

Chapter 2

An overview of the postulates and concepts of auditing

Questions

2.1 Identification of management assertions in respect of figures in the financial statements is a vital part of the audit process. State whether you agree with this statement, giving practical examples.

2.2 Explain what is meant by the principle of auditor integrity. How do you think we should ensure that the principle is adhered to?

2.3 Auditors are expected to approach their work with thoroughness and with an attitude of professional scepticism. What do you think that professional scepticism means in practice?

2.4 You are auditing a company that shows a loss for the year of £700 000. This figure is after charging impairment of property, plant and equipment of £1 500 000. As a part of your work you note that in the Directors' Report a profit of £800 000 is quoted as profit for the year. What are your responsibilities in respect of this matter?

Solutions

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, examples of what management is implying in relation to trade receivables are:

- 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 receivables will be received in full, the implied assertion here being that full provision for bad and doubtful debts has been made.
- c) All customers balances on credit are reflected in the trade receivables 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 inventory cut-off is accurate to ensure that trade receivables represent amounts due at the balance sheet date. Specific tests would include a credit customers' 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 trade receivables is valid. To this end, the auditor will examine credit customers' ageing statements and look at the past record of payment by them. Other procedures would include examining payments by credit customers 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. You might check, for instance, that the unbound copies are in respect of a current edition. 20,000 copies of the 4th edition of *The Audit Process* might not be saleable when the 5th edition is already available. 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.