detailing reasons for non-acceptance. Further controls would be numbering of the orders processed by the sales clerk and the preparation of control totals for all transactions entered by the clerk during the day (the clerk would also need to be identified and authenticated). We would expect sequence checking of orders entered by the sales clerk. Apart from these controls the auditor would be interested in the completeness of the information/audit trail (see answer to SAQ 4).

8.3 We made the assumption above that the sale was on credit. If so the following records would be affected by the transaction:

- (a) The transaction should give rise to hard copy documents - order form (numbered), despatch note (numbered) and sales invoice (numbered)
- (b) the following permanent records would be affected: sales transactions record (assuming that the company sells in its own name rather than on a commission basis); stock record (assuming that this company keeps books on hand rather than having them supplied by a third party); debtors ledger for transaction and amended balance
- (c) the information audit trail should include the following features: customer name, identification word, authentication and credit card details); clerk and terminal handling the transactions; confirmation of stock on hand requested by clerk; calculation of invoice; the sum of existing balance and transaction and comparison with credit limit; acceptance or non-acceptance of order together with reasons; record of order number; update of stock record (and despatch note number) and debtors ledger (before and after balances in each case) and invoice details including number and duration of transaction.

8.4 In this system the requisition is the computerised trigger that results in an order being prepared. So we have to ask: 'Who decided that goods should be ordered in that quantity - who input the master file data of minimum reorder levels and reorder quantities. We would also ask whether minimum stock levels and reorder quantities are reviewed at regular intervals and particularly when conditions change. Auditors would also wish to find out who decides which supplier is to supply the goods and who negotiates prices. This would lead to a number of subsidiary questions:

- 1. Is the person entering minimum stock levels and reorder quantities on master files independent of the buying department, stock room and computer operations?
- 2. Has that person received specific authorisation and is that authorisation checked at the time that the master files are updated?
- 3. Is the program tested from time to time to ensure that the trigger is operating properly?
- 4. Are minimum stock levels and reorder quantities reviewed regularly to ensure that they are at the appropriate level?
- 5. Are suppliers' prices, terms and qualities of goods compared periodically with those of other suppliers by persons independent of the buying department to ensure that the company is supplied with the goods that they require at optimal terms?
- 6. Are statistics kept of suppliers selected and are enquiries made if some suppliers are favoured over others?

You may have suggested other questions, but these give a flavour of the kind of subsidiary question that would enable the key questions to be addressed.

Chapter 9

Testing and evaluation of systems

Case study 9.1 Broomfield plc: Sales and debtors system: Suggested solution

1. There would seem to be a number of objectives, namely, to ensure that:
 - a) Customers receive the goods that they require at advertised prices and quality
 - b) Customers receive goods on credit only if they are likely to pay for them
 - c) Recorded sales are genuine, accurate and complete
 - d) Debtors' accounts are debited with sales on credit, which are genuine, accurate and complete
 - e) All cash received is recorded in full before banking
 - f) Stock records reflect genuine movements out in correct quantities
 - g) A full audit trail of transactions and impact on balances is maintained.

All of these systems objectives could be framed as audit objectives. This is the case, even for objective a) as satisfied customers are more likely to pay for goods received and less likely to make claims against the company.

2. We can identify the following control points:
 - a) Identification of customers when they interact with salespersons at the interface with the system. There may have been prior control procedures when a customer wishing to buy on credit supplied bankers references and private information. At the interface the salesperson may require the customer to provide private information (banks often ask, for example for letters, say, 4 and 6 of a password).
 - b) Identification of salesperson by entry of code
 - c) Check on the completeness of order forms, that is that all boxes have been completed before acceptance. The numbering of order forms and insertion of a code representing either a cash or credit sale are also control features, the former enabling a subsequent sequence check and the latter giving an indication to the cashier that cash will be paid or not.
 - d) Credit worthiness check by comparing adjusted debtors balance with credit limit. For this control to be effective, credit limits need regular review by the credit control department.
 - e) Signing of official sales order by both customer and sales person is also a control over accuracy of the order form.
 - f) The check by the cashier of the customer details at the point where the order form is received from the customer and the instruction to prepare the invoice is made.
 - g) The stamping of the invoice with PAID or CREDIT SALE indicates to personnel at the pick-up point that prior procedures have been properly carried out. The stamping of the invoice with a GOODS RECEIVED stamp would indicate that the goods have been transferred to the customer. The same control is in force when the delivery person takes the goods to the customer.
 - h) We are not given full information about certain matters but we would expect to see recording of all actions from entry at the interface to the entry in final records. In addition, data does seem to be available to allow sequence checks to be carried out (have we performed actions on all official orders issued) and for control totals to be checked for all transactions initiated by salespersons.

Some of these matters will also be covered on the ICEQ for Broomfield in 3, below.

3.

Broomfield plc Key and Subsidiary Questions: Sales system		
Stage or component	Subsidiary questions	Comment
Key questions 1. Receipt of sales order Are all orders received processed in such a way that keeps errors to a minimum in acceptance of the order, filling the order and in pricing, delivery and payment terms?	(a) Are the persons responsible for preparation of sales orders independent of credit control, of custody of stock and recording of sales transactions?	Yes, salespersons have no responsibility for credit control or for holding stock. They initiate sales transactions but do not cause sales invoices to be prepared
	(b) Are they responsible persons authorised to prepare sales orders?	Yes, and they are identified by personal codes
	(c) Are standard forms used to record orders in hard copy or on screen?	Yes
	(d) If not, is there a written record of sales orders in every case?	Salesperson keeps hard copies of sales orders and files sequentially
	(e) Are sales orders pre-numbered or automatically numbered by computer system?	Yes, numbered by program
	(f) Do the sales order clerks take steps to ensure that the customer is genuine?	New customers are required to give bank references and private information. The system checks the accuracy of customer details.
	(g) Do sales order clerks ensure that the goods ordered are available in quantity and quality desired?	Yes, salespersons can access stock files and other details such as lead times
	(h) Are up to date standard prices, delivery and payment terms provided for the use of sales order clerks?	Yes
	(i) Are special orders (special qualities, quantities, prices) authorised by a responsible official?	Not known, but special offers should be agreed by a responsible official who should enter details on master files.
	(j) Are sales orders prepared by one person checked by another or by computer program?	Yes, the computer checks for completeness of order form. We are not informed if there are other controls such as check digits and limit/reasonability checks. In addition, the customer signs the official sales order.
2. Credit control Are potential customers submitting sales orders checked for creditworthiness before the order is accepted?	(a) Is the credit controller independent of the sales order clerks?	Yes, see above
	(b) Are new customers wishing to buy goods on credit vetted for creditworthiness by reference to independent persons or organisations or by means of credit card?	Yes
	(c) Are orders from existing customers checked for payment record, sales ledger balance and credit limit?	Yes

(d) Are credit limits set by responsible officials on the basis of reliable data?	Not known, but they should be - and on a regular basis
(e) Is the credit approval evidenced on the sales order by the signature of a responsible official or by programmed code?	Not known but the fact that credit approval has been given should appear on the document. However, cashier does check credit rating independently of salesperson.
(f) Is the work of the credit control clerk checked by another?	Not known, but master file data like this is critical and such data should be checked periodically by an independent person.

4. The two stock matters that might cause concern for the auditor are:

- a) Some goods are sold below normal prices. If below cost, these goods in stock would need to be valued at net realisable value. The auditor would find out what the company policy was on loss leaders and how the company identified goods that might be sold below cost.
- b) At the year-end, the auditor might be concerned whether some goods on hand belong to the customer and not to the company. This would be the case if a sales invoice has been issued but the goods have not yet been delivered to customers or picked up by them. If the stock figure is taken from the stock records there would not be a problem, but if stock quantities are established by count, there might be. We shall look at this matter in greater depth when we discuss audit of stocks in Chapter 13, but at the year end we would expect the company to identify sales invoices where stock has not yet been given to the customer. The company may need to provide the warehouse with details of sales invoices issued to allow comparison with actual stock movements.

2. Case study 9.4 Burbage Limited Suggested solution

As well as commenting on application controls and other matters, we are, for the sake of completeness, commenting on development, organisational and security controls too.

General controls: Development controls

We do not have much information about development controls but we make the following points:

- a) The modification of software was made following informal discussions with user departments. No formal agreement seems to have been made after these discussions and the needs of user departments may not have been given proper recognition.
- b) Testing appears to have been carried out by programming staff only. Again the needs of users appear to have been overlooked. The tests should include tests of the whole system by user department staff and the manager of the user department should confirm agreement in writing. That some test results are available is, however, a strength.

General controls: Organisational controls

- a) User departments have insufficient control over data. The duty operator prepares the control totals and is solely responsible for investigating differences between computer-generated controls and the original totals. There seems to be a good case for salesmen to send in the orders together with a control slip containing document count, hash totals of quantities, stock codes and customer numbers, and value totals. Allocation of new customer numbers could be given to salesmen on request.

- b) There is no segregation of duties between systems analyst, programmer and operator. This may be because there are insufficient staff in the department, but an operator who is a skilled programmer might be able to stop the preparation of a sales invoice while allowing despatch of goods to proceed. As sales orders do not appear to be pre-numbered and leave the hands of sales order clerks without a control listing, there may be a serious lack of control. Generally, the ability to amend programs without authorisation is a weakness.

General controls: Security of data

- a) It is a good control that daily dumping of the hard disc files take place and also that a grandfather, father, son system is in operation. However, it would be better if backup copies were held in a secure place outside the building in which the computer is housed. If a fire were to occur in the building, the company might lose all its valuable computer-generated data.
- b) A good control is that only computer department staff are allowed to enter the computer room. The auditor would wish to know, however, how unauthorised entry is prevented (keys, password identification etc.)
- c) Satisfactory controls seem to be in existence for identification of magnetic tapes in the library and for booking in and out. But, a weakness is that no one person has control of the library control book as it is very easy to fall into sloppy habits and leave tapes and removable disks lying around the computer room where they may be damaged. At the very least Mrs Houndkirk should review the control book from time to time and check the computer room for orderliness.

Application controls: Input controls

- a) There is no validation of input data before computer master files (sales ledger and stock record file) are updated. That an exception report is prepared is a good control in itself but it is produced too late to avoid corruption of data. For instance, a sales order incorrectly entered produces an invalid invoice and/or an invalid stock record entry, which then has to be manually corrected and re-entered into the system in the next run. In the meantime the accounting records are incorrect. To prevent this there should be a validation run, during which edit checks on incorrect customer number, invalid stock codes, seemingly excessive orders etc are carried out and exceptions printed out for investigation and correction before the updating run takes place. The sales order clerks should be involved. This would avoid much of the messy correction procedures that are taking place at the present time (See note 8 in the flowchart).
- b) The same applies to the authorisation procedures. That a check for balances exceeding credit limits is made by the computer is satisfactory. Much trouble would be avoided, however, if the sales order clerks were to access the sales ledger file at the time the order is received and to obtain permission to process from a responsible official (say, Mr Moscar) if credit limits were to be exceeded following processing.
- c) As mentioned above computer operators batch sales orders instead of the user department. This is bad practice as is the failure to take full advantage of the control total technique. (Hash totals are not prepared for customer number, stock code, nor is a value total prepared.

Application controls: Processing controls

Run to run controls seem to be in operation as trailer labels and header labels exist and there is manual identification. This is assuming that control totals for the disk file are produced at daily dumping and that a responsible official (Mr Moscar?) compares father dump with son dump and reconciles them with the use of the control sheet for the current day's run.

Application controls Output controls

The distribution of output would appear reasonable but we do not have enough information to be certain about this.

Other matters

- a) It is bad practice for warehouse staff to count stock on their own. Stock control should be involved to ensure that stock is properly safeguarded and that the stock records are accurate.
- b) Sales despatch notes are sent to despatch before checking of the sales invoice listing and sales invoices by the sales order clerks. This may mean that goods are despatched in error. As we mentioned above the current system for correction of errors is very weak.
- 3 In practice we would have more information about the company, but on the face of it the following areas are of low risk:
 - Fixed assets. There has been no movement on fixed asset cost and accumulated depreciation has increased by 10% of cost. Provided that you are satisfied that this is in line with company policy you might decide to little systems work in the area, restricting yourself to checking significant fixed assets visually.
 - Petty cash appears to be very insignificant and you would probably do no work in the area.

Other balances appear to be much higher risk as can be seen from a significant reduction in gross profit percentage and significant increases in stock, debtors, and creditors days. These changes would require the auditor to direct work to testing the system in use for ensuring that cut-off is accurate and that sales and debtors, and cost of goods sold and creditors are genuine, accurate and complete. The auditor would also wish to ensure that the system in use for determining physical stock and for arriving at appropriate cost and net realisable value is satisfactory.

Chapter 10
Substantive testing, computer-assisted audit techniques and audit programmes

10.1 a) *True*

Tests of control are tests directed towards checking the operation of systems. The objective of using them is to prove that the auditor's assessment of control risk is proper.

b) *False*

While the **role** of substantive testing differs from that of tests of control in that it is directed not towards systems but towards proving that transactions and figures are completely and accurately recorded, the **nature** of the tests may be very similar. Thus, selecting goods despatch notes to prove that the entry to stock records is accurate may be used in both compliance of the stock movements and purchases system and in substantive testing to prove that stock records and purchases are complete and accurate.

c) *True*

Audit programmes should be tailor-made to the circumstances of the particular organisation. For instance, if the auditor discovered that credit control procedures were weak, the audit programme should emphasise steps to prove collectability of the recorded debtors.

d) *False*

Audit programmes give effect to the scope decision and therefore must be drawn up after the scope decision has been made.

e) *False*

The purpose of directional tests are to test for over- and under- statement of transactions or figures or balances and such tests should therefore be regarded as substantive tests of details.

10.2 Audit software could have been used in the following manner. We have assumed that the software contains a random number generator.

Programme step 3:

- a) The sequence of purchase orders could be checked by computer software that could also make a random selection of these orders. It could marry the selected purchase orders with the related goods received note.
- b) The software could make a random selection of receipts in the stock records and compare with goods received notes.

Programme step 4:

The software could check the sequence of goods received notes.

Programme step 6:

The software could select the goods received notes randomly and compare with purchase order, stock records and recorded purchase invoices, assuming that the record of invoices contain quantity data.

Programme step 8:

The purchase invoices could be compared with entries in the purchase day book and purchase (creditors) ledger.

Programme step 9:

Creditors' balances could be selected randomly.

10.3 Major matters to be considered for inclusion in audit programmes for restaurant income of The County Hotel Limited received in cash include the following:

Much of this income, particularly that relating to non-residents, is likely to be in cash, but some will be on credit. It is likely that residents will ask for meals to be added to their bill. A particular problem for the auditor is the large number of different meals available in the restaurant in circumstances of poor portion control. Portion control is the procedure to control the amounts placed on each plate and the related costs. Auditors should establish the 'normal' relationship between restaurant costs and income. Clearly, if portion control is poor it will be difficult to control restaurant costs and there may be no constant relationship between costs and revenue. This problem may be greater if temporary staff are employed, as is often the case in restaurants. The auditor's interest is to ensure that restaurant income is accurately and completely recorded.

Programme step: Refer to restaurant costs and income work programme and confirm that our work has enabled us to conclude that such income is fully and accurately recorded. The audit programme in the restaurant income section should include the following steps:

- a) Review restaurant income for the year to date and the corresponding period last year and enquire into any significant changes in total income and table usage. The actual and potential effect of the new chef should be discussed with management.
- b) Using management information and statistics, discuss with management the reasons for any changes. In particular, the effect of any policy change by management on table usage should be noted. Enquiries into the correlation between restaurant income and accommodation income should be made in conjunction with the accommodation income work.
- c) Review management estimates, showing that restaurant capacity break-even point is 55%.
- d) In view of poor portion control, discuss with the head cook and headwaiter (independently of each other), the average quantities of food used per plate for popular selected dishes. (But note that portion control is now said to be more effective than in the past).
- e) Check the numbered menu in the restaurant (for breakfast, luncheon and dinner) to the computer master file, ensuring in particular that standard prices are accurate.
- f) Check: that:
 - i) Waiters' pad copies agree with cash desk and accounts copies and have all resulted in the preparation of invoices
 - ii) The total of the invoices issued for cash on selected days equal the amount recorded in the restaurant cash till and cash book.
 - iii) All entries, including price, on the waiters' pads agree with the master file menu details.
 - iv) Waiter's pad copies agree with kitchen copies

- g) Check that kitchen costs as recorded appear reasonable in relation to restaurant income.
- h) Perform purchases depth test on food orders, deliveries, invoices (matching operation) and subsequent recording in purchases record.

10.4 Suggested audit conclusion on the purchase of fixed assets

On the basis of the work performed on the purchase of fixed assets as set out in the fixed assets audit programme on working paper **F100**, as supported by working papers **F101** to **F105**, I can conclude that, within reasonable limits, all purchases of fixed assets in the period from 1 January 2007 to 30 September 2007 have been fully and accurately recorded and that such purchases have been made on the basis of properly prepared budgets duly authorised at appropriate levels within the company. The audit programme was prepared on the basis of scope decisions recorded in working paper **F10**, supported by systems notes in the permanent audit files (Section **F**).

Chapter 11 Sampling and materiality

11.1 (a) *False*

The use of statistical sampling requires the auditor to make judgements about the level of confidence, estimated error rate or amount and tolerable error rate or amount to use when performing statistical sampling tests. The use of statistical sampling does, however, result in auditors quantifying and making visible their judgements on the items mentioned in the previous sentence.

(b) *False*

Tolerable error is the maximum error the auditor is willing to accept in the population without considering revising the confidence limit or extending audit testing. The level of error the auditor anticipates will be in a population is called the expected error rate or amount.

(c) *True*

The use of monetary unit sampling allows the auditor to extrapolate from their sample results to the population and obtain estimates of the most likely error and maximum error or upper error limit in the population.

(d) *False*

The auditor uses the concept of materiality at the planning stage, the testing stage and at the end of the audit.

(e) *True?*

We have said true, with a question mark, to this because normally the monetary value of an item will be the most important factor influencing its materiality. However, there are other aspects, such as the nature of the item, which also influence materiality. For certain items, such as, directors' remuneration the crucial factor influencing why it is material is because it is a specific statutory requirement that it be accurately disclosed in the financial statements.

(f) *True*

The level of profit a company has earned during a year is an important influence on the materiality level set by auditors. It is important to stress that it is not the only factor. There are a number of other factors which influence the level of materiality, for example, the net assets and turnover of the company and when considering individual account balances their nature.

11.2 (a) Three situations when the auditor would be unlikely to use sampling techniques are:

- (i) When the population is very small it is practical for the auditor to examine all the items in the population. It may also be more cost-effective. This is because the time it may take the auditor to design and implement a sampling strategy may outweigh the additional time they spend checking all the items rather than a sample.
- (ii) When individual transactions or balances are material they will usually be automatically tested by the auditor as a matter of course and therefore not be subject to audit sampling techniques.

- (iii) Where the company's records are held in such a way that it is impossible to identify the population, it may be more convenient and cost-effective for the auditor to use alternative audit procedures to verify the account balance or transactions.
 - (iv) Where items are specifically identified as high risk, they may all be checked. An example would be the items included in a computer generated exception or error report.
 - (v) Where auditors have obtained evidence to suggest that some form of fraud may be occurring, they may carry out a complete check of specific types of transactions or balances where they believe the fraud may be taking place rather than checking a sample of those transactions or balances.
- (b) (i) Attribute sampling is commonly applied in compliance testing where the auditor is testing whether a company's control procedures are implemented properly. From the sample selected auditors are concerned with identifying whether for each item in the sample the control has been applied or not. Thus the auditors are essentially concerned with identifying two attributes relating to the control procedures; YES! - the control has been applied, or NO! - the control has not been applied. In applying attribute sampling to internal control procedures the auditor's objective is to determine the likely error/deviation rate and upper error/deviation rate in the population. From these two figures the auditors can decide whether the amount of confidence they have in the control being tested is justified or whether they need to revise their estimate of control risk. Attribute sampling can also be used to estimate likely error in account balances and indeed the statistical foundation of it forms the basis of monetary unit sampling.
- (ii) Monetary unit sampling is used to provide the auditor with an estimate of the most likely and upper error limit in monetary terms which may exist in an account balance. The auditor can then compare the upper error limit with the tolerable error and decide on an appropriate course of action. This course of action will depend on whether the upper error limit is less than or in excess of the tolerable error. The auditor may also be influenced by how close the upper error limit is to the tolerable error. In this form of sampling the population is assumed to consist of £1 units and the auditor selects a sample of those £1 units. The auditor does not actually audit the £1 units selected but the balance or transactions associated with the individual £1 units. The auditor then tests the balances or transactions to see if they are correctly stated. For those not correctly stated the auditor calculates for each the level of tainting, defined as 'the percentage of error in the account balance or transaction' and is calculated by dividing the amount of error by the book value of the item. The percentage of tainting found in the individual balances are then summed to give an overall tainting percentage. Using this in conjunction with the average sampling interval and appropriate reliability tables the auditor can then calculate the most likely error and the upper error limit.
- (c) The factors auditors consider when determining the size of a sample are:
- The expected error rate or amount in the population. This would depend among other things on the effectiveness of the internal control system, the results from other related audit tests and the auditor's results relating to testing this internal control in the previous year's audit.
 - The confidence level used by the auditor. This would depend on the auditors' assessment of inherent and control risk over the internal control or account balance being tested, the degree of assurance the auditor has gained from other audit tests of the same (or related) internal controls or

account balances, and the materiality of the account balance or the importance of the internal control being tested

- If the population is stratified this would also influence the sample size. Normally stratification results in a smaller sample sizes.
- (d) Although the question does not state what is meant by 'enhance' it is probably safe to presume that it means quality or reliability of the evidence has been improved. In a question of this sort students should attempt to give a balanced answer including, where appropriate, both arguments for and against the proposition that using statistical sampling will enhance the quality of audit evidence. It may be argued that the use of probability theory and the requirement that the auditor specifies their confidence level, expected error level and so on enhances audit evidence. The use of random selection methods does reduce the possibility of bias in determining the sample and this is likely to increase the reliability of the audit evidence. In addition, it may be argued that quantification of the results of the sample enhances the audit evidence. The use of a systematic and statistically based method is also likely to improve the consistency with which audit sampling is conducted. It must be reiterated, however, that the results of the sample and hence the evidence obtained will be influenced by the auditor's judgement in relation to the aspects mentioned above. Thus, if the auditors' judgement of these aspects is faulty the use of a statistical sampling method will not of itself compensate for the inappropriate judgement. It has been suggested that in non-statistical or judgmental sampling the auditor can use their instinct in determining the size of the sample and sample selection and this can be more effective in identifying errors and misstatements and hence producing reliable evidence than mechanically applying statistical sampling methods. Adherents of statistical sampling would obviously disagree that statistical sampling reduces the scope for using the auditor's instincts. It also needs to be stressed that audit sampling is only one form of audit testing. Depending on the circumstances it may not be the most cost-effective method of obtaining reliable audit evidence.

Finally it should be mentioned that statistical sampling only enables the quantification of sampling risk. Like other audit testing it does not control for non-sampling risk. Thus, if the statistical sampling tests are poorly conducted by audit staff they will not produce reliable audit evidence. It may also be considered that the very fact of quantifying sampling risk may obscure the existence of non-sampling risk. As with other audit tests, non-sampling risk can be reduced by the audit firm instigating good training and review procedures.

11.3 Leslie Ltd has had a steadily increasing trend of profits.

The £5,000 adjustment would, however, cause the straight x line to bend downwards as shown by the dotted line and this may be an indication that it will flatten more in the future. This is a matter that should make you think. The £5,000 represents 2.5% of net profit as stated and you might argue that it is not material to the view given by the draft accounts. However, the downturn of the straight trend line might make it necessary for the accounts to be adjusted if a true and fair view is to be given.

11.4 The case of Leven Ltd gives a chance to consider the principle that disclosure of circumstances in the notes to the accounts may not be enough to cause the accounts to give a true and fair view. What the directors are proposing needs further appraisal. Are they really suggesting that:

- (a) The profit and loss account and balance sheet figures are not true and fair in themselves; but that
- (b) If readers take information in the notes to the accounts *and makes the necessary adjustments themselves*, they will have been given all the information necessary to make proper decisions and that, therefore, the accounts taken as a whole will give a true and fair view?

It seems unlikely that a rational person would agree with them. The amount in question (£30,000) is clearly material, at more than 15% of stated income and more than 5% of stated debtors. In these circumstances the auditor would have to explain that an adjustment to the financial statements should be made if a qualification of the audit opinion were to be avoided.

Chapter 12

Final Work: General Principles, Analytical Review of Financial Statements, Fixed Assets and Debtors

12.1 (a) *True*

Condition must be considered in respect of any asset. Thus, an item of stock or equipment should be in a condition to be sold or used within the organisation. A debtors balance should be valued in the financial statements at the lower of its monetary value recorded initially in the accounts and its realisable value (being the recorded amount less bad debts provision). A debtors balance against which a provision of this nature has been made is clearly not in good condition. The auditor looks for evidence of collectability by assessing the 'condition' of debtors balances. Even cash can have a condition that renders it of less value. Consider a company having cash balances in a country that forbids remittances or taxes remittances to the company's home country.

b) *False*

The analytical review is only one of several forms of substantive procedure. Normally, it will not stand on its own but will be interpreted in the light of other evidential matter. Lack of variation from prior years may cause the auditor to enquire further if variations were expected.

c) *True*

Analytical review can be a substantive procedure, the objective of which is to substantiate transactions and figures and the analytical review will aid the auditor in this respect.

d) *True*

Planning feedback is the term used to indicate the alteration of original plans because of changes in circumstances or of events unexpected at the time the plan was originally conceived.

e) *False*

This is an incomplete statement. Authorisation is an important procedure to ensure that recorded transactions are genuine, but it is only part of the story. Thus approval of purchase orders is an important control, but proof is also needed that goods have been received in the quality and quantity required and that purchase invoices agree with orders and goods received notes. 'Genuine' in this case means that a recorded purchase represents real goods or services received, in other words that a real event has caused the purchase invoice to be prepared.

12.2 (a) Programme for audit of fixed asset additions:

- (i) Discuss acquisition policy with senior officials.
- (ii) Compare fixed asset additions with fixed asset budget on a global basis. Enquire into any major variation between budget and actual additions in total.
- (iii) Select all additions to freehold land and buildings and additions to plant and machinery and motor vehicles on a random basis and trace to:
 - Fixed asset budget
 - Purchase invoice

- Suppliers despatch note
 - Goods received note
 - Documents of title (such as land and building title deeds).
 - Fixed assets register
 - Entry in general ledger account
- (iv) Check that fixed asset budget has been properly authorised by appropriate authority.
- (v) Consider the propriety of capitalisation of each item selected.
- (vi) Peruse the repairs and maintenance listings and check revenue nature.
- (b) Programme for audit of fixed asset disposals:
- (i) Discuss disposals policy with senior officials
 - (ii) Consider the disposal procedures used, such as auction and selection by management of long-standing customers
 - (iii) Check that major disposals have been authorised, if necessary by the board of directors.
 - (iv) Trace major disposals to:
 - Sales invoice
 - Goods despatch note
 - Cash book or sales day book entry
 - Sales ledger entry (if any)
 - General ledger entry
 - Fixed asset register (removal of entry)
 - (v) Enquire into any material profits or losses on sale and satisfy yourself that these are in order.
- (c) Programme for audit of fixed assets at 31 December 2007:
- (i) Perform analytical review and identify areas requiring further investigation and testing
 - (ii) Check that opening balances have been brought forward correctly
 - (iii) Check reconciliation between fixed assets register and fixed assets accounts in the general register and enquire into any discrepancies.
 - (iv) Enquire into the results of the company's own inspection of fixed assets and reconciliation to fixed assets register. (This will help to determine the number of tests the auditor will make).
 - (v) Select major assets from the fixed assets register and physically inspect them, noting condition and whether in use.
 - (vi) Select physical pieces of equipment and motor vehicles and trace to the fixed assets register.
 - (vii) Check ownership where possible to evidence of title
 - (viii) Check revaluation of freehold land and buildings to the valuer's certificate, and check that the valuer is of good repute and has valued on existing use basis. If possible check valuation to similar properties in the neighbourhood.
 - (ix) Check that disclosure has been properly made in the fixed assets note supporting the fixed assets entry in the balance sheet.
- (d) Programme for audit of depreciation charge of the year
- (i) Determine the depreciation policies of the company and check on a global basis that the depreciation charge appears to be reasonable.
 - (ii) Obtain the company's reconciliation between depreciation recorded in the fixed assets register and the charge in the profit and loss account. Enquire into the reasons for discrepancies, if any.
 - (iii) Reconsider useful lives of selected plant and machinery by discussing

with management and production staff.

- (iv) Review the fixed assets register to determine if any assets are in existence with written down values at or near zero. Discuss these specific cases with management and consider whether assets should be restated.
- (v) Select assets from the register randomly, both existing and new, and test calculation of depreciation, taking into account the stated rate for the asset and the policy on additions.
- (vi) Check that depreciation note has been properly stated.

12.3 Request for confirmation of a debtors balance:

Sterndale plc
27 Andrews Street
RUFFORD

A Adams
36, Muir Street
CARLTON

Dear Sirs,

In connection with their audit of our accounts, our auditors, Messrs John Gunn and Co., 57 High Street, RUFFORD wish to obtain direct confirmation of your indebtedness to us at 30 November, 2007, which according to our records amounted to £1,100.

We should therefore be grateful if you would confirm direct to our auditors using the enclosed pre-addressed stamped envelope that you are in agreement with the stated balance or to report details of any differences by completing the attached slip. We enclose a copy of a statement to aid you in agreeing the balance. Please do not send any remittance with your reply.

We should appreciate an early reply to this request.

Yours faithfully,

Name and designation

From: A Adams
36, Muir Street
CARLTON

To John Gunn and Co 57 High Street RUFFORD

We confirm that the balance of £1,100 shown on the attached statement is in agreement with our records.

We cannot agree the balance of £1,100 shown on the attached statement for the reasons indicated below:

(Please delete as appropriate)

Signed..... (Title or position)-----

Notes:

- (a) This is a positive confirmation request, so that a reply is required whether in agreement or not. A negative confirmation request only requires a reply if the recipient disagrees with the balance.
- (b) The debtor is given both the balance and its composition. This is a common procedure but you might argue that it would be better not to give these details in case the balance in the debtors books is higher than the client has indicated. There is some force in this argument but as a practical matter a larger number of replies is likely the more information is given.
- (c) The request is from the client and not the auditor because the business relationship is between client and customer.
- (d) The stamped pre-addressed envelope is enclosed to increase the likelihood of reply and to ensure the reply is returned direct to the auditor.
- (e) Remember that should the debtor send a remittance to the auditors they should immediately forward it to the client
- (f) The title or position of respondents is required to judge whether they have the requisite authority.

12.4 i) The following items are likely to bear a direct or partially direct relationship to sales of a manufacturing concern:

- Commission to sales personnel (normally bearing direct relationship to sales on commission)
- Distribution expense, except to the extent that there is a fixed cost element

The following are not likely to be directly related to sales, although there may be some relationship:

- Administrative expense (normally containing overhead unaffected by sales levels).
- Bank interest (This is a finance expense not normally directly related to sales, although if turnover is expanding rapidly additional finance may be required to finance expansion).
- Royalties payable for use of a production process (If royalties are paid on the basis of product sales, the relationship would be a direct one. In this case, however, they are related to production and not to sales, although there might be a relationship if production was made to order or if finished stock levels were constant).

ii) The following are likely to bear a direct relationship to cost of production of a manufacturing concern:

- Cost of fixed assets in use (Depreciation of production fixed assets will be an element of cost of production and bears, therefore, a direct relationship. However, there are many more costs in cost of production than depreciation and you would need to analyse the cost of production figure to establish whether the depreciation charge seemed reasonable).
- Stock levels (Stock levels of raw materials and components are likely to be determined on the basis of production needs and the relationship is therefore a direct one. Levels of finished goods are more likely to be related to sales needs).

The following are not likely to be directly related to production cost:

- Trade debtors (Related to sales)
- Loss on disposal of factory equipment (This loss is likely to be affected by the market for second- hand equipment and the skill of the person disposing of it).
- Directors' emoluments (The production director's salary is likely to be a component of production cost and there may be a direct relationship if his bonus is production-related but directors' emoluments generally are not likely to bear a relationship to cost of production).

The following are likely to bear a direct relationship to Gas company income:

- Number of units of gas sold
- Temperature in winter months (This will tend to cause a higher rate of consumption of gas and have a direct bearing on income. However, cold weather in January and February may not have an effect until March or April, when the gas usage is billed to customers).
- Electricity company prices. (Electricity is an alternative energy source to gas and the price charged to the consumer may, therefore, have an effect on gas prices and on income of a gas company. The price of energy is often a matter of political significance and the gas company may feel it necessary to keep its prices in line with other energy sources, even if consumers are tied to the company because of (say) investment in gas central heating.

It is not likely that the total number of employees will in the short run have a relationship to income from gas sales, as most employees will not have a direct role in generating income.

Chapter 13

Final work: Specific problems related to stocks, long term contracts and trade creditors

13.1 a) *False*

The omission of a short-term liability from the balance sheet will cause liabilities to be understated, and the company will appear more liquid than it really is.

b) ?

The auditor's search procedures are designed to prove that trade creditors are complete, so the statement is true as far as the auditor is concerned. However, management may well have formed this conclusion earlier as a result of their own procedures to ensure that all liabilities, including trade creditors have been detected.

(c) *False*

Cut-off is usually regarded as a completeness matter as it is one measure to ensure that all trade creditors have been identified at the balance sheet date. Of course, it is also true that cut-off procedures will be designed to prove that trade creditors represent genuine transactions and that they are accurate. (Accuracy basically means that trade creditors consist of items whose valuation reflects such matters as proper pricing and calculation of invoices and changes in foreign currency exchange rates.)

d) ?

Generally it is not permissible to include administrative expense in the valuation of stock at cost as such expense is not directly related to current production or to getting the goods for sale to their present condition and location. However, it may be difficult to decide in practice how costs are to be classified (for instance as production overhead or administrative expense). Note also that in certain circumstances it may be permissible for administrative expense to be included in overheads (where, for instance, a large project is using a significant proportion of the company's resources).

e) *True*

Judgment has to be exercised in many accounting situations and long-term contracts are no exception. Sometimes judgment is about the genuineness, accuracy and completeness of accounting records, such as the allocations of costs to individual contracts, but frequently judgment has to be exercised in relation to accounting estimates. An example from long-term contracts is estimated costs to be incurred in completing the contract. The auditor has to identify the points where management exercises judgment, as it is at these points that management is asserting that accounting treatments are valid. As we made clear in the text, these assertions become audit objectives that set the scene for the efficient and effective evidence search.

13.2 Computer controlled warehouse

The auditors are faced with an unusual situation where technology is being used to do a task formerly performed by human beings. The first task of the auditors would be to find out how the company satisfied itself that the goods in the warehouse were in existence and in good condition. It may be, for instance, that the company withdraws complete stocks of goods on a rotation basis for test checking. If the company does

this, the auditors should enquire into the results of the counts and any other investigations the company carried out into discrepancies between count and stock records.

The auditors would also wish to ascertain that the system for controlling stock movements was satisfactory. For instance, they would wish to find out if movements could only take place as the result of properly authorised documentation and if there was segregation of duties between computer operations, custody of goods and stock control.

The auditors may decide that a test count will also be appropriate, in which case arrangements should be made with top management for them to be provided with proper authority (The auditors may decide to do this on a surprise basis). The test count should be carried out by company personnel in the presence of the auditors, immediate comparisons made with stock records and investigation of differences conducted.

13.3

(a) *Stock determined by count*

At the time of the stock count the auditors would have noted that the last despatch note number was 1460 and would test that sales attributable to that and prior numbers were recorded in 2007 and to subsequent numbers in 2008. The following adjustments would be required:

1457	Add to sales in 2007	+ 12,550
1460	Add to sales in 2007	+ 6,000
1461	Deduct from sales in 2007	- 5,600
1464	Add to sales in 2007	+ 5,995
		<u>+ 18,945</u>

In making the above calculation we have assumed that stock despatched on 31 December 2005 has not been included in stock. The auditor would enquire into this. The journal entry would be:

	Dr	Cr
Debit trade debtors	£18,945	
Credit sales		£18,945

The effect of this adjustment would be to increase profit by £18,945. The auditor would wish to determine why sales despatch note number 1464 had been used to record a movement at 31 December 2007. If it transpired that the movement had occurred in 2008 the sales and debtors would be increased by £18,945 less £5,995 = £12,950

(b) *Stock determined from stock records*

The stock records will have been updated for transactions up to and including 1460, dated 31 December 2007. Stock records should be adjusted to include despatch note 1464, assuming the movement was genuinely in 2007. The sales record should be amended to record 1457, 1460 and 1464 in sales of 2007 and to remove 1461 from the sales record. Cut-off adjustments are identical to those required for stock determined by count. Cut-off must be tested whether stock is determined by count at the year-end or taken from the stock records.

(c) *Sales/stock cut-off.* Cut-off should be tested to ensure all sales in the year have been recorded in that year and that no sales in the subsequent period are included. A useful procedure would be to record the last stock despatch note number for

subsequent matching to sales invoices. A suitable substantive test would be to select a number of despatch notes before the critical number and ensure that sales invoices have been prepared and recorded before the year-end. This is an important completeness test because it helps to ensure that all the sales had been recorded and in the correct period. Of course the test would also help to prove that the sales transactions are genuine because it will show that a genuine movement of goods to customers has occurred. Further, comparing the quantities on the despatch note and invoices will be an accuracy test. A selection of despatch notes after the year-end should be checked to sales invoices to ensure they are included in the following year. Tests may also be performed from invoices to despatch notes to ensure that a despatch note has been raised for each invoice issued. We looked at this in some detail when we discussed stock count procedures earlier. The auditor should ascertain that a responsible official is given the task of considering cut-off matters at the time of the stock count. Sometimes the company may have a system of continuous stocktaking throughout the year, taking year-end quantities from stock records. This is acceptable provided that stock records can be shown to be accurate. Accurate cut-off must be established at the time of count AND at the balance sheet date.

- 13.4 Powerbase plc. The gross profit percentage at 53.64% is much higher than the previous year, and is some three percentage points higher than at 30 November 2006 (See comments on case study 9.2), so it may be that many liabilities remain unrecorded. This conclusion is supported by the higher number of days that stock bears to cost of sales at 31 May 2007 (84 compared to 75 for the previous year), which suggests that stock may have been received without a corresponding purchase being recorded. You will remember that we decided at the interim that delay was occurring in recording liabilities and at the final examination we should direct particular audit effort to testing for unrecorded trade creditors. Interestingly, the relationship between trade creditors and cost of sales does not provide a warning signal. Appropriate programme tests at the year-end would include the following:

Assertions to be tested:

All trade creditors are properly recorded in the accounting records (all purchases of goods and services have been recorded.)

Trade creditors represent amounts due at the balance sheet date (purchases of goods and services have been recorded in the right period)

- (1) Perform bridging tests similar to those performed at the interim date to ensure purchases are being properly processed in the whole year. This would include obtaining assurance that goods received notes are complete.
- (2) Search for unrecorded liabilities by selecting all invoices recorded for one month after 31 May 2007 and checking to goods received notes to ensure that none should have been accrued at 31 May 2007.
- (3). Carry out a similar search in the cash book to ensure that no payments are in respect of items purchased in the period prior to 31 May 2007, unless in respect of purchases recorded in the prior period or accrued.
- (4) Reconcile creditors statements to suppliers balances outstanding in the accounting records. If management have already done this you may test their reconciliation work.
- (5) Circularise selected creditors and ask them to inform you of the balance outstanding at 31 May 2007 and of invoices issued 14 days prior to and after 31 May 2007.

Chapter 14

Final review: post-balance sheet period, provisions, contingencies, letter or representation

14.1 a) *True*

Audit working papers should be a synopsis of the assignment. This means that all important evidential matter should be included in them, the basic rule being that they should be self-explanatory. To give only one example, if the auditor has discovered that not all sales orders have been subjected to a credit control check, the working papers should contain identifying references to the documents in question and ideally should contain copies of some if not all of them.

b) *False*

While it is generally true that auditors' responsibilities cease on the date the audit report is signed (that is, they are not expected to search for evidence of balance sheet after that date), ISA 560 - Subsequent events - makes clear that, should auditors become aware of such events they do have certain responsibilities. Read paragraphs 9 and 14 of ISA 560.

c) ?

As a matter of practicality the financial statements signed by the directors may not be in the precise printed or typewritten form submitted to members. However, auditors should satisfy themselves that the approved financial statements are complete in all **material** respects with those subsequently issued to members.

d) *True*

Paragraph 4 of ISA 580 states that the auditor should obtain written representations from management on matters material to the financial statements *when other sufficient appropriate audit evidence cannot reasonably be expected to exist* (our italics). Thus, if management has explained orally to the auditors that the reason for a reduction in gross profit percentage has been a decision not to increase prices to match cost increases, it would probably be possible for them to confirm this by checking sales invoices and cost records and no reference would be needed in the letter of representation. On the other hand, if the auditors had tested for the existence of unrecorded liabilities, but it was common in the industry for creditors to be late in submitting invoices for work performed, a representation from management that creditors were complete might be desirable.

e) ?

It is unlikely that the auditor would be able to form conclusions in the absence of a letter of representation from management. See paragraph 15 of ISA 580. It might be possible for the auditor to form conclusions as to truth and fairness by reference to other sources particularly where the areas of contentious judgement were slight, but we would not be too sanguine about this. A refusal to sign the letter might indicate a breakdown in the working relationship between auditor and management or of problems in the company that management wish to hide.

f) *False*

The word 'provision' was often used by accountants to mean the setting up of an accrual or for amounts deducted from assets, such as debtors and fixed assets. FRS 12 and IAS 37, however define a 'provision' in a very particular and

restrictive way, but exempts a number of items from its application, including so-called executory contracts, except where the contract is onerous. Contracts of this kind are defined as contracts under which neither party has performed any of its obligations or both parties have partially performed their obligations to an equal extent. They generally relate to the delivery of future services, including electricity and telephone. This means that this kind of accrual is not covered by FRS 12 and IAS 37.

- 14.2 a) **Company A.** The discovery that the profit on the long-term contract amounted to £30,000 and not £100,000 is an adjusting event in the terms of IAS 10 as it gives more information about a condition that existed at the balance sheet date. It would therefore seem appropriate to take up a profit of £22,500 and not £75,000.

The auditor would determine why the company had been so wrong about the estimated profits on this contract and might consider examining the records of the company to determine extent of completion at the balance sheet date, including the reports from the qualified surveyor. The costing records in the old and new period should be tested to ensure costs (including overhead costs) and income have been properly allocated to the contract in question. The matter should be fully discussed with management, and in addition, whether there were implications for other contracts not complete at the balance sheet date..

- b) **Company B.** The acquisition of the fixed assets does not appear to be a matter providing more information about conditions existing at the balance sheet date. The acquisition does seem to be very material and disclosure should be made in the notes to the accounts that it has been effected. CA 1985 does require capital commitments to be stated in the notes and there seems to be a good case for indicating the actual date of acquisition in this note.

The auditors would examine the contract for the supply of the fixed assets, the purchase invoice and the entry in the fixed assets register. They would ensure that all related costs (such as installation costs) had also been determined and, in view of the significance of the amount, may feel that a physical inspection would be appropriate.

- c) **Company C.** The decline in stock market prices seems to be a further example of a non-adjusting event, but if material the reduction in market value by £200,000 should be disclosed in the notes to the accounts.

The auditors would need to obtain the stock market quotation at the audit report date and ensure the disclosure in the notes reflected it. If the stock markets are volatile (that is, see-sawing up and down or moving downwards or upwards) the auditors may feel the need to ensure that the quoted value of the investment is made known to the shareholders at the AGM. To this end they should discuss the matter with the directors to determine the action they intend to take. They may also consider making a statement to the shareholders at the AGM, depending on the materiality of the matter.

- d) **Company D.** This event has the hallmark of an adjusting event as it gives more information about conditions that existed at the balance sheet date and the amount of the provision should therefore be adjusted to £120,000.

The auditors would wish to inform themselves of the background of the dispute and to examine the agreement between the two parties.

- e) **Company E.** This scenario looks very much like deliberate window dressing by the company to improve the appearance of liquidity. The auditor should look carefully into the circumstances of the sale and repurchase, considering in particular if the transaction was other than arms length to a related party.

Transactions with related parties should be disclosed and, if they are not, the auditor would wish to qualify the audit report. The sale and repurchase might need to be the subject of an 'emphasis of matter in the audit report. We discuss audit qualifications and emphases of matter in Chapter 16.

- 14.3 Clearly, any asset only has value if it can generate profits and positive cash flow, so a downturn in profits and the occurrence of losses might indicate that impairment has occurred. Unlike tangible assets, goodwill cannot be sold, so an impairment review would concentrate on value in use within the company, unless the decision was made to dispose of the whole subsidiary, in which case net realisable values for goodwill might be appropriate if it were to be sold as a going concern. The auditors would discuss the future of Gateside and its operations with management. To assist in these discussions, the auditors would establish the trend of profits over the last ten years. It seems that the trend into a loss-making situation has been evident 2006 and 2007. If this trend continues, Gateside may be in even more trouble in the year to 31 December 2008 and the auditor would determine what actions the directors of Bandon are taking to remedy the situation of their subsidiary. What are their views on why the downward trend has occurred? For instance, has a new competitor entered the market, or has there been new legislation that has made the company less viable, or have one or more key employees left Gateside, rendering the company less well managed. The auditors would ask management if they have a response to these matters that might turn the company round. They may find that the directors have decided to change product lines and management structures, in which case it may become clear that the existing goodwill has little to do with the 'new' company, in which case write down or even complete write-off of the goodwill might follow the impairment review. The carrying amount of the investment in Gateside in Bandon's own accounts should probably be written down. This is clearly a subjective matter, but the auditors should find as much external evidence as possible by reviewing industry trends, reading business news and specialist industry news-sheets.
- 14.4 The auditors are clearly concerned that the third party will be successful in an action against the company and that material damages may become payable. From the accounting point of view the auditor has to decide if this is:
- A provision in the terms of FRS 12 and IAS 37 that is an event has occurred (the use of the patent registered by a third party) that creates a present obligation (either legal or constructive) that is expected to result in the outflow of economic benefits that can be assessed with sufficient reliability.
 - A contingent liability that is not remote and should therefore be disclosed under the terms of FRS 12 and IAS 37.

This is clearly both a legal matter and a technical matter. If the patent has been infringed, then legally the company may well be liable. However, if there is doubt that the patent has been technically infringed, Prospect may not be able to make a successful claim for damages in court. The first step for the auditors would be to determine the facts. They would examine a copy of the patent held by Prospect and determine the nature of the claims made. There would be a need to determine the nature of the manufacturing process concerned and the technical matters that are involved in its operation. The auditor might seek expert advice about the patent and about the process and whether the latter has or has not been using the former. The process may prove to be in the public domain, in which case the claim for damages would be unlikely to be successful and the success of the court case regarded as remote. If, however, the contingency is other than remote, the decision must be taken whether to it is a provision in the terms of FRS 12 and IAS 37 or merely a disclosable contingent liability. Legal advice should also be sought once the technical matters have been clarified.

Chapter 15

Assurance engagements and internal audit

15.1 Case study 15.4 Photocopy costs in an educational institution

The internal auditor should pursue the following matters:

- a) As a first step check the cost of 4p per sheet from rented photocopying machines and also review print room costings to determine whether the figures provided by management are accurate. The auditor should ascertain how frequently the costings are reviewed and up-dated, particularly as the policy has been in force for 5 years. Modern photocopying machines are much more efficient than machines manufactured a comparatively short time ago.
- b) During the visit to the print room it was noticed that there was a six working days delay in the processing of print requests, a delay that might prevent teaching and other staff from using print room facilities. Although much teaching material is prepared in advance, the nature of teaching (at advanced levels particularly) is such that often hand-out material for students is required at short notice. Another matter you should investigate is whether management has considered the question of overload at some times and under-load at others, and, if so, what decisions have been taken and why.
- c) You would discuss with the department head the reasons for the decision to acquire a photocopying machine from its own budget. (for instance, was it the result of delays or was it because the department could obtain copies cheaper than through the print room, particularly when the reduction facility was being used). You might also wish to consider if the department head had authority to purchase a machine of this type and cost.
- d) You would confirm that the departmental costings are accurate and also to discover at what point the print room could produce copies cheaper than the departmental machine. The direct question to be considered is whether copies in excess of 100 would be cheaper.
- e) Finally, it would seem desirable to discover why staff members were photocopying quantities in excess of 100. Was it because of poor planning on the part of the staff member or was it for a good reason, such as being called on to take a class at short notice or to provide students with up to date material for a special project. You might wish to comment in your report on the amount of time that academic staff seemed to be taking on a relatively menial task.

Further actions would be dependent on responses and the results of the tests made.

15.2 Case Study 15.6 Internal Audit at Troston plc

Matters that might lead to effectiveness

- i) Staff appear to be qualified for the audit task. Two staff members, including the head of internal audit are members of reputable accounting bodies and two others appear to have good audit experience, although professionally unqualified. The department has a computer expert in place, who, it is noted, has been asked to give advice to the IT committee.
- ii) The head of internal audit is directly responsible to a board member, although it could be argued that responsibility to the chief executive would be better (see 'Matters that might detract from effectiveness' below). However, internal audit reports also go to board members and the chair of the audit committee and the audit committee has direct contact with the head of internal audit and discusses internal audit reports with him on its own initiative. This feature increases the

status and independence of the internal audit department. That the head of internal audit reports to the whole Board at six monthly intervals is also a positive feature. It is of note that the production work planned was initiated by the production director.

- iii) The internal audit planning process seems to be performed on a timely basis. A good feature is that the plan is discussed with the external auditor to allow co-ordination of the total audit process.
- iv) The audit task is broad in scope and not restricted to accounting and finance. A positive matter is that the plan contains work on internal audit's own initiative - sales statistics (to find if they are reliable) and research and development (to discover if R & D activity is effective). It is also of interest that the department is directing its effort to 'value for money'. A further positive feature is the fact that the internal audit computer expert takes an active part in the development process, but she should be made aware of the independence issue.
- v) A good feature is the review of reports by the head of internal audit and that comments are invited from auditees. This will tend to increase respect for the internal audit by auditees.

Matters that might detract from effectiveness

- i) There is evidence of the short stay syndrome as one member of the department is being moved on after only two years. The external auditors should recommend that internal audit be provided with high quality staff and that promotion outside the department be done on the basis of proven high quality work.
- ii) This is a particularly important matter in view of the department's planned commitment. It might be argued that the programme is too wide-ranging for five staff members, even if all were experienced. The newly appointed Certified Accountant has only recently qualified and may, therefore, lack the experience to carry out VFM audits effectively. This should be discussed with the head of internal audit and with the audit committee with a view to strengthening the audit team and to decide what approaches should be adopted to VFM studies.
- iii) The reporting and task lines on Figure 15.3 suggest that if higher level decision-making by the finance director are the subject of audit scrutiny, there might be conflict with the formal reporting line to that director. A stronger reporting line to the chairperson of the audit committee would clearly be desirable, particularly in the light of the wide range of responsibility of the finance director.

Ways in which the work of the department might be extended to make it more useful

We should perhaps ask initially who would benefit from the work of the internal audit department whether extended or not. Obvious groups are executive management and audit committee and perhaps also wider society, particularly as corporate governance is assuming ever greater importance. We discuss corporate governance in Chapter 18. Some suggestions are:

- (a) Adopting a business risk approach to their work to aid management in adopting risk strategies
- (b) Becoming more involved in participative auditing, working together with management staff on particular projects needing an independent perspective. This could be done in relation to the work on research and development and efficiency of the production process
- (c) Adopting an active relationship with the audit committee to serve its needs and to consider how corporate governance arrangements could be strengthened. One

important area might be ensuring that the company is adhering to rules and regulations affecting it.

Clearly approaches such as these could only be achieved if the company ensures that the department has adequate resources.

15.3 Billowness Beach

This is an interesting question as the body providing a conclusion - in this case the quality of the water - is not a practitioner in a firm of accountants and auditors. Nevertheless, there is undoubtedly a conclusion that will increase the confidence of intended users in the subject matter. Let us now address the question:

- (a) (i) The body exercising the role of practitioner is clearly the Scottish Environment Protection Agency (SEPA), as far as the quality of water is concerned. It is important to note that SEPA is independent of Fife Council, thereby possessing the important quality of independence.
 - (ii) The responsible party is Fife County Council which has put the information about Billowness Beach together and made it public.
 - (iii) The intended users are the members of the public and their families who use the beach.
 - (iv) The subject matter is the notice that we reproduced in all material respects, containing much information about facilities and water quality and the subject matter information is the assertion by SEPA about water quality.
 - (v) The notice does not detail all criteria, merely stating that for this rural beach 13 criteria have been fulfilled under the general headings of water quality, management, safety, cleanliness, and information. The criteria concerning water quality is very specific, although most people would probably not know what a coliform is unless they go to SEPA's website.
 - (vi) The report of the practitioner is the clear statement made by an identified body that the water quality meets certain criteria established by the European Union.
- (b) The conclusion given is clearly positive. SEPA is not saying that they have no reason to doubt that the water quality on 11 July 2003 was excellent. They are stating positively that the sample taken showed that the water quality on that date was excellent.
- (c) We think that the subject matter would be of great value to intended users. On the basis of SEPA's report families would be confident that they and their children could bathe in the sea without danger. They are also well informed about who they should contact if they experienced problems when on the beach, as contact telephone numbers have been made available to them. They have the opportunity too to keep the beach clean themselves because of the provision of litter bins and bins for dog waste.

We make one further comment about the data in the public notice given in the question and that is the poor standard on 13 May 2003. We talked to a Fife Council official about this and he indicated that it is very difficult to prevent pollution coming from other areas and ships. This is clearly one of the difficulties that environmental auditors have to consider.

Chapter 16 The auditors' report

Suggested solutions to self-assessment questions (available for students)

16.1 a) *False?*

The overriding concern of auditors is that the financial statements should give a true and fair view. If the auditors believe that a true and fair view can only be achieved by departing from the provisions contained in a specific SSAP or FRS or IFRSs, the alternative treatment should be applied. However, it should be appreciated that such circumstances are likely to be rare perhaps even extremely rare which is why we have appended a question-mark to our answer.

b) *True*

During their work, auditors are likely to come across many errors. Although even small errors, under certain circumstances, may be of interest to statutory auditors, their main concern is whether they result in the accounts being misleading or not giving a true and fair view. If they believe this to be the case and the client will not amend the accounts, there will be no alternative but to give a qualified audit report.

c) *False*

Auditors also have a duty to check that the information in the Directors' Report is consistent with the financial statements. In listed companies they also have certain duties as specified in the Listing Rules of the Financial Services Authority in respect of corporate governance. They should also read other information in the corporate governance statement and ensure it is consistent with their knowledge of the company. In respect of quoted companies the auditors are also expected to check that the audited part of the Directors' Remuneration report has been properly prepared in accordance with the Companies Act 1985 and is free from any material misstatements. In addition, ISA 720, Other information in documents containing audited financial statements, requires them to read the other information in the annual report, such as, a chairman's statement to check there is no misstatement and that it is consistent with the audited financial statements.

d) *True*

Auditors should always date the audit report and ensure that it is as close as possible to the date the accounts are signed by the directors. Clearly the date of the report should be the date upon which the auditors are satisfied that their audit fieldwork is complete.

e) *True*

For further details on this you should refer back to the section above which outlines the matrix of audit qualifications. See Figure 16.2 on page 616.

16.2 The auditors' unqualified audit report consists of the following sections:

Title and Addressee section – In this section the auditors state to whom the report is addressed. In the case of a company this will usually be the shareholders.

Scope paragraph – In this part the auditors will specify the pages in the annual report, on which they are reporting. These pages will encompass the financial statements and accompanying notes. Instead of quoting the page numbers the auditors may instead list the statements that come within the scope of their audit. They will also indicate that

the financial statements have been prepared using the accounting policies set out in the notes. They will further indicate, where appropriate, that their audit encompasses certain aspects of the Directors' Remuneration Report.

Responsibilities paragraph – In this part the auditors state that they are responsible for forming and reporting an opinion on the financial statements and for quoted companies the part of the Directors' Remuneration report that is required to be audited. They will also state that they have a responsibility to ensure that the Directors' Report is consistent with the financial statements. In addition, the auditors will state their responsibilities in respect of other information contained in the Annual Report and specify what that information comprises. They will further indicate if the company has not kept proper accounting records or if they have not received all the information and explanations they considered necessary for their audit. Where the audit report is for a listed company the auditors will also specify their corporate governance responsibilities. In addition, there will be a reference to the page on which the directors' responsibilities can be found in the annual report.

Basis of Opinion Paragraph – In this paragraph the auditors state that in performing their audit they complied with International Standards on Auditing. In addition, they include some information relating to the audit process. In particular, they stress that an audit involves collecting evidence on a test basis and includes an assessment by the auditors of estimates and judgments made by the directors in the preparation of the financial statements. This paragraph also states that the auditors collect enough information to provide them with reasonable assurance that the financial statements are free from material misstatement. Lastly, it emphasises that in forming their opinion the auditors evaluate the adequacy of the presentation of the information in the financial statements.

Opinion paragraph – In this part of the audit report the auditors state that the financial statements give a true and fair view and are in conformance with UK GAAP or IFRSs. The opinion paragraph will also state that the financial statements have been prepared in accordance with the Companies Act 1985. For a quoted company they will also state that the audited part of the Directors' Remuneration Report complies with the Companies Act 1985. Finally, the auditors will report whether the information in the directors' report is consistent with the financial statements.

In the final part of the audit report the auditors give the firm's name, their address and the date on which they signed the audit report. You may also have mentioned that the audit report might include a disclaimer of liability to third parties paragraph.

Gamston Burgers plc

- (i) This situation refers to an uncertainty where the auditors agree with the directors about the value of the tangible fixed assets. In addition, the auditors have obtained all the evidence they could have reasonably expected to be available. The facts indicate that this is a situation of uncertainty. The next stage is to determine whether the uncertainty is a significant or fundamental uncertainty. There are a number of factors the auditor will consider when deciding upon this, including, the range of possible outcomes and their consequences. From the information given in the question, one possible outcome is that the tangible fixed assets would be worthless and this seems to suggest that it is a significant uncertainty. Further support for this is given in the question where it states that the effect of the tangible fixed assets being worthless would be material but that the financial statements would not be misleading, that is, they would still give a true and fair view. The auditors would include an explanatory emphasis of matter paragraph in their audit opinion. This paragraph would preferably be situated just after the opinion paragraph and it would describe the uncertainty and also, where possible, quantify the possible effect. It would also refer to the note in the financial statements describing the uncertainty. Finally, the paragraph would

state that the opinion is not qualified in respect of the uncertainty. An example of an audit report including an emphasis of matter paragraph is Example 1 in Appendix 2 of APB Bulletin 2006/06

- (ii) This example differs from the previous situation in that the auditors believe that the branch will have to close and that the tangible assets will be worthless. If the company were to include, as the question seems to indicate, the tangible fixed assets at a value of £710,000 then this would be a situation where the auditors disagree with the treatment adopted by the company. Where the auditors disagree they can issue one of two types of qualified opinion; an except for or an adverse opinion. An adverse opinion would only be issued when the disagreement is so material that it would result in the financial statements as a whole being misleading - that is, that an except for opinion would not be adequate to convey the extent to which the financial statements are misleading. The question indicates this is not the case and therefore the appropriate qualification would be an except for opinion. The opinion paragraph would be headed "Qualified opinion arising from disagreement about accounting treatment." In the except for opinion the auditors' opinion paragraph would include details of the disagreement, and quantification of the effects. The detail would state that in their opinion one of the company's branches tangible fixed assets are likely to be worthless and that the company should have made a provision of £710,000. The opinion would conclude with a paragraph stating "Except for the financial effect of not making this provision". See example 2 in Appendix 2 of APB Bulletin 2006/06 for typical wording of this type of qualification.

Keyworth Supermarket Limited

- (iii) In this example the auditors have not been able to collect all the evidence they require to reach an opinion on the company's sales figure. In addition, we are told that where the uncertainty relates to all the company's sales then it could result in the financial statements as a whole being misleading. If this is taken as indicating that the extent of the financial effect of the uncertainty is so material and pervasive that the auditors are unable to express an opinion, they should issue a 'disclaimer' opinion. In the basis of opinion section of the audit report the auditors would explain why and in respect of what account items they were not able to collect all the evidence they consider necessary. The opinion section would be headed "Opinion: disclaimer on view given by financial statements." The auditors in the opinion section of the audit report would state why they are unable to form an opinion on the financial statements, that is, because of the possible effects of the limitations of the evidence that is available. The paragraph will also state that the limitation relates to the company's cash takings and stock. It is likely that the paragraph would conclude with a statement by the auditors on the following lines:

In respect solely of the limitation on our work relating to cash sales:

"We have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and we were unable to determine whether proper accounting records had been maintained."

Typical wording of this type of qualification is given in example 5 of Appendix 2 of APB Bulletin 2006/06.

- (iv) This example is similar to the above except that the uncertainty only relates to the sale of certain items comprising 10% of the company's sales. The question states that the uncertainty would have a material effect on the financial statements but that it would not result in them being misleading. By this we can take it that the auditor can form an opinion on the financial statements and thus the appropriate qualification would be an except for qualification. In the basis of

opinion section of the audit report the auditors would explain that they were not able to obtain all the evidence necessary in respect of £XXX of the company's sales and that there was no other tests they could perform to provide the necessary evidence. The opinion paragraph would be headed "Qualified opinion arising from limitation in audit scope." In the opinion paragraph it would be stated that except for adjustments that might be required in respect of the company's cash takings and stock because of the insufficiency of evidence the financial statements give a true and fair view. It is likely that the paragraph would conclude with a statement by the auditors on the following lines:

In respect solely of the limitation on our work relating to cash sales:

"We have not obtained all the information and explanations that we consider necessary for the purpose of our audit; an we were unable to determine whether proper accounting records had been maintained"

Typical wording of this type of qualification is given in example 4 of Appendix 2 of APB Bulletin 2006/06.

- 16.3 (a) Whether or not you believe it is useful to include a basis of opinion paragraph and some details of the auditors' responsibilities in the audit report would depend upon whether you think there is confusion or little understanding of the nature of the auditors' role and responsibilities. Research in the area suggests there is some confusion over the auditors' responsibilities. Based on this research including details in the auditors' report would seem useful in helping to reduce the misunderstandings.

Informing users in the audit report that the auditors' work involves estimates helps to convey the message that the audit process is subjective and that the audit report is not a guarantee. This and other text included in the basis of opinion paragraph may reduce expectations users have about what they expect from the auditors. It may be argued that the effectiveness in reducing any misunderstanding is dependent on users of the financial statements actually reading the audit report. If the audit report is not read thoroughly by users, it is unlikely that its wording will have any effect on users' perceptions of auditors' responsibilities. Finally, we suggest that including information about the auditors' work and responsibilities is not likely to be detrimental to users, so that, even if any benefits are marginal, such information should be included in the audit report.

- (b) The main merit of the short form audit report is that because of its succinctness it is more likely to be read by users. Its very brevity may, it is argued, also mean that there is less opportunity for misunderstanding its content. In other words if you don't say very much, there will be fewer issues that might cause users confusion or misunderstanding. Of course, if you take this to its extreme it would imply that misunderstanding would be eliminated if the auditors said nothing. Since this is not the case it would appear that the amount of misunderstanding is likely to be dependent on the length of the audit report. It will also be affected by what is reported and the nature of the wording used.

The merit of the extended audit report is that it gives the opportunity to auditors to explain matters and issues in more detail and hence, perhaps, reduce misunderstanding and improve the usefulness of the audit report. If the above seems rather contradictory do not be alarmed. At various stages when the audit profession considered changing the audit report in the 1940s and 1970s many auditors argued that the short form audit report should be retained because it was more useful and less likely to lead to misunderstanding than an extended audit report. When, however, APB advocated an extended audit report one of the arguments they used was that it would be more useful and reduce users misunderstanding about the auditors' responsibilities and the nature of an audit.

It would thus seem that even the audit profession and its members are slightly confused about the merits of the two types of audit report.

- (c) The arguments, in brief, for and against auditors reporting on the effectiveness of company's internal control system are as follows:

Arguments for:

Auditors document and evaluate internal control systems as part of their audit work and therefore reporting on them would seem a logical and reasonable end product of their investigation. The effectiveness of internal control systems may provide clues as to the value the directors place on appropriate systems to safeguard the company's assets, control the business and so on. Thus, indirectly, any report may provide information about directors' abilities and integrity. A number of recent scandals, for instance, Barings Bank and Enron, have highlighted the implications of deficiencies in internal control.

Overall, it may be argued that reporting on the effectiveness of internal controls provides useful information to users. In the United States the requirement that auditors report on the effectiveness of internal control systems has caused considerable controversy because of problems related to its implementation and its cost.

Arguments against:

If the auditors were to report that the internal controls were poor this might lead to conflict with the directors and sour any personal relationship they have built up. In response it may be argued that the auditors are there to look after the shareholders interests and not those of the directors. It might be argued that the assessment of internal control is rather subjective and that the auditors would prefer not to report on something that is open to interpretation and dispute.

If a company went into bankruptcy and it became evident that weaknesses in its internal control existed and previously the auditors had reported favourably on its system of internal control, this might lead to the auditors being sued for negligence. Thus, auditors may prefer not to report on internal controls because it might increase the likelihood of them being sued.

It might also be argued that because of its complexity reporting on internal control systems cannot be reduced to a simple standardised report. Thus any report would have to be complex and contain a substantial amount of information, explanation and technical terms. Following from this, it may be argued that such reports might lead to misinterpretation and misunderstanding on the part of readers of the audit report.

Finally, in the question we have left open what is meant by a company's systems of internal control. Normally auditors are mainly concerned with a company's financial system of internal control. If, however, we take it in its widest sense, this would require auditors to investigate aspects of internal control that they do not normally consider in depth or may not even have the expertise to evaluate.

- (d) Before answering this question it is useful to review the responsibilities of auditors in respect of corporate governance. As we mentioned above they are required to review the company's statement of corporate governance as it relates to certain Code provisions. It is likely that they will state in the audit report their responsibilities in respect of corporate governance. Where the Code has not been complied with, they should, where possible, give the required details in their report.

The limited responsibilities of auditors would suggest that they play a relatively minor role in corporate governance, the major role being taken by the directors of

a company. Whilst their specific responsibilities in respect of companies' statements on corporate governance may suggest that this is a reasonable conclusion, one might argue that their role is a more subtle one and that auditors do play an important 'behind the scenes' role in ensuring good corporate governance conduct by the directors. Other more strident critics have suggested that even the directors' responsibilities in respect of corporate governance have been so diluted that they are not very useful in the move towards greater corporate governance. If one holds this view then it is likely that the auditors' responsibilities would likewise be viewed as being not very onerous or useful.

Chapter 17

Fraud and going concern

17.1 (a) *False*

The statement as it stands is too wide. Directors have the prime responsibility for detecting fraud and error. ISA 240 makes it clear that in planning and performing the audit to reduce audit risk to an acceptable low level, the auditor should consider the risks of material misstatements in the financial statements due to fraud.

(b) *True*

Sound systems of internal control should help in both deterring and detecting fraud. No system of internal fraud is, however, perfect, so there is always a possibility of fraud (or errors) occurring. This is especially so where the fraud is committed by management, well thought out and involves collusion.

(c) *False*

If auditors suspect or detect fraud they have to decide when and to whom to report their findings. The auditors have to decide on the appropriate level of management to discuss the matter, though as a minimum it will usually be senior management. Obviously, they will not want to report it to individuals who may be implicated in the fraud. Thus, if auditors have any doubts about whether the individual's immediate superior is involved or was possibly even aware of the fraud, but took no action, they should not report it to that individual. They would also want to report it at a level where it will be taken seriously and some action can be taken. The level at which they report it will also be influenced by their judgement as to the materiality of the fraud. Other possibilities are to report the matter to the audit committee, if one exists, and in the case of regulated industries/commercial sectors to the appointed regulator.

(d) *False*

The preparation of financial statements does not imply that the company will continue trading indefinitely. Instead, its use assumes that the company will continue to be a going concern for the foreseeable future. This period, however, will vary from company to company and it is at the discretion of the directors how far ahead they look into the future. Normally this period will not be less than one year from the date of approval of the financial statements.

(e) *False?*

The directors have the prime responsibility for determining if a company is a going concern. The auditors, however, have to carry out such investigations as are necessary to arrive at an opinion about whether the directors' judgement is appropriate. When arriving at this opinion the auditors will consider how far the into the future the directors have looked when assessing going concern, the evidence the directors have used in assessing going concern and any additional information the auditors are aware of arriving from their audit investigations. We have inserted a question mark because the auditors do have a responsibility to determine if the company is a going concern, but this is a second order requirement in the sense that the directors have first to decide if it is appropriate to prepare the financial statements on a going concern basis.

(f) *True*

Where the directors have adequately disclosed the matter(s) giving rise to concern about the going concern status of the company, the auditors will include an emphasis of matter paragraph in their (unqualified) audit report drawing attention to their concerns about the going concern status of the company. Where the auditors do not believe that the directors' disclosures about the going concern status are adequate, they would qualify their audit report. They would, however, only do this when their disagreement with the directors about the disclosures included in the financial statements is significant, in other words, they do not consider that the financial statements give a true and fair view. It is important to note that the auditors are only required to include reference to doubts about the going concern status of a company when those doubts are significant. It would be left to the auditors' judgement when they consider their concern about the going concern status of a client is significant. Finally, if the auditors do not agree with the financial statements being prepared on a going concern basis they should qualify their audit opinion.

17.2 (a) It is difficult to come up with any definitive answer as there are reasons both why errors might be easier for auditors to detect and reasons why they may be more difficult to detect. The main reason errors should be easier to detect is that, because errors are unintentional, it is unlikely that there will be an attempt to conceal them from the auditors. This should enable auditors to detect them more easily. Fraud, however, being a deliberate act may involve sophisticated procedures to ensure it is not detected. The reasons why errors may be more difficult to detect are:

- Many errors may be for relatively small amounts and because of this they are not obvious and therefore may be difficult to detect.
- The auditors usually rely to some extent on the company's internal control system for detecting errors, so errors which have eluded that system have a high chance of also eluding the limited transactions testing performed by auditors.
- Errors are very often likely to be random events and this of itself makes their discovery more difficult.

(b) There are a number of points you should make:

- (i) If the auditors were to take greater responsibility for the detection of fraud they would have to undertake more audit testing to increase the likelihood of detecting fraud. If auditors believe that audit clients would be unwilling to pay for this additional work, they are likely to be unwilling to perform the additional work or assume the additional responsibility.
- (ii) The auditors may be concerned that if they extended their responsibilities in respect of fraud it might simply lead to the public increasing their expectations about what can be expected from an audit. In other words, it could lead to an upward spiral of what the public expects from auditors. If auditors believe this is a possibility they might conclude that it would not be in their interests to assume responsibility for fraud detection.
- (iii) Auditors may believe that it is almost impossible to detect small frauds or frauds involving the directors or top management. As such, they might consider that taking responsibility for fraud would be an undertaking they cannot meet.
- (iv) Auditors may consider that taking responsibility for fraud would lead to them being sued for negligence every time they failed to detect a fraud. The costs of failing to detect fraud, legal costs, out of court settlements and damages awarded by courts are such that auditors are likely to be unwilling to assume greater responsibility unless some limit or restriction was placed on their potential liability.

17.3 (a) The audit procedures the auditors would undertake include the following:

- reviewing budgets or forecast profit and loss accounts and their sensitivity to changes in assumptions underlying them
- examination of cash flow forecasts
- determination of the company's borrowing facilities with particular regard to how close the company is to the limit on their borrowing capabilities
- checking that the company has not infringed any debt covenants or has a bank overdraft in excess of its limit
- consideration of the company's plans for the future, including any financing requirements
- assessing the company's trading position by investigating the company's order book
- calculation and the assessment of appropriate accounting ratios, for instance, liquidity ratios
- checking whether the company appears to have difficulty in paying its creditors as evidenced by repeated requests from creditors for payment by the company
- checking that the company has not needed to restructure its debts because of an inability to meet its obligations
- checking that the company is not subject to impending major litigation that could threaten the existence of the company
- checking whether there has been any changes in technology that might threaten the company's position in the market place
- checking if the company has made any staff redundant or has lost key members of staff

(b) Factors that might cast doubt on the going concern status of a company include:

- substantial and sustained losses incurred by the company over a period of a few years
- inability of the company to pay its creditors or meet debts
- poor liquidity as demonstrated by low and deteriorating current and acid test ratios.
- infringement of debt covenants giving rise to the possibility of action by lenders, such as, lenders petitioning to declare the company insolvent
- exceeding overdraft limits
- a decision by management not to pay any dividend or reduce the dividend paid to ordinary shareholders
- a decision by management to factor their debtors
- high levels of creditors and stock indicating an inability to pay creditors and difficulty in selling stock
- the company losing major customers
- the company launching a new and important product which flops in the market place
- the company making a number of staff redundant
- the company having a very low order book
- high levels of gearing

Chapter 18

The audit expectations gap and corporate governance

18.1 a) *False*

The audit expectations gap has been in existence ever since auditing has been seen as a means to confirm the validity of information. In particular we can identify many cases where stakeholders have discovered that their beliefs were wrong about the quality of financial information or the ability of auditors to discover matters material to the view given by the financial statements. We gave the 1939 McKesson Robbins case in the United States as an example in the text, but we can go back to the 1880s to find evidence of an audit expectations gap.

b) ?

This statement is only partially true. Many individuals may have unreasonable expectations about financial statements and the audit process. The accounting profession has often maintained that the problem lies in ignorance but it can equally be argued that there are audit duties not required by existing professional requirements and the law, which are on the face of it reasonable, one example some would argue being the expectation that the auditor will discover all material fraud and report on it.

c) *True*

This statement acknowledges that if a material error is not reported by the auditor, it is very difficult to decide if the failure is because of incompetence or lack of independence on the part of the auditor. Consider the following scenario. You have been auditing a company for 10 years and have established a good working relationship with the assistant controller of the company. In the current audit you discover that certain material payments have been made to individuals who had not provided a legitimate service or goods to the company. The assistant controller had given approval to the payments without sufficient investigation. You decide not to report the matter and tell the assistant controller not to let it happen again. Do you think that an outsider could tell whether you had missed the payments because of poor audit work or because you had allowed close contact with the assistant controller to affect the reporting of the matter.

d) *False*

This statement is false in that the committee will only be effective if it has proper authority, if the non-executive directors possess integrity and competence and supported by the allocation of resources to perform their role.

18.2 (Moorfoot plc)

- (a) The Cadbury Committee was concerned with corporate governance, which might be described as the total management system to ensure within reason that persons with legitimate interests in a company have their needs satisfied. To give an example from Moorfoot plc, hospitals and family doctors and their patients have a legitimate expectation that the company's systems for controlling the production and prescribing of pharmaceutical products are appropriate. 'Appropriate' in this case means that controls over production of inherently dangerous products ensures that they meet predetermined specifications and that other controls ensure that patients receive correct doses.
- (b) The auditor is not expected to perform audit procedures on internal controls above those required to form an opinion on the truth and fairness of the published financial

statements. The review of the directors' statement on internal control is designed to determine 'to assess whether the company's summary of the process the board has adopted in reviewing the effectiveness of the system of internal control, is both supported by documentation prepared by or for the directors and appropriately reflects that process.' (Paragraph 33, APB Bulletin 2006/5 The Combined Code on Corporate Governance: Requirements of Auditors under the Listing Rules of the Financial Services Authority and the Irish Stock Exchange).

- (c) Auditors seek to be satisfied that controls are adequate to reduce the impact of inherent risks to acceptable levels. General matters to be considered include:
- Ethical dimension derived from the need to ensure that the public does not suffer as the result of using the company's products.
 - Risk, including the inherently dangerous nature of the company's products and the fact that they are prescribed by individuals outside the control of the company
 - Quality of information given to those running internal control systems
 - Communication links between persons involved in the production and sale of the company's products

Specific controls will be necessary in the following areas:

- Production of dangerous drugs (see (a) above).
- Instructions for prescription of dangerous drugs, including maximum dosage levels and testing for allergies and usage by patients of other medication. Literature made available to hospitals and family doctors should be factually accurate and explain carefully the likelihood of unwelcome side effects
- Proper procedures on appointment of salespersons to ensure they are competent and experienced in the sector and continuous training of them to ensure that they remain well-informed and understand that it may be unethical to 'push' products.
- Salespersons should be remunerated by basic salary as well as commission, so that they are not totally dependent on commission.
- Identification of circumstances where it will be appropriate to seek guidance from independent experts.

18.3 This situation is a very good example of a matter that should be raised with the audit committee. The auditors would explain the restriction in scope and the need therefore to qualify their opinion. Apart from this it would be necessary to explain that the Combined Code recommends that the directors review the effectiveness of the internal controls and report in the Annual Report that they have carried out such a review. Failure to back up files of material significance, it might be argued, represents a major systems failure that should have been detected by a review of the effectiveness of the internal controls. The auditor should also explain that the non-executive members of the Board, including those on the audit committee, have the same responsibilities with respect to system failures and published statements by directors as executive management. Finally, the auditor would ask the members of the audit committee to make their own investigations and to discuss the relevant matters with executive management.

18.4 You should tell your audit assistant that the report on a review will give a lower level of assurance than a full audit, because many audit procedures and tests performed in a full audit would not be carried out in a review. In other words the scope of examination is different. As the scope of a review is lower the report would have to contain a disclaimer to the effect that a full audit had NOT been carried out. Tell your assistant too that you would carry out the restricted review procedures in a professional way so that some reliance could be placed on the report.

The basic difference between review and audit procedures is that detailed procedures such as debtors circularisations, stock count observations and search for unrecorded liabilities would not normally be carried out in a review. Be careful about this, however, as review instructions might require you to carry out SOME detailed procedures. This

means that the review instructions should be carefully drafted and obtained in writing from the client. Typical procedures in a review would be to carry analytical procedures such as those that we discussed in Chapter 11 and those we discussed in Chapter 15. Also important are the discussions with management not only about critical matters revealed by the review, but also about known inherent and control risk areas.

Chapter 19
The auditor and liability under the law

19.1 (a) *False?*

Decisions in the JEB Fasteners and Twomax cases would appear to suggest that at least for part of the 1980s the courts would go beyond contractual relationships. The test in these cases was whether the auditors should reasonably have foreseen that the accounts would be used by an individual or class of individuals. However, the recent cases of Caparo Industries and James McNaughton Paper Group Ltd. appear to limit auditors' liability to those parties with whom they have a direct and close relationship. Thus, although it is not impossible, as was seen in the ADT case against Binder Hamlyn, and the Bannerman case discussed in the chapter for a third party action to be successful, the plaintiffs have to satisfy a number of criteria.

(b) *False*

It is true that the use of inside information for share trading purposes is a criminal offence but it is also possible that individuals would be disciplined by their own professional body. The professional body would have to decide whether the behaviour of individual constituted misconduct. Given that the status of the accounting profession is highly dependent on its members possessing qualities such as integrity and honesty, it is likely that the accounting body would discipline its member in this case.

(c) *True*

Assuming that the auditors have indeed been negligent, it is necessary, if the plaintiffs' case is to succeed, that their decision has been influenced by the financial statements, that is, that they have relied upon them. This was illustrated in the JEB Fasteners case in which the auditors were found to be negligent but no damages were awarded. This was because, although the plaintiffs had relied on the financial statements to some extent when they made their investment, their decision would not have changed had they known the true financial position of the company. The court held that the motivation for the take-over was to obtain the services of two of the directors of BG fasteners and not to acquire the company as such. The Galoo case also illustrated that the courts may consider whether the plaintiffs should have used their own financial advisors when determining if they are owed a duty by the auditors.

(d) ?

It is very difficult on the basis of the information given to give to give a definitive answer. While auditors are not specifically responsible for the detection of all frauds. You will remember our discussion of fraud in Chapter 17. it is expected that they will design audit procedures and plan their audit so as have to have a reasonable expectation of detecting material frauds. In this case, although we would need some additional information, for instance, the profit for the year, before we could come to a definitive conclusion on the basis of amount of funds embezzled, it appears unlikely that the truth and fairness of the financial statements will be affected. Nevertheless, auditors, as part of their audit, are expected to review controls and carry out tests on the wages system. If the fraud had been made possible by poor control over wages and the auditors had not brought this deficiency in control to the attention of management, it could be construed that they have not properly discharged their duty. If the auditors had brought the deficiency to the attention of management and they have ignored the warnings and suggestions, the accusation that the auditors have been negligent is less well founded. In addition, the auditors in any court case could claim

contributory negligence on the part of the client. You will recall that we mentioned this in the case of *AWA Ltd v Daniel* in the text of this chapter. It should, however, be acknowledged that, if the controls in the wages area are weak, there is some obligation on the auditors to take this into account in designing audit tests and not merely ignore it. It will also be necessary to take into account the nature of the fraud (whether it was ingenious and complex, for instance, involving the alteration of computer programs, or whether it was simple and straightforward). Generally speaking, the more complex the fraud, the less likely it is the auditors would be found to be negligent. It should be noted that the existence of complexities, including complex computer systems, does not in itself limit the auditors' responsibilities. Prior to accepting the audit, they should ensure that they have the necessary skills and resources needed for the assignment. Other features that should be discussed are:

- a) The problems posed to auditors by managerial fraud. Management are often in a position where they can override controls.
- b) The length of time the fraud has been going on. Generally, the longer the length of time, the more likely it is that the auditors will be considered to have been negligent.

(e) *False*

Putting a ceiling on the liability of auditors is known as capping. At present it is not legal in the United Kingdom for auditors to agree a cap with their clients for audit work, although they can do so for non-audit work. <<margin note>> The Companies Act 2006 has introduced provisions whereby the auditor can negotiate a limit on their liability with their client. At the time of writing these provisions had not yet come into force. <<end>> Proportionate liability arises where more than one party is to blame for losses suffered by another party and the damages awarded (assuming the parties are adjudged to have been negligent) are allocated among the "guilty" parties in accordance with the extent to which they are to blame for the losses incurred. Under this rule if one or more of the guilty parties had no (or insufficient) resources to pay their share of the allocated damages, the party who suffered the loss would not receive the full amount of the damages that had been awarded. In the United Kingdom, because of the law relating to joint and several liability, if one or more of the parties has no or insufficient resources, the party who has sufficient resources would have to pay the full amount of damages. In practical terms, if a plaintiff knows that one of the guilty parties has limited resources, they may not bother to sue them, but would concentrate their efforts instead on the party with the greatest resources, which in many cases are the auditors because they carry insurance against such actions. Thus in the United Kingdom the concept of proportionate liability cannot presently be used by auditors in an attempt limit their liability. In other words they cannot claim that they were only responsible for one-third of the losses incurred and therefore should only be responsible for one third of any damages awarded by a court. A defendant could, however, claim contributory negligence on the part of the plaintiff to reduce the extent of damages should the courts decide that both they and the plaintiff were responsible for the losses incurred.

- 19.2 (a) From the details given it seems highly likely that the auditors have been negligent. Not attending the stocktake nor circularising debtors, both of which are generally considered to be standard practice, would provide strong evidence of negligence by the auditors. The importance of attending stocktakes is illustrated by the recent publication (January 2004) by the APB of a Practice Note titled 'Attendance at Stocktaking'. The omission of both these procedures has been highlighted in case law. In the American case of *McKesson and Robbins*, a major management fraud involving the over-statement of sales, debtors and stock, it is very likely that the fraud would have been detected if the auditors had attended the stocktake and circularised debtors. Although it was common

practice at that time (The McKesson Robbins case was heard in 1939) not to carry out the above procedures, it should be noted that following the investigation by the SEC, the American Institute of Accountants (now the American Institute of Certified Public Accountants) issued a statement on Auditing Procedure that required auditors to attend stocktakes and circularise debtors. Students should also refer to the discussion on the Thomas Gerrard case in chapter 17 and Twomax case in the text of this chapter.

The request that certain debtors not be circularised is one occasionally met with in practice and, although the auditors should attempt to convince the client that these debtors should be circularised, they should be aware that, occasionally, there may be good reasons for managements' attitude. For instance, the company may be in dispute with certain companies about the amount owed and believe that circularising them would only hinder any settlement between the parties. The auditors should ask why the client does not wish certain debtors to be circularised and should ensure that they are verified using alternative audit tests, such as extended audit work on sales to the debtors, including movement of stock, examining documentation and cash receipts. It would also be appropriate to examine correspondence with debtors. If these procedures were not carried out it could be further evidence that the auditors have indeed been negligent.

- (b) The crucial issue would seem to resolve around whether it was reasonable to ignore the provisions in FRS 18 for the items concerned. We emphasised in Chapter 16 that accounting standards should normally be followed unless this leads to the accounts not giving a true and fair view. The Companies Act 1985 << Margin note >> Sch 4, Part III, Section 36A. << end >> specifically requires that companies should state whether the accounts have been prepared in accordance with applicable accounting standards << Similar provisions are included in the Companies Act 2006. << end >> and, where there has been a material departure from standards, that particulars be given together with the reasons for the departure. Although ISA 700 does not specifically state that there should be an assessment of the financial effect of any material departure from the standard << Margin note >> The predecessor to ISA 700, SAS 600, paragraph 40 specifically stated that there should be an assessment unless it would be impractical or misleading in the context of giving a true and fair view. << end >> it would appear reasonable in the interests of the financial statements giving a true and fair view that such an assessment be disclosed. The auditors should assess the reasons for the non-compliance and whether the disclosures are adequate. Furthermore, they will have to decide if the non-compliance results in the financial statements not giving a true and fair view. In this case the auditors appears to have been negligent in not ensuring that there has been adequate disclosure of the departure from FRS 18. It is possible that the lack of explanation of the departure should in itself have led to the accounts being qualified because it impairs the ability of the accounts to give a true and fair view. Therefore, on the basis of the lack of disclosure the auditors would appear to be negligent in respect of their audit work. It would also have to be determined whether in the circumstances departure from FRS 18 was appropriate. Details of the disclosure requirements when a company departs materially from an accounting standard are given in paragraph 62 of FRS 18. Since the need to depart from an accounting standard to give a true and fair view is considered to be relatively rare event the auditors will need to have identified exceptional circumstances which allows non-compliance with FRS 18. We are not given sufficient information in the question to make this judgment but it would appear that the auditors would have an uphill task to prove the correctness of their judgment and that they were not negligent. Leaving aside the issue of the non-disclosure discussed above, a non-justified departure from FRS 18 should lead to a qualified opinion.

In relation to the issue of going concern there are two main aspects to consider. Firstly, although the audit report contained an explanatory emphasis of matter

paragraph about the going concern the adequacy of both the auditors' and the company's disclosures would need to be assessed. Secondly, it would have to be determined if it was actually appropriate to prepare the accounts using the going concern basis. If either of the above two conditions are not met, this would be evidence that the audit work has been negligently performed.

On the basis of the above it would appear that the auditors have been negligent in respect of their audit work. It is important to stress, however, that in audit negligence cases before evaluating the actual work of the auditors, it would have to be determined if they owed Bibbington Ltd a duty of care. This would be decided on the facts of the case using the criteria we discussed in the chapter. For instance, did Bibbington Ltd actually rely on the accounts when making their decision and how close was the relationship between the auditors and Bibbington Ltd.

- (c) You will recall from Chapter 6 that it is normal practice to collect and accept third party evidence. Indeed, we emphasised that evidence originating from outside an organisation is generally regarded as stronger than internal evidence. However, the auditors should not blindly accept evidence as giving absolute proof. This was stressed in the English case of *re City Equitable Insurance Co. Ltd. (1925)* and the Australian case *Pacific Acceptance Corporation Ltd V Forsyth and others (1970)*. In the former case the auditors accepted certificates relating to loans and securities from a firm of stockbrokers. Although the appeal judge did not consider that this constituted negligence he emphasised that the auditors need to consider the trustworthiness of third parties before relying on any certificate. If there is doubt, the auditors should physically inspect the certificates.

Although the judge in the *Pacific Acceptance* case largely re-iterated the above, he took the view that if the auditors decided not to physically inspect the certificates they should ascertain the reliability of the third parties' system. Thus, in the *Gage Ltd* example we need to ascertain what procedures the auditors took to determine the trustworthiness of the stockbrokers. If the stockbrokers were a long established firm of good repute with whom the auditors had dealt with over number of years without finding fault, this would provide strong evidence that he or she had not been negligent. Ideally the auditors should perhaps on a rotational basis have physically inspected some of the certificates, assuming it was practicable. Additionally, where possible, the auditors should obtain corroborative evidence. For instance, if the company has an investment in another company, there may be dividends that can be checked by inspecting the dividend warrant and entry in the cash book.

19.3 In general for an action of negligence to succeed against auditors it must be shown:

- a) that the auditors did not exercise due care and skill
- b) that a duty was owed to the party bringing the action
- c) that this party relied on the financial statements and suffered loss because of the auditors' negligence
- d) it is just, fair and reasonable to impose liability on the defendant

We comment as follows:

- (a) (i) As has been emphasised in the text, adherence to current auditing practice and following auditing standards would be strong evidence an auditor has exercised the necessary care and skill. The issue in this case is the non-attendance by the auditors at the company's stocktake. It would be normal practice to attend the stocktake and given the judgements in *McKesson* and *Robbins* and the *Twomax* cases this would suggest the possibility that the auditors had been negligent.

- (ii) Although the use of analytical review is accepted as an important audit test the fact that stock was considerably overstated may suggest that the review had not been properly carried out. Given the absence of the stocktake the auditors should have extended their analytical review and other audit tests. The fact that the stock figure apparently made sense perhaps highlights the importance of the physical stocktake.
 - (iii) Although the contractual relationship is between the auditors and company, recent cases have suggested that the auditors' responsibilities may in certain specified and restricted circumstances extend beyond that of the members. Mention should be made of the following cases: *Hedley Byrne, JEB Fasteners, Twomax, Caparo Industries, ADT v Binder Hamlyn, James McNaughton Paper Group Ltd. v. Hicks Anderson & Co, Andrew and others v Kounnis Freeman* and *The Royal Bank of Scotland v Bannerman Johnstone Maclay and Others*.
 - (iv) It is likely that the courts would lay most stress on the precedent set and judgments in the *Caparo* and subsequent cases. Thus, since there was no direct relationship between the auditors and the lender, no duty of care would be owed. Although the lender might try and bring the case within the remit of the *Bannerman* case a feature militating against this is that the question states that the auditors were unaware that the accounts had been used by the company in obtaining finance from a lender. It is likely that this would distinguish this case sufficiently from *Bannerman* for a court to follow *Caparo* and deem that a duty of care was not owed by the company to the lender.
- (c) The firm would need to ensure that it complied with current auditing practice and in particular that it applied auditing standards. Specifically, each audit should be adequately planned, recorded and controlled, sufficient evidence must be acquired, and a competent review must be carried out by the reporting partner. The audit firm should also have quality control procedures. For instance, there should be procedures for adequate and effective review by the engagement partner and, where appropriate, by an independent partner that ensures the audit work complies with the standards and procedures laid down by the audit firm. More generally, the audit firm should follow the requirements of ISA 220 - Quality control for audits of historical financial information. Finally, the audit firm might wish to consider adding a disclaimer paragraph to their audit report.

Chapter 20

Criticisms and developments in auditing

- 20.1 We list here a number of points that would form the subject of discussion of the issue in the question.

As a starting point it is useful to consider whether auditors are suffering undue financial hardship because of exposure to third party negligence claims. This is not particularly easy to establish. The auditing profession claims that it is expending considerable resources in meeting or defending themselves against claims and in the cost of obtaining indemnity insurance. The critics argue on the contrary that the profession exaggerates such costs. From published data it would appear that accounting practices are profitable and that audit partners earn substantial amounts of money. The accounting profession's riposte would be that the returns earned are not out of line with what similar professions, such as the legal profession, earn. To establish the validity of the competing claims it would be necessary to gather data on the: number of claims made against auditors, the financial costs arising from claims, the extent and costs of cases settled out of court by auditors and the actual level and costs of obtaining insurance for audit work. Unfortunately, this data is not readily available and therefore it is difficult to arbitrate between the competing claims. We would, however, add that since audit firms appear to remain profitable and we are not aware of any major UK firms going bankrupt, Even in the case of Arthur Andersen their demise was due to loss of reputation and hence of audit clients rather than excessive damages claims. The onus is on the firms to show that they are suffering financially as a result of their exposure to third party claims. Audit firms would claim that they make their profits not from audit work but from other activities. It might be suggested by critics that the reason for the lack of profitability of audit work is partially the result of low-balling and that audit work gives them the opportunity to make profit from non-audit work performed for audit clients. It might also be argued that since audit fees have started to increase in recent years audit is no longer the loss leader critics assert.

As a second strand to answering this question, it is useful to consider whether in principle they should be held fully liable to third parties. The profession would argue that because of the principle of joint and several liability they are often the party plaintiffs look to for damages even though a number of alleged guilty parties may be involved, because they are the party with the greatest resources. On this ground it is not unreasonable to argue that the situation is unfair to auditors. If, however, the innocent third party was not able to recoup the full amount of any losses they have suffered, they would no doubt argue that it is unfair that they suffer as a result of some alleged guilty parties having insufficient resources. A partial way of trying to remedy this situation is to require directors and officers of a company to carry sufficient indemnity insurance to allow them to contribute towards claims arising from actions by third parties. As an alternative it might be argued that some form of capping auditors' liability to third parties should be implemented. It is recognised, however, that it might be difficult to find a practical way of doing this, though, since a form of liability limitation is included in the Companies Act 2006, we will shortly be able to determine how this operates in practice.

Another alternative would be to give greater weight to the principle of contributory negligence to claims by third parties. What we envisage here is the court giving greater consideration to the role the third party plays in the transactions in which they have incurred loss. In particular the courts could consider mitigating factors, such as, the extent of the third parties investigations before they entered into the transaction and the level of reliance they placed on the fact that the financial statements had been audited. It is interesting that the courts in cases, such as *Galoo Ltd and others v Bright Grahame Murray (a firm)*, (1994) have considered these factors when arriving at their decision. Similar considerations entered into the court's deliberation of the *Bannerman* case. Although consideration of these factors may be subjective we would regard this approach as an interesting and worthwhile development. As an aside it is pertinent to

emphasise that buying and holding of shares not only bring rewards but also carry risk. One of those risks is that the shares may not be worth as much as the purchaser expected. When third parties enter into these transactions we believe they have some responsibility to investigate thoroughly the purchase they are considering. It might be argued that some distinction should be made between small purchases of shares by individuals and the purchase of the entire share capital of a company by a third party. We would expect that, where the transaction involves the take-over of a company by a third party for a substantial amount of money, that third party should not just rely on the audited accounts of a company without further investigation. Some distinction might also need to be made between the situation where the financial statements on which the third party has relied are deliberately misstated by the directors of the company and the situation where the financial statements simply contain errors but there has been no deliberate attempt to mislead the third party.

Finally, it might be argued that with the introduction of LLPs in the UK, this has at least reduced some of the potential liability that individual partners might face should their audit firm be sued by a third party. This would seem to indicate that the government believes there is a need to limit to some extent individual partners' liability. It might be argued that the introduction of the LLP is simply a pragmatic step by the government to help sustain the UK as a centre of financial capital. You will remember that certain accounting firms had explored the possibility of locating their business in a jurisdiction other than the United Kingdom. You may also recall from Chapter 19 that since the 1989 Companies Act, audit firms have had the opportunity to become limited liability companies, suggesting that the government of the day considered such arrangement to be suitable for audit firms.

20.2 In response to this question you might have made the following points:

Power has identified and opened up a debate about the increasing and varied use of the term 'audit'. This in itself is a useful exercise because it causes individuals to reflect upon the practices they are either involved in or affected by. In addition, his thesis that the increased use of audit has been caused by three main factors, is one that raises particular issues about accountability and regulatory compliance. His contention that having an audit is more important than the actual practices forming an audit is an issue which would benefit from further investigation. The significance of his proposition that audit is more concerned with testing controls and systems rather than the direct testing of transactions and the implications of this is also an area that is worthy of further exploration. Finally, his questioning of whether the increase in audit has actually led to greater accountability and democracy raises important issues about the way in which society is structured and the role of trust in that society.

Although Power has not actually set out a program of reform for the audit profession or indeed the role of audit in society he has identified and discussed a number of issues that should provoke debate. However, critics of his work might suggest it is too abstract and lacking in actual specific suggestions for it to be a useful stimulus for reform of auditing.