AUDITING AND THE PUBLIC ACCOUNTING PROFESSION

CHAPTER 1

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After studying this chapter you should be able to:

1 appreciate how auditing developed

2 discuss the historical and other factors that influence the role of auditors, and the resulting complexities of meeting public expectations

3 explain the scope of auditing within the assurance framework and its relationship with other nonaudit services

4 describe the accounting profession in the United Kingdom and the constituencies that influence the profession and audit practices

5 explain the nature of and scope of assurance services performed by public accountants

6 explain the nature of nonaudit services, and describe several types performed by public accountants

7 distinguish different types of audit activity and auditor

8 explain the regulatory framework for ensuring quality services

9 state the elements of quality control applicable for audits and assurance services.

PROFESSIONAL STATEMENTS

IAASB	*International Framework for Assurance Engagements*
ISA 200	*Objective and General Principles Governing an Audit of Financial Statements*
ISA 240	*The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*
ISA 250	*Consideration of Laws and Regulations in an Audit of Financial Statements*
ISA 220	*Quality Control for Audits of Historical Financial Information*
IAPS1010	*The Consideration of Environmental Matters in the Audit of Financial Statements*
ISQC 1	*Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*

Audit (as well as other assurance services) plays a vital role in business, government and our economy. The nature of this role will be explained in Chapter 2. Evidence of its importance is provided by the fact that all of the following bodies are required to have an annual audit:

- all public and larger private companies
- government departments, local authorities, NHS Health Trusts and local authorities
- registered charities and other 'not-for-profit' organizations, including educational institutions.

It is estimated that well over a million audits annually are conducted in accordance with statutory requirements in the member states of the European Union.

Auditing services have been changing rapidly since the early 1990s. Audit practices have been evolving in response to growing public expectations of accountability and to the complexities in economic and technological advances being made in business organizations. An important recent development has been the challenge of globalization and the need for harmonization of financial reporting in facilitating the most efficient allocation of investment funds globally. Harmonization applies not only to the financial reporting standards applied in preparing financial statements but also to the credibility attached to the audit process. As a vocation, therefore, a career in audit and assurance offers the opportunity to work in a challenging and rewarding dynamic business environment as well as providing the opportunity to develop a thorough understanding of a wide range of professional services and serve the interests of users of financial information.

This chapter traces the conceptual development of auditing over the years. It also provides a broad framework of the accounting and auditing profession and its related associations, a description of the general types of audit activity and a review of the system of quality procedures prescribed for the profession.

The Evolution of Auditing Practices

Auditing has developed from what, in the twelfth century, was primarily a check of the accounting for stocks and revenues by authorized officers of the Exchequer of England into a sophisticated professional assurance service performed by independent accountants in the interests of their clients and other users of financial information. This section describes the development of the auditing role over the years, with particular reference to the nature and objectives of auditing, the responsibilities of auditors and the evolution of the accounting and auditing profession. This historical perspective is particularly relevant given the current shift away from traditional accounting and auditing services to a broad variety of assurance services more relevant to the emerging information revolution.

The traditional conformance role of auditing

The traditional conformance role of auditing first appeared in the United Kingdom during the 1800s. The nature of this role was articulated in major legal case decisions at the end of that century. In fact, the development of the auditing role is very much an outcome of court cases, as is seen in the following sections.

Auditing in the United Kingdom

The word 'auditing' comes from the Latin word *audire*, meaning 'to hear'. In the late Middle Ages in Britain, accounts of revenue (tax receipts) and expenditure for manors and estates were both 'heard' by an auditor, whose task was to examine such accounts. With the spread of double-entry book-keeping, first described by Luca Pacioli in 1494, associations of accountants were formed, and auditing gradually established an important role.

Auditing as we know it today can be traced back to the development of joint-stock corporations in the United Kingdom during the Industrial Revolution from the early 1800s. The increasing use of the company form of business organization led to growth of a professional class of managers who handled large sums of capital on behalf of shareholders. Recognizing the need for periodic reporting by managers to shareholders, the Joint Stock Companies Registration and Regulation (Joint Stock Companies Act) 1844 stipulated that 'Directors shall cause the Books of the Company to be balanced, and a full and fair Balance Sheet to be made up.' The Act provided for the appointment of auditors who were empowered to examine the accounts of the company.

Regulation 94 of the UK Companies Act 1862 required the auditors to state in their report.

> . . . whether, in their Opinion, the Balance-Sheet is a full and fair Balance-Sheet, containing the particulars required by these Regulations, and properly drawn up so as to exhibit a true and correct view of the State of the Company's Affairs . . . such Report shall be read, together with the Report of the Directors, at the Ordinary Meeting.

Table 1.1 shows the development of the audit function through successive Companies Acts. In particular it shows how the audit first became compulsory for all companies in 1900, how the auditors were required to have appropriate professional qualifications from 1948 and how the accounts to be reported on and the wording of the report gradually evolved over time. Sometimes the legislation was revolutionary and designed to curb abuses, such as the introduction of compulsory audits for specific classes of business during the latter part of the nineteenth century. On other occasions the legislation merely confirmed and regularized practices that had become commonplace. By 1900 most companies with significant numbers of outside shareholders were audited and, by 1948, most auditors were professionally qualified.

Table 1.1 Development of audit requirements in companies legislation

	ACT	AUDIT REQUIREMENTS/ RESPONSIBILITIES	INFORMATION TO BE AUDITED	REPORT WORDING
1844	Joint Stock Companies Act	Required but neither independent nor professional	Balance sheet	Full and fair
1856	Companies Act	Not compulsory. Model set of articles, published as a Table to the Act, and whose adoption was optional, incorporated the audit requirements of the 1844 Act	Balance sheet	Full and fair
1868	Regulation of Railways Act	Compulsory audit	Uniform balance sheet	—
1871 1879 1882	Gas Banks Electricity	Similar requirements as for railways	—	—
1900	Companies Act	Compulsory audit. Not by a director or officer. Auditor given right of access to books, records, information and explanations	Balance sheet	True and correct
1948	Companies Act	Professional audit	Balance sheet	True and fair

1976 1980 1981	Companies Act	Auditors' powers progressively strengthened especially against arbitrary dismissal and given right of access to subsidiaries' records	Increasing disclosure requirements in P& L and notes to be covered by auditors' report. True and fair override introduced	True and fair
1989	Companies Act	Statutory regulation of auditors	Recognition of accounting standards	True and fair
2006	Companies Act	Reckless reporting by auditors becomes a criminal offence. Provisions for limitation of auditors' liability introduced. Auditors to consider whether 'adequate' accounting records have been kept	Recognition of international accounting standards	True and fair

It is sometimes suggested that the emphasis of the Companies Act auditing requirements has changed over the years from fraud and error detection to attesting the credibility of financial statements for investment purposes. For example, in Lawrence R. Dicksee's book *Auditing: A Practical Manual for Auditors*,[1] published in 1892, the objective of an audit was said to be threefold:

- the detection of fraud
- the detection of technical errors
- the detection of errors of principle.

The Companies Act 2006 recital of auditors' responsibilities still reflects the unsophisticated methods employed by Victorian directors to mislead their shareholders, notably the requirement to determine whether or not the company's accounts are in agreement with the accounting records. With the increasing sophistication of creative accounting and the development of the securities markets, directors are more likely to defraud investors by producing accounts intended to mislead the securities markets rather than by the simple device of paying dividends out of capital. In recent additions to companies legislation we see an increasing concern with full disclosure and with increasing responsibility being imposed on auditors to determine whether the accounts are indeed fair.

The influence of case law on auditing

While 'hearing' the accounts and checking records were then the predominant functions of auditors, two major audit cases in the late 1800s helped to establish the fundamental principles of auditing. These cases, *London and General Bank* (1895)[2] and *Kingston Cotton Mill Co.* (1896),[3] are described in Chapter 4. They make clear that auditing is a professional activity with auditors required to exercise reasonable care and skill, but that what is proper conduct in any set of circumstances is inevitably a subjective question which the court determines with hindsight.

The complexity of accounting and the business environment makes it impossible for auditors to detect all aspects of fraudulent activity in an organization. Hence, the auditors' responsibility for detecting fraud and errors continues to be a much-debated issue. Nonetheless, following these two landmark cases, efforts continued to be made to define the responsibilities of the auditors, with the primary duties being subsequently confirmed in legislation.

The development of auditing in the United States

Auditing in the United States has developed along similar lines to those in the United Kingdom and both the profession and the courts in the United Kingdom closely watch developments in the United States.

In 1931 the *Ultramares* case in America prompted the accounting profession to clarify that the auditors were expressing an opinion and not giving a guarantee, and that the 'balance sheet and the related statement of income and surplus present fairly . . .'

In responding to severe criticism of the financial community and corporate management, the Congress of the United States passed the Securities Act 1933 and the Securities Exchange Act 1934. These Acts contained the requirements for the audit of financial statements of corporations seeking to issue securities, or corporations wanting to register with the Commission for the public trading of securities. The Acts placed a significant responsibility on professional accountants and increased their authority.

The hearings held by the Securities Exchange Commission into the *McKesson & Robbins* fraud case in 1939 and the findings released the following year had an impact not only on audit procedures, but also on the development of auditing standards and the content of the auditors' report. The confirmation of debtors and the observation of stock-taking procedures were made mandatory.

The development of an enhancing role

Apart from a change in the audit approach, auditors face an increasing demand for more accountability and for more perceived benefits for users. One development has been the issue of formal standards to improve the quality and consistency of auditing. There is also an expectation that auditing, as a professional service, should not only provide assurance for the credibility of financial statements, but also enhance the integrity of financial information and its usefulness in decision making by management and other users.

Defining reasonable care and skill

A number of cases, such as that of *Thomas Gerrard & Son Ltd* 1967,[4] have indicated that what constitute reasonable skill and care evolve with time. These cases made it clear that auditors should pay due regard to the possibility of fraud and actively investigate that probability should suspicious circumstances arise. The courts also continued to exercise their prerogative to assess the reasonableness of professional standards in specific circumstances and therefore what constitutes reasonable care and skill.

Enhancing the credibility of financial information

In the 1970s, auditors described their role as one of enhancing the credibility of financial information and furthering the operations of an effective capital market.[5] In the *New York Times* of 6 April 1975, audits were said to affirm the truthfulness of financial statements and ensure that financial statements were 'fairly presented'. This function was loosely linked to various audit practices, including:

- the review and testing of company records and the procedures and controls used to assemble financial information
- the approval to use various accounting principles
- the examination of financial statements to ensure they contained no material misstatements, omissions or misleading presentations of data.[6]

Auditing as a service to provide reasonable assurance to users

The International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC) defines an assurance engagement as one

> in which a practitioner expresses a conclusion designed to enhance the degree of confidence that intended users can have about the evaluation or measurement of a subject matter that is the responsibility of a party, other than the intended users or the practitioner, against criteria.[7]

The IAASB's *International Framework for Assurance Engagements* states that an assurance engagement involves the following elements:

- *a three-party relationship* involving the practitioner, such as the independent auditor, the responsible party, such as the board of directors of a company, and the intended users, such as the company's shareholders
- *a subject matter*, such as the financial statements, whereby the directors demonstrate their accountability to the shareholders
- *suitable criteria*, such as truth and fairness in accordance with international financial reporting standards
- *sufficient appropriate evidence*, such as the company's books and records
- *a written assurance report*, such as the auditors' report.

Under the Framework, there are two types of assurance engagement: a reasonable assurance engagement and a limited assurance engagement.

The objective of a reasonable assurance engagement (such as an audit) is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.

For example, in an audit engagement the practitioner:

- identifies the risks that the subject matter may be materially misstated
- performs procedures to gather and evaluate evidence in response to those risks to reduce the overall level of risk that the subject matter is materially misstated to an acceptably low level
- expresses a positive opinion with respect to the agreed criteria, such as 'in our opinion the financial statements *(the subject matter)* give a true and fair view *(conform in all material respects with the criteria)*'.

The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

An example of this is a review engagement where the practitioner obtains assurance primarily through inquiry and analytical procedures but not detailed verification of transactions and balances (fewer evidence-gathering procedures than an audit). Further procedures are carried out only if there is reason to suspect the subject matter may be misstated. The resulting assurance is limited and expressed in a negative form, such as 'nothing has come to our attention that causes us to believe that *the subject matter* does not conform, in all material respects, with *the criteria*'.

For practical purposes the IAASB also distinguishes between regulation of engagements to provide assurance on historical financial information (audits and reviews) and, in acknowledgement of the growing demand for providing assurance on other subject matter, other types of assurance engagements. Audits are regulated by International Standards on Auditing (ISAs) and International Auditing Practice Statements (IAPSs). Reviews are regulated by International Standards on Review Engagements (ISREs) and International Review Engagement Practice Statements (IREPSs).

Assurance engagements other than audits or reviews of historical financial information are regulated by International Standards on Assurance Engagements (ISAEs).

In addition, because professional accountants may provide other services that do not provide assurance, the IAASB have also issued International Standards on Related Services (ISRSs). These cover:

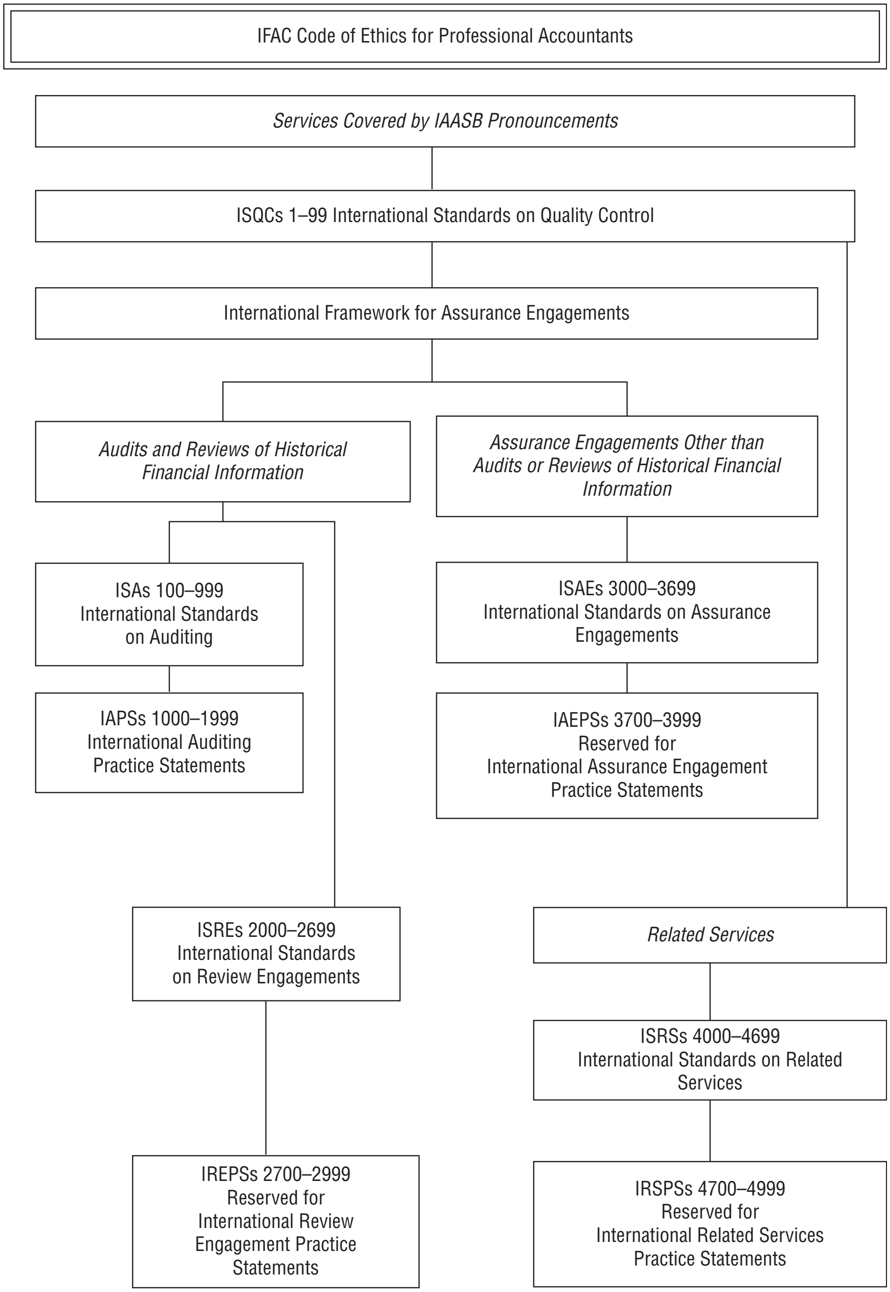
- *agreed procedures* that result in a report as to findings after performance of specified procedures
- *compilation engagements* (for example, *preparation of financial statements*) that provide no specific assurance but users derive benefit from the fact that the professional accountant has applied an appropriate level of skill and care in performing the service.

It is important that, in providing nonassurance services, users are not misled into believing that any level of assurance is being provided.

Assurance services – satisfying the information needs of users

For many years, independent auditors have provided assurance on an entity's financial statements. However, traditional financial reporting is being criticized for failing to meet developing users' needs. In 1991, the American Institute of Certified Public Accountants (AICPA) formed a special committee, the Jenkins Committee, to assess the needs of the users of financial information and recommend improvements to the financial reporting framework. One recommendation of the Committee was that business reporting should provide more forward-looking information. However, such recommendations were a conundrum for the world of financial reporting and the accounting profession in particular.[8] On the one hand, there was justifiable demand for improvement in financial reporting. On the other hand, any change in the direction of providing more forward-looking information would, where auditors give assurance as to the presentation of financial data, potentially increase auditors' risk of exposure to liability/litigation. It is in this context that the AICPA formed another special committee on assurance services – the Elliott Committee. The charge of the Elliott Committee was to:

> . . . analyse and report on the current state and future of the audit/assurance function and the trends shaping the audit/assurance environment, focusing on the current and changing needs of users of decision-making information and other stakeholders in the audit/assurance process, and how best to improve the related services.
>
> *Board of Directors, AICPA, Charge to AICPA Special Committee on Assurance Services (Apr. 22, 1994)*



IFAC Handbook (Part 1) – January 2008

Figure 1.1 Structure of pronouncements issued by the International Auditing and Assurance Standards Board.

Source: Copyright © January 2008 by the International Federation of Accountants (IFAC). All rights reserved. Used with permission of IFAC. *IFAC Handbook* (Part 1), http://www.ifac.org/Members/Pubs-Details.tmpl? PubID=12053500512580151&Category=Auditing%2C%20 Assurance%20%26%20Related%20Services (accessed 31 July 2008).

The Elliott Committee recognized the need for the profession to diversify its product potential away from the traditional financial statement audit in the light of declining demand for that service. It recommended that this be achieved by embracing and significantly expanding the assurance services provided by the profession in order to consolidate its existing markets, and to capitalize on its competitive advantages in the emerging information markets.[9] Furthermore, it recommended that the audit/attestation function should evolve into the assurance function, with a significant movement towards broader-based assurance services.[10]

The collapse of the giant US corporation, Enron, at the end of 2001 provided an increased impetus in the development of improvements in financial reporting and auditing. Among proposals currently being considered are requirements for auditors to report on the effectiveness of entities' risk frameworks and on the Operating and Financial Review that is to become a mandatory disclosure by listed companies.

While the professional, regulatory and standard setting bodies reassess their position regarding audit and assurance services, the professional firms continue to address the complexity of the changing needs of users and the rapid growth of information technology. In a 1997 publication by KPMG Peat Marwick LLP, William Kinney Jr, its Director of Assurance Services, announced that business viability and profitability assessments are essential elements of financial statement auditing today.[11] He refers to the need to establish, as key audit steps, the audit procedures of strategy analyses, business processes, key indicators necessary to monitor business performance and risk assessment. The viability of the business strategy, the reasonableness of business plans and the effectiveness of internal controls are all essential matters about which decisions need to be made in determining audit procedures.

The following paragraph provides some indication of how auditing practices are evolving to yet another level – an enhancing role that adds value to business reporting:

> As the global economy, the business organisations operating within it, and organisations' business strategies become increasingly complex and interdependent, we believe more attention should be paid to the development of audit methods and procedures that focus on assertions at the entity level – methods and procedures that promise greater power to detect material misstatements as they allow the auditors to ground key judgements in a more critical and holistic understanding of the client's systems dynamics. We further believe that today's complex economic world requires a break from the auditing traditions that have evolved from the early balance sheet audit – traditions under which the auditors' attention is focused primarily at the sub-unit level, and his views about what is evidence are heavily skewed toward tangibility (i.e. the physical existence of assets, the existence of tangible documentation supporting transactions, etc.). Today's auditors should place more weight on knowledge about the client's business and industry, and its interactions with its environment, when forming an opinion about the validity of financial statement assertions . . .[12]

Auditing – a shifting paradigm

From the previous sections, it is clear that the role of auditing has evolved through a number of stages. The relevance of auditing was established through its historical value in ensuring the correctness of the accounts, detecting fraud and errors and providing an independent opinion on the truth and fairness of financial statements for users. Nowadays, to address the complexity of the information needs of users, auditors are expected not only to enhance the credibility of financial statements, but also to provide value-added services, such as reporting on irregularities, identifying business risks and advising management on internal control weaknesses as well as consideration of other governance issues. Alongside the changes in audit expectations is the increasingly competitive audit environment, where traditional audit services are blurred with nonaudit services. The paradigm of independent auditing can be argued to be shifting and the auditors' role is being redefined. Changes in three major aspects of auditing are discussed below:

- its scope with respect of the detection of fraud and error
- the essential characteristics of audit independence
- the sustaining factor of auditors' liability.

Detection of fraud and errors

Prior to the collapse of Enron in 2001, auditing had been moving away from the fraud detection emphasis as described on p. 4 of L.R. Dicksee's *Auditing: A Practical Manual for Auditors*. Greater emphasis had been placed on the truth and fairness of the financial statements as such, regardless of whether the misstatement was fraudulent or accidental. Enron showed that such an approach lulled auditors into disregarding deliberate management intent in producing fraudulent financial statements. However, two recent changes in auditing standards have strengthened the auditors' responsibility to detect fraud, whether leading to the misappropriation of assets or the misstatement of financial statements.

First, auditors are now required to evaluate the effectiveness of an entity's risk-management framework in preventing misstatements whether through fraud or otherwise, in all audits. Previously they had been required to undertake such an evaluation only where they chose to place reliance on that framework and reduce the extent of their own investigation. Moreover, all staff members engaged on an audit are required to communicate their findings to prevent situations where staff members, working independently on their own section of the audit, fail to appreciate the significance of apparently minor irregularities that, if combined, take on a more sinister aspect.[13]

Second, auditors are now required to be more proactive in their search for fraud. They are required to assess the risk of fraud occurring. This includes considering incentives, opportunities and rationalization among potential fraudsters that the fraudulent act may be justified. They are also expected to inquire more closely into the reasons behind such matters as errors in accounting estimates, unusual transactions that appear to lack business rationale and a reluctance to correct immaterial errors discovered by the audit. Again, the need for collaboration among audit team members is emphasized.[14]

Auditor independence

As auditors provide assurances on the credibility of the financial statements, the concept and practice of audit independence – the cornerstone of auditing – is also subject to much debate. The codes of ethics laid down by the professional bodies of accountants refer to a range of risks concerning actual and perceived independence. Independence is the essence that underlies the success and credibility of the accounting profession and its service to the public. It helps to provide the objectivity that permits the profession to perform its attestation and monitoring functions effectively. The current paradigm for addressing independence issues is based on the underlying belief that allowing auditors to perform nonaudit functions for audit clients, or to engage in management activities, presents the greatest potential for conflict. Those espousing this viewpoint would argue that auditors should do little nonaudit work for audit clients. After the collapse of Enron, the United States passed legislation banning auditors from providing a wide range of nonaudit services for their audit clients.[15] However, as pointed out by Wallman,[16] while this approach to audit independence may seem reasonable, it fails in a number of respects and may well be contrary to the public interest. It is perceived to have failed to recognize the complexity of audit practices, the sophisticated business environment and the acute competition in which accounting firms operate. The United Kingdom and other countries have failed to follow the US lead but have imposed rules for tighter control over and transparency of the provision, by auditors, of nonaudit services to audit clients. Moreover, responsibility for setting and enforcing ethical codes of conduct has been transferred from the professional bodies to independent regulators. Furthermore, the influence and status of the IFAC has increased and has effectively benchmarked the level of standards to be applied globally by its member bodies. These matters are further discussed in Chapter 3.

Auditor liability

Another example of changes in the auditing environment is in relation to auditors' liability. In an audit conducted in accordance with the Companies Act 2006, the auditors are liable under statute and common law to the shareholders, who made the appointment and to whom auditors report, for any negligent performance of statutory duties. The auditors' liability to the organization being audited is contractual and stems from having undertaken to perform, with due care, for the purpose of expressing an opinion on the financial statements. Although the duties of auditors cannot be restricted or reduced the Companies Act 2006 has introduced provisions that allow 'limited liability agreements' to be entered into. This will result in a reduction in the amount of damages paid out by auditors and their insurance companies. A considerable body of case law has built up over the years with respect to the duty of care auditors owe to the auditee and the owners of the entity.

The common law concerning the auditors' liability to third parties is complex and has been subject to broad interpretation. The landmark case of *Caparo Industries PLC vs. Dickman and Others* (1990) 1 All ER 568 saw the concept of proximity redefined. This case reversed the judgement in *Hedley Byrne & Co. Ltd vs. Heller & Partners* (1963) 2 All ER 575 and restricted the auditors' duty of care. As auditors they are responsible only to members of the company relying on audited financial statements for collective decisions as to the management of the company. The auditors hold no duty of care for economic loss suffered by potential investors and individual shareholders unless the auditors have held out, to such parties, that they could place reliance on the financial statements.

The development of auditing practices over the years suggests a possible shift of the auditors' conformity role into a far more dynamic role of enhancing the value of financial reporting. Although the fundamental principle of audit assurance services has not changed explicitly, one can envisage the development of an expansion of assurance services within the audit function. On the other hand, there have been fundamental changes in the business environment within which auditors' professional services are required. The increasing expectations of business entities and the high level of accountability required of the auditors give rise to a change in the audit framework. It might be too early to predict the auditing practice of the future; however, it is apparent that there is a possible shift in the audit paradigm from a conformative attestation to the enhancing role of a value-added service.

The European Commission has also considered the issue of auditor liability from the perspective that variations in liability within member states may affect the internal market within the European Union. The results of a consultation exercise in 2007 confirmed that there was overwhelming support in favour of auditors being able to limit their liability. As a result the EU has recommended that from 2008 member states commence preparations to limit auditors' liability. The question of auditor liability is considered further in Chapter 4.

LEARNING **CHECK**

- Auditing, in the last century, was confined to the conformance role of ascertaining the correctness of accounts and the detection of fraud and errors.
- The development of case law, globalization, company failures and other economic factors have impacted on the expectations of auditing.
- An audit is now considered to be a service to provide a reasonable level of assurance in which a positive opinion is rendered about an accountability matter.
- Although primarily concerned with financial statements, the auditor needs to examine analyses of strategy and business processes (as well as many other factors) as part of a complex process of providing audit assurance.
- The auditing environment is changing to facilitate the expanded role of audit and the provision of a wide range of other professional services. These include engagements that provide a limited level of assurance and those that do not provide assurance.

The Accounting Profession and its Associated Organizations

Accounting bodies have influenced the development of the profession and audit practice through:

- maintaining standards of qualifications achieved through accredited courses, examinations and practical experience for accountants seeking to become members
- furthering standards of practice achieved through research and the issuance of standards, the provision of continuing professional education and the establishment of codes of ethics and professional conduct to be observed by the members
- ensuring professional conduct and effective regulation on quality of service.

In recent years the second function and elements of the third relating to matters that are described as being in the public interest have been devolved to independent regulatory bodies at both national and international levels.

Private sector organizations

In the United Kingdom the accounting profession traces its origins back to eighteenth century Scotland and the management of estates confiscated after the 1745 rebellion. From this beginning, legislation dealing with the management of bankrupt and deceased estates developed more rapidly in Scotland than in England. It was a natural progression from such work to take on other employment requiring the preparation and maintenance of accounting records, such as for growing industrial firms. In order to protect their image from the risk of adverse publicity brought about by the incompetent and even dishonest administration of estates, a group of accountants in Edinburgh set themselves up as a society committed to upholding sound ethical principles in the conduct of their professional practices. Soon, similar societies were springing up elsewhere in Scotland and then in England and Ireland. Membership of the newly formed professional bodies expanded rapidly with auditing becoming their major source of revenue in the closing decades of the nineteenth century. Local bodies joined forces with each other to create national bodies until, in 1880, the Institute of Chartered Accountants in England and Wales was formed and, in 1891, the Association of Chartered Certified Accountants.

The public accounting profession continues to be represented directly by these two prominent accountancy bodies and also by the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland. The three institutes of chartered accountants cooperate closely in matters such as setting ethical standards and investigating complaints against members and will be referred to collectively as the institutes. Membership of these bodies is voluntary but is nevertheless important. For example, membership is necessary to satisfy the registration qualification for company auditors. Membership provides for self-regulation within the profession in setting competency standards. This is in the public interest.

The Association and the institutes provide a broad range of services to their respective members to assure that they serve the public interest in providing quality professional services. The accountancy profession is also active internationally. All of the bodies are represented on the International Accounting Standards Board (IASB), the International Federation of Accountants (IFAC) and on its standard-setting boards and committees. These include the International Accounting Education Standards Board (IAESB), the International Auditing and Assurance Standards Board (IAASB), the International Ethics Standards Board for Accountants (IESBA), which develops ethical standards and guidance for use by professional accountants, and the International Public Sector Accounting Standards Board (IPSASB). The work carried out by these standard-setting boards forms a valuable part of the process in developing accounting and auditing standards within the United Kingdom and Ireland both by way of representation and collaborative projects.

Association of Chartered Certified Accountants

The Association has over 115 000 members and approximately 300 000 students and is expanding rapidly internationally. Over two-thirds of students come from outside the United Kingdom and Ireland – the Association is represented in 170 countries. Almost one-third of its members are engaged in public practice, and almost half in commerce and industry. The remaining members are employed in the public sector or in education. The Association issues professional and technical statements, has a code of ethics, conducts education programmes aimed at continuing professional development, funds research and holds annual congresses. It maintains libraries and publishes a monthly journal *(Accounting and Business)* and a separate journal for student members *(Student Accountant)*.

The Institute of Chartered Accountants in England and Wales

The Institute of Chartered Accountants in England and Wales was established by Royal Charter in 1880. Until recently, it recruited educated and trained members in public practice. However, it is now encouraging commerce and industry to participate in the training of chartered accountants and is proactively seeking to broaden its international presence. It has over 128 000 members, a third of whom work in public practice. The services it provides to its members are similar to those of the Association and, additionally, include a highly successful advisory service to members on professional ethics. In addition to its monthly journal, *Accountancy*, the Institute publishes a quarterly research journal, *Accounting and Business Research*. Members who hold public practice certificates are subject to the

Institute's practice monitoring programme. It also has six specialist faculties covering areas of expertise in accountancy and related areas including one for audit and assurance. In 2005 the Institute established the Audit Quality Forum. This is highly respected and provides a platform for the debate of audit quality issues amongst the profession, regulators, investors, business and other interested parties.

Practice entities

Since the 1970s the accounting profession has been dominated by giant multinational firms. There were eight such firms in 1990 but, as a result of mergers, the number is now reduced to four, who between them audit the majority of companies quoted on stock exchanges around the world. The Big Four firms are continually engaged in innovative strategies in order to deliver the range of professional services demanded by clients. The growth of electronic commerce and technology is pushing the profession to develop continuous or 'live' audits and engage in a wider range of information-based management services. It is argued that accountants and auditors will need to be 'reskilled' in order to meet the dynamic growth in business advisory and consulting services.

Below the Big Four is a second tier of 10–15 national firms. These firms have offices in the major towns and cities in the United Kingdom and serve mainly medium sized and small clients. Their main strength is in the private and family company sector. Many of these firms have some form of association with smaller firms in other countries to handle the international needs of their clients.

Regional firms have offices within a limited geographical area and usually serve smaller clients relative to the size of those served by international and national firms. Local firms may consist of a sole practitioner or a relatively small partnership. These are by far the most common form of practice unit. Such firms serve small entities and individual clients providing mainly tax and write-up services. Some of the smaller regional and suburban firms have flourished by developing their own specialities such as specific aspects of tax practice, pension consulting, provision of litigation support and business advisory services. In summary, the expertise and experience of the practitioner and the size and resources of the practice entity dictate the range of services a firm is able to offer.

Vigorous competition has encouraged the growth of multi-service practice entities. The Big Four accountancy firms are able to provide a broad range of services to their clients although, in response to growing concern over the provision of nonaudit services to audit clients, the management consultancy arms have been demerged into separate business entities. Medium-to-small firms tend to be more localized and specialized in the nature of the services they offer.

Two of the leading UK firms of accountants, Price Waterhouse (now PricewaterhouseCoopers) and Peat Marwick Mitchell (now KPMG) established branch offices in New York at the end of the nineteenth century to oversee the interests of British investors into American companies. British accountants also opened up branch offices throughout the Commonwealth. An accounting profession modelled on the UK profession thus developed in the United States and most countries of the British Commonwealth. As a result accounting and auditing practices have also developed along similar lines in these countries, which has facilitated the development of international harmonization in recent years. This harmonization has been encouraged by UK and US firms who had developed links with each other and with firms elsewhere in the world. These links have proved particularly useful with the development of multinational industrial corporations after the Second World War. Audit reliability could be strengthened if the parent company auditors knew that associated auditing firms whose reputation they could rely upon were auditing subsidiaries.

The structure of the audit market is currently a much debated topic. One of the major concerns is that because the big firms are so few in number the audit market lacks competition. This issue is considered further in Chapter 17.

London Stock Exchange

The London Stock Exchange (LSE) is a private sector entity that organizes a national market for company securities. The listed companies enter into a contract with the LSE to comply with their rules and regulations. Responsibility for setting listing rules has now been transferred to a statutory body, the UK Listing Authority under the oversight of the Financial Services Authority. However, prior to this the LSE played a useful role in directing the attention of the accounting profession to important financial reporting issues. In particular it was the LSE, together with the accountancy profession, that set up the Committee on Financial Aspects of Corporate Governance under the chairmanship of Sir Adrian Cadbury in 1992. The work of this committee set international precedents in developing improved financial reporting. Responsibility for development of the resultant Combined Code on Corporate Governance, incorporated within the Listing Rules, now lies with the Financial Reporting Council.

Standard setting bodies

Financial Reporting Council (FRC)

The independent regulator within the United Kingdom and Ireland is the Financial Reporting Council (FRC).

The overall aim of the FRC is to promote confidence in corporate reporting and governance. The FRC Board, which from November 2007 has replaced the former FRC Board and Council, is composed of the Chair, a nonexecutive Deputy Chair, the Chief Executive, seven nonexecutive directors and the Chairs of the FRC's six operating bodies. The FRC appoints members to its operating bodies and committees, which are:

- *Accounting Standards Board (ASB)* – responsible for the issue of Financial Reporting Standards (FRSs);
- *Auditing Practices Board (APB)* – responsible for issuing auditing standards (ISAs (United Kingdom and Ireland)) and other guidance relevant to auditors and reporting accountants;
- *Board For Actuarial Standards (BAS)* – responsible for setting actuarial technical standards;
- *Professional Oversight Board (POB)* – provides independent oversight of the audit, accountancy and actuary professions and monitors the audit quality in relation to economically significant entities;
- *Financial Reporting Review Panel (FRRP)* – reviews company compliance with accounting requirements;
- *Accountancy and Actuarial Discipline Board (AADB)* – responsible for operating and administering disciplinary schemes for the accounting and actuarial professions. The focus of the AADB is the investigation of public interest cases;
- *Committee on Corporate Governance* – responsible for promoting high standards of corporate governance.

All of these bodies are important to the audit function and will be referred to further in the text.

In appointing members the FRC is required to consider the respective requirements of expertise and independence. Technical expertise predominates in the case of the ASB but independence and a majority of lay members (those who are not members of the accounting profession) predominate in the case of the POB and the AADB. Expertise is necessary among members of the APB but a majority should not be practising auditors.

The APB is also responsible for establishing ethical standards on independence, objectivity and integrity applicable to independent auditing and assurance services. The professional bodies are responsible for setting ethical codes of conduct for members. (These matters are dealt with in Chapter 3.)

The constitution of the FRC and its subsidiary bodies is drawn up so as to maximize their independence and freedom from any accusation that the standard-setting process is captured by any group in its own self-interest. The FRC is committed to the Better Regulation Commission principles of good regulation. Further information about the work of the FRC and its operating bodies can be found on the FRC's Web site: www.frc.org.uk.

International Accounting Standards Board (IASB)

At present financial statements prepared in accordance with International Financial Reporting Standards (IFRS) issued by the IASB are fully acceptable on any stock exchange except in the United States (although significant progress has been made towards achieving convergence in standards and acceptance of IFRS in the United States). Also, from 2008, foreign private issuers are permitted to file IFRS financial statements without a reconciliation to US GAAP. The ASB has adopted IFRS as the basis for the development of its own standards. Many other countries also use IFRS as the basis for financial reporting. In the European Union IFRS must form the basis for group financial statements prepared by listed companies.

The IASB is governed and funded by the International Accounting Standards Committee Foundation. This is an independent entity governed by a body of Trustees. The Trustees represent both geographic and sectional interests, such as the accounting profession, preparers and users, and are required to fill vacancies in their ranks to maintain a similar representation. They appoint the members of the IASB having backgrounds as auditors, preparers and users who have the sole responsibility and authority to set IFRS in consultation with national standard setters. As with the FRC, the intention is to maintain the independence of the standard-setting mechanism from any attempt to manipulate that process.

The International Federation of Accountants (IFAC)

The IFAC is the global organization for the accountancy profession. It has 157 members and associates, which are primarily national professional accountancy bodies in 123 countries, Through its independent standard-setting boards, it develops international standards on ethics, auditing and assurance, education, and public sector accounting standards. The IFAC's mission is to serve the public interest by strengthening the worldwide accountancy profession. It promotes high-quality professional standards, furthers the international convergence of such standards and speaks out on public interest issues.

International Auditing and Assurance Board (IAASB)

The IAASB is an independent standard-setting board of the IFAC.

Until recently the aims of the IFAC (and the IAASB) have been purely advisory. The decision to endorse or adopt recommendations has been made by authoritative bodies in each country and it is these bodies that take on responsibility for ensuring an absence of bias in those recommendations. With the decision by the European Commission to require the application of IAASB standards on all statutory audits performed within member states, the status of the IAASB has been raised from advisory to authoritative. At a worldwide level in 2007 over 100 countries were identified as having adopted IAASB standards or using them as a basis for national standards. The United Kingdom and Ireland first adopted a tranche of International Standards on Auditing (ISAs) in December 2004. These are identified as ISAs (United Kingdom and Ireland).

The International Ethics Standards Board for Accountants (IESBA)

The IESBA develops ethical standards and guidance for use by professional accountants. Standards issued by the IESBA must be incorporated into the ethical codes of member bodies.

Statutory audit regulation

The Companies Act 2006 lays down provisions for the purposes of securing that only persons who are properly supervised and appropriately qualified are appointed company auditors, and that audits by persons so appointed are carried out properly and with integrity and with a proper degree of independence.

To be eligible for appointment as a company auditor a person must be a member of a recognized supervisory body and eligible for appointment under the rules of that body.

Properly supervised

A supervisory body is one that maintains and enforces rules as to persons eligible to seek appointment as company auditors and the conduct of company audit work that is binding on its members. Supervisory bodies must maintain registers of their members open to public inspection. Members must describe themselves, after their signature on the auditors' report, as 'registered auditor'. It is an offence for a person to act as a company auditor if he or she is not eligible to do so. A second audit may be required for any company audited by an ineligible auditor.

For recognition as a supervisory body the Companies Act 2006 requires that there must be rules and practices to ensure that:

- persons eligible for appointment as company auditor are:
  - appropriately qualified;
  - fit and proper persons;
- audit work is conducted with integrity by persons with no conflicts of interest;
- technical standards are established and applied;
- there are procedures for maintaining competence (such as postqualifying education);
- there are adequate arrangements and resources for effective monitoring and enforcement of compliance with its rules;
- rules relating to membership, eligibility and discipline are fair and reasonable and provide for appeals;

- there are effective arrangements for investigating complaints both against eligible persons and the body itself;
- persons eligible under its rules are able to meet claims against them by means of adequate indemnity insurance or otherwise;
- high standards of integrity in the conduct of audit work are promoted and maintained by cooperation with other bodies.

Appropriately qualified

For the most part an appropriate qualification will be membership of a qualifying body being a UK body offering a professional qualification in accountancy. A qualifying body must have rules, which it has power to enforce, with respect to:

- requirements for admission to a course of study leading to the qualification
- those approved for the purposes of giving practical training.

European Union

European Union company law in the form of EU company law directives must be enacted by member states. For example the Companies Act 1989 incorporated into UK law the requirements of the Eighth EU Company Law Directive applicable to statutory audits. In 2006 the Revised Eighth Directive (incorporated into UK law under the Companies Act 2006) broadened the scope of application of former legislation by specifying the duties of statutory auditors, their independence and ethics, by introducing requirements for external quality assurance, ensuring better public oversight over the audit profession and improving cooperation between oversight bodies in the EU.[17]

Financial Services Authority (FSA)

The FSA is an independent nongovernmental body, given statutory powers by the Financial Services and Markets Act 2000. One of the FSA's aims is to promote efficient, orderly and fair financial capital markets. It regulates most financial services markets, exchanges and firms. One of its subsidiary bodies, the UK Listing Authority, lays down requirements for the admission of securities for listing on the stock exchange. This includes both the financial reporting and auditing requirements listed companies are to meet.

LEARNING CHECK

- The practice of auditing is influenced by three main types of constituency: private sector organizations, standard setters and regulatory bodies.
- Although the private organizations are largely self-regulating they are required to comply with the requirements of the standard setters and regulatory organizations and are monitored by them.

Services Provided by Public Accountants

Accountants in public practice provide a variety of services. These can be classified as assurance services or nonassurance services.

Assurance services

An assurance service is one in which a public accountant issues a written communication that expresses a conclusion about the reliability of a written assertion that is the responsibility of another party. In recent years, there has been a growing demand for a variety of assurance services. These services (as already referred to in previous sections) include the audit or review of historical financial statements and the audit or review of other financial information. Other examples of matters on which assurance may be required include:

- value for money;
- nonfinancial performance measures;
- internal control effectiveness;
- risks facing the enterprise;
- systems reliability;
- e-Commerce assurance;
- social matters (for example employment policies);
- environmental issues;
- compliance/behaviour (such as corporate governance, compliance with regulations).

Nonassurance services

The principal types of nonassurance services provided by public accountants are those of traditional accounting, taxation, management consulting or advice and insolvency and business recovery. The common characteristic of these services is that they do not result in the expression of an opinion, negative assurance or other form of assurance, by the public accountant. Nevertheless, the client benefits from the technical expertise and knowledge provided by the public accountant in the performance of the engagement. Examples of such services include compilations and agreed procedures.

Traditional accounting and taxation services

A public accountant may be engaged by a client to perform a variety of accounting services such as manual or automated book-keeping, journalizing and posting adjusting entries and preparing financial statements. Accountants who specialize in taxation are thoroughly knowledgeable about the intricacies of the tax laws. Most accountancy firms have tax specialists and many have separate tax departments. Tax services include assistance in filing tax returns, tax planning, estate planning and representation of clients before government agencies in relation to tax matters. Tax services constitute a significant part of the practice of most accountancy firms. The preparation of financial statements and the filing of tax returns are two examples of compilation services. In performing any of these services, the public accounting firm serves as a substitute for, or a supplement to, the accounting personnel of the client. The accounting firms do not assume the decision-making role of management, which remains responsible for the preparation of financial statements and the filing of tax returns.

Management consulting or advisory services

Management consulting or advisory services entail providing advice and technical assistance to clients to help them better use their capabilities and resources to achieve their objectives. Examples of such services include advising on staff recruitment, the use and acquisition of information technology and the provision of internal audit services.

When providing management consulting services, the practitioner is acting as an outside expert business consultant and, in this capacity, should not be making management decisions. Many of the larger accounting firms have separate management advisory services departments. Today, management advisory services revenues represent a significant proportion of the total billings of many accounting firms.

Insolvency and business recovery

Many accounting firms provide a professional service in the area of insolvency and business recovery. These services are provided pursuant to the Insolvency Acts, the Companies Act 2006 and other statutes. When businesses are in difficulty, secured creditors might intervene in a variety of ways in order to protect their interests. Accounting firms might take on the assignment to review and perhaps reconstruct companies that are still solvent but have underlying difficulties. Also, much of the work required in the area of insolvencies and liquidations is quasi-legal administrative work. It relates generally to establishing and documenting competing claims and obtaining information required for alternative courses of action.

Accounting firms nowadays embrace of the use of information technology. Each of the Big Four now has its own Web site. Students are strongly advised to consult these Web sites for up-to-date information on the nature of services provided by leading edge firms in the accounting profession.

LEARNING CHECK

- Public accountants are engaged to carry out a variety of services. Assurance services are those which involve providing an opinion on written assertions (for example an audit or a review), whereas other types of professional accountancy and related advisory services require the expertise and competence of the auditor or accountant but do not provide assurance, for example compilation of financial information.

Types of Audit Activity and Auditor

Audit and other assurance engagements can involve different types of activity and be performed by different types of auditor.

Types of audit activity

As well as financial statement audits other types of audit activity and assurance engagements may be undertaken in connection with financial and nonfinancial information as referred to above. Here are just a few examples to compare with a financial statement audit:

- the adequacy of internal control systems
- compliance with statutory, regulatory or contractual requirements
- economy, effectiveness and efficiency in the use of resources (value-for-money auditing)
- environmental practices.

Financial statement audit

ISA 200, *Objective and General Principles Governing an Audit of Financial Statements* states that:

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

The financial statement audit involves obtaining and evaluating evidence about an entity's financial affairs in order to establish the degree of correspondence between the management's assertions and the established criteria, such as Financial Reporting Standards and legal requirements. This type of audit is performed by independent auditors appointed by the shareholders of the company, or by equivalent proprietors of nonincorporated entities whose financial statements are being audited. The auditors must be qualified and able to exercise their skills in an independent and objective manner. The nature and extent of the audit examination are functions of the requirements of these entities in terms of the audit mandate. Sections 475 and 495–8 of the Companies Act 2006 provide guidelines for an audit stipulated by that Act. This is further explained in Chapter 2.

Internal control effectiveness

At present, auditors may review certain of the controls laid down by management to ensure the reliability of their financial accounting information in the course of undertaking a financial statement audit. If they discover weaknesses in those controls they will advise management as will be explained in Chapter 14. However, assessing internal control is not the purpose of a financial statement audit and reports to management refer only to weaknesses discovered incidentally to the examination of the financial statements. The Turnbull Report in the United Kingdom[18] and the Sarbanes–Oxley Act in the United States require directors to evaluate and to report on the effectiveness of their entity's internal controls. It is expected that the directors would be assisted in this matter by their independent auditors or other public accountants. Guidelines for the provision of such services are discussed in Chapter 3.

Compliance audit

A compliance audit involves obtaining and evaluating evidence to determine whether certain financial or operating activities of an entity conform to specified conditions, rules or regulations. The established criteria in this type of audit may come from a variety of sources. Management, for example, may prescribe policies (or rules) pertaining to overtime work, participation in a pension scheme and conflict of interests. Compliance audits based on criteria established by management may be undertaken frequently during the year. This type of audit is usually carried out by company employees who perform an internal audit function.

Business enterprises, not-for-profit organizations, government units and individuals are required to prove compliance with a myriad of regulations. In many instances, the audit opinion issued under the requirements of the Companies Act 2006 has elements of a compliance audit, where the audit is required to express an opinion on the company's compliance with the provision of the Act.

In the public sector, the term audit is used to denote an examination that reports on the legality and control of operations and the probity of those dealing with public funds, including the expression of an opinion on an entity's compliance with statutory requirements, rules, ordinances or directives that govern its activities.

Findings related to a compliance audit are generally reported to the authority that established the criteria and may include:

- a summary of findings or
- an expression of assurance as to the degree of compliance with those criteria.

Value-for-money audit

A value-for-money (VFM) audit involves obtaining and evaluating evidence about the efficiency, economy and effectiveness of an entity's operating activities in relation to specified objectives. This type of audit activity may also be referred to as a performance, operational or management audit. The term 'value-for-money audit' is usually applied in the public sector. The other terms are common to both private and public sectors. Auditing literature provides strong support for equating the conceptual definitions of a VFM audit, performance auditing, operational auditing and management auditing.

In a business enterprise, the scope of a value-for-money audit (management audit) may encompass all the activities of a division, or a function which applies across a number of business units. In the public sector, a value-for-money audit is an independent, expert and systematic examination of the management of an organization or function for the purposes of:

- forming an opinion about the extent of the economy, efficiency and effectiveness and
- the adequacy of internal procedures for promoting and monitoring the economy, efficiency and effectiveness

of such organization or function. In this context 'economy' can be defined as the acquisition of financial, human, physical and information resources of appropriate quality and quantity at the lowest reasonable cost, and 'efficiency' is the use of a given set of resource inputs to maximize outputs and focuses on the achievement of an intended outcome. The auditors in a value-for-money audit task provide a report on the extent to which predetermined goals have been achieved economically and efficiently.

Social and environmental audits

Political pressure and global awareness have made corporate social and environmental responsibility a high priority in achieving good corporate image.

An environmental audit is undertaken to assess and report on the environmental performance and position of companies on the environment in relation to relevant law, company policy and good practice. An environmental audit goes beyond legal requirements and covers all aspects of company impact on the environment (for example production methods, transport, supply chain, energy conservation and sustainability). Environmental audits will normally require a range of specialist skills and expertise.

Similarly, the objective of a social audit is to determine the extent of a company's social responsibility and compliance with company policies as well as legal requirements.

Where such audits are performed and statements thereon are made by management, reporting accountants are often requested to undertake an assurance engagement and provide an assurance report on the statements made by management.

Furthermore, environmental matters may have an impact on the financial statements and therefore must be considered in the process of a financial statement audit. Some examples of environmental matters affecting financial statement accruals, impairment of assets, disclosures or the basis of preparation include, for example:

- pollution prevention system, the cost of which may be accrued for remediation costs
- liability relating to transportation of or contamination by hazardous waste or
- obsolescence of stock due to environmental laws and regulations.

Auditors are required to carry out their audit with an attitude of professional scepticism, recognizing that the audit may reveal conditions and events that would lead to questioning whether the entity is complying with relevant environmental laws and regulations. International Standard on Auditing ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, requires auditors to obtain a general understanding of the legal and regulatory framework applicable to the entity. In addition, International Audit Practice Statement IAPS 1010, *The Consideration of Environmental Matters in the Audit of Financial Statements*, lists a number of factors that the auditors should take into consideration when obtaining knowledge of the business and when identifying risk and internal controls in respect to environmental matters.

The environmental audit is the subject of a discussion paper issued in 1995 by the International Auditing Practices Committee.[19]

Internal audit

While the previous audit activities are classified according to the outcome of the activity, an internal audit merely refers to any of the above audit activities carried out by audit professionals who are employees of the entity being audited. Internal audit is a management tool used by the organization to enhance internal control. The role of internal auditors varies. It may involve straightforward internal checking, complex systems review, intensive forensic investigations, internal appraisals of operations and financial planning, or, in some cases, a financial statement audit. It is possible that the independent auditors may be able to work with the internal auditors in some aspects of the work where objectives are similar.

Internal audit professionals are sometimes qualified accountants. The Institute of Internal Auditors, which was formed in the United States in 1941, operates in chapters worldwide. The UK chapter offers a number of professional development services to its members.

With the growth of consultancy and audit-related services demanded by clients, public accounting firms are seen to engage themselves in internal audit tasks. The outsourcing of internal audit, whereby the expertise of an accounting firm is employed to carry out an audit-related service of an internal audit nature, is a recent trend.

Types of auditor

Individuals who are engaged to audit economic actions and events for individuals and legal entities are generally classified into three groups: independent auditors, internal auditors and government auditors.

Independent auditors

Independent auditors, sometimes referred to as external auditors, are either individual practitioners or public accounting firms who render professional auditing services to clients. By virtue of their education, training and experience, independent auditors are qualified to perform audits and other assurance services. The clients of independent auditors may include profit-making business enterprises, not-for-profit organizations, government agencies and individuals. Like members of the medical and legal professions, independent auditors work on a fee basis. There are similarities between the role of an independent auditor in a public accounting firm and a solicitor who is a member of a law firm. However, there is also a major difference: the auditor is expected to be independent of the client in making an audit and in reporting the results, whereas the solicitor is expected to be an advocate for the client in rendering legal services. Audit independence involves both conceptual and technical considerations. It is enough to say at this point that to be independent, an auditor should be both without bias with respect to the client under audit and appear to be objective to those relying on the results of the audit. More attention will be given to independence in later chapters.

The audit of companies in the United Kingdom can be performed only by auditors registered with a supervisory body. The purpose of registration is to ensure that audits are performed by persons who are properly supervised and appropriately qualified. The criteria for registration of auditors have been referred to earlier in the chapter.

Internal auditors

Internal auditors are involved in providing an independent appraisal activity, called internal auditing, within an organization as a service to the organization. The objective of internal auditing is to assist the management of the organization in the effective discharge of its responsibilities. The importance of the internal audit function in minimizing risk is such that the Combined Code on Corporate Governance requires listed companies without an internal audit function to explain why they do not regard an internal audit function as necessary.

Traditionally internal auditors have been employed directly by the entity. However, this tends to impair their ability to deter wrongdoing by the more senior executives because it might threaten their continued employment. In recent years it has become common for public accounting firms to provide an internal audit service that improves the independence of those undertaking internal audit activities as well as ensuring the quality of the service provided. Moreover, a good internal audit may reduce the cost of the independent audit. The potential cost savings are maximized where the internal audit function is provided by the same firm that acts as independent auditor. This practice, however, has recently come in for criticism in that it potentially impairs the independence of the independent auditor as will be explained in Chapter 3.

Government auditors

Audits of government departments are the responsibility of the National Audit Office headed by the Comptroller and Auditor General. The Comptroller and Auditor General is appointed directly by Parliament, not by the government, and reports to the Public Accounts Committee of Parliament. The Public Accounts Committee has the power to require the Comptroller and Auditor General to undertake specific audits and investigations of government departments in addition to the required reporting on departmental accounts. Most of the audit work on government departments is undertaken by staff of the National Audit Office, although outside experts, including firms of public accountants, may be called in to undertake special investigations.

The audits of local authorities are regulated by the Audit Commission under the Controller of Audit who is appointed by the Secretary of State for the Environment. The Audit Commission may appoint one of its own officers or a firm of public accountants as the auditors of the local authority. The auditors then report to the Commission, not to the local authority, and have the power to initiate legal proceedings against the authority and its officers for unlawful expenditure or losses.

For most other public sector bodies, the sponsoring government department is responsible for appointing the auditors, determining the auditors' terms of reference to the extent that they are not specified by statute, and taking appropriate action on receipt of the auditors' report.

As noted previously, this text deals primarily with financial statement audits performed by independent auditors practising as members of the public accounting profession. We will learn more about financial statement audits in the next chapter. For now, we turn our attention to some important background information about the public accounting profession.

LEARNING **CHECK**

- The different types of audit include the financial statement audit, the compliance audit, the value-for-money audit and the environmental audit. Internal audit refers to all types of audit activity carried out by internal employees of the organization.
- Independent auditors are those auditors who provide audit and other services for the public and are independent of the auditees.
- Internal auditors are employees of the organizations who are appointed to carry out certain types of audit or review functions within the organization.
- Government auditors are employees of the government who are employed to carry out different types of public sector audits.

Regulatory Framework for Ensuring Quality Services

Every profession is concerned about the quality of its services and the public accounting profession is no exception. Quality audits are essential to ensure that the profession meets its responsibilities to clients, to the general public and to regulators who rely on independent auditors to maintain the credibility of financial information. To help assure quality audits, the profession and the regulators have developed a multi-level regulatory framework. This framework encompasses many of the activities of the organizations associated with the profession that were described in previous sections of this chapter. For the purposes of describing the multi-level framework, these activities may be organized into the following components:

- *Standard setting*. The Financial Reporting Council (FRC), International Accounting Standards Board (IASB) and International Auditing and Assurance Standards Board (IAASB) establish standards for financial reporting, auditing, quality control and codes of ethics to govern the conduct of accountants and practice entities.
- *Firm regulation*. Each public practice entity adopts policies and procedures to ensure that practising accountants adhere to professional standards.
- *Self-regulation*. The accounting profession has implemented a comprehensive programme of self-regulation including mandatory continuing professional education, and a programme of quality control and practice monitoring.
- *Independent regulation*. The government has the power to recognize professional accountancy bodies as meeting the statutory criteria as supervisory and qualifying bodies. Company audits may only be undertaken by auditors who are properly supervised and appropriately qualified.

Each component is discussed further in the following sections.

Standard setting

The roles of the FRC, IASB and IAASB in setting standards for the various types of assurance services have been noted in previous sections. The accounting bodies also establish rules of professional conduct for accountants as discussed more fully in Chapter 3. All these professional pronouncements provide guidance to individual practitioners who aspire to do high-quality work.

Quality control standards

The pursuit of quality practice must occur at the firm level as well as the individual level. The quality of auditing services rendered by a firm is dependent upon auditing standards and upon quality control policies for the firm's auditing practice as a whole and procedures for each engagement. The statement relevant to audit practice as a whole is International Standard on Quality Control ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements*. This statement describes general quality controls applicable to the audit practice as a whole. ISA 220, *Quality Control for Audits of Historical Financial Information*, requires the engagement partner to ensure that the firm's quality control procedures are appropriately applied in each audit engagement.

The firm is required to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements and that reports issued by the firm or engagement partners are appropriate in the circumstances. The system of quality control is required to include documented policies and procedures addressing:

- leadership responsibilities for quality within the firm;
- ethical requirements;
- acceptance and continuance of client relationships and specific engagements;
- human resources;
- engagement performance;
- engagement quality control review;
- monitoring.

Firm leadership and responsibilities

These are basic principles and essential procedures regarding leadership and responsibilities within the firm to promote an internal culture that recognizes that quality is essential in performing engagements. There is a requirement that the firm's policies and procedures are inspired by and overseen by the leaders of the firm and who bear ultimate responsibility for the firm's system of quality control.

Ethics

The firm is required to establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements. In this way, ethical requirements are given due weight and recognition. With regard to independence specifically, the firm is required to establish policies and procedures to provide it with reasonable assurance that the firm and its personnel maintain independence. It is also required to establish policies and procedures designed to provide it with reasonable assurance that it is notified of matters that may pose a threat to independence so that appropriate action can be taken to resolve such situations. The firm is also required to obtain, at least annually, confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the IFAC's *Code of Ethics for Professional Accountants* and national requirements.

The firm is required to establish policies and procedures that require the rotation of the engagement partner after a specified period of time for all audits of financial statements of listed entities. The firm is also required to set out criteria against which audits of nonlisted entities as well as assurance and related services engagements should be evaluated for the purpose of determining whether the engagement partner should be rotated.

Acceptance and continuance of client relationships and specific engagements

The firm should have basic principles and essential procedures regarding acceptance and continuance of client relationships and specific engagements. These involve the integrity of the client, the competence of the firm to provide the engagement service and ability to comply with ethical requirements.

Human resources

The firm is required to establish policies and procedures to provide it with reasonable assurance that it has sufficient personnel with the competencies and commitment to ethical principles necessary to perform its engagements in accordance with professional standards. It is also required that the firm assigns an engagement partner and appropriate staff with the necessary competencies to undertake each engagement.

Engagement performance

The firm must establish principles and procedures to ensure that each engagement is properly performed in accordance with professional standards and applicable regulatory and legal requirements including an appropriate level of supervision and review. These policies and procedures must require consultation on contentious matters and provide for the resolution of differences of opinion.

Engagement quality control review

Such reviews are required for all financial statement audits of listed entities. The firm is also required to set out criteria against which other audit, assurance and related services engagements should be evaluated to determine whether they should be subject to engagement quality control reviews. An engagement quality control review includes an objective evaluation of the engagement team's evaluation of independence, significant risks identified and responses, the significant judgements made by the engagement team, appropriateness of consultations, the significance of misstatements identified, matters to be communicated to management, those charged with governance and other parties, whether working papers reflect the work performed and conclusions reached, and the appropriateness of the report. The review involves discussion with the engagement partner, a review of the financial statements or other subject matter and the report. The actual extent and depth of review depend on the complexity and risk of the engagement as well as the experience of the engagement team.

Monitoring

The firm is required to establish policies and procedures to provide them with reasonable assurance that their quality control policies and procedures are relevant, adequate and complied with in practice. The monitoring process includes both ongoing consideration and evaluation of the elements of the system of quality control, and the periodic inspection of a selection of completed engagements, with the inspection cycle ordinarily spanning no more than three years.

The firm is also required to establish policies and procedures for dealing with formal complaints and allegations about whether the work performed fails to comply with applicable professional standards.

Firm regulation

Firm regulation occurs within the public accounting firm. A prime example is implementing a system of quality control as mandated by quality control standards discussed in the preceding section. This means that the firm's day-to-day actions will comply with the policies and procedures pertaining to quality control elements. For example, to assist staff in meeting professional standards, firms generally provide on-the-job training and require their professionals to participate in continuing professional education courses. Personnel who adhere to standards for professional services will receive pay rises and promotions. Personnel whose work is substandard should be counselled and, if improvement is not forthcoming, their employment terminated. Motivation also results from the desire to avoid the expense and damage to a firm's reputation that accompanies litigation and other actions brought against the firm for alleged noncompliance with professional standards. Auditors' exposure to litigation is discussed in Chapter 4.

Self-regulation

The institutes and the Association independently undertake quality assurance practice reviews as part of their responsibilities as supervisory bodies. In order to continue to hold an auditing certificate, members have to demonstrate compliance with quality control standards. Members are obliged to give assurance that the established quality control requirements are being met. Practice inspectors appointed by the institutes and the Association visit all practices on a cyclical basis. Findings from the reviews are confidential. The reviewed practice is given an assessment made by the reviewer. If there are unsatisfactory findings, the practitioner is required to take remedial action and will be subject to re-review within an agreed time frame. Serious deficiencies are dealt with through disciplinary procedures. The primary focus of practice reviews, or self-regulation, is educational. Also, at the request of the DTI the Audit Quality Forum was established by the ICAEW in December 2004. Its programme is about working in the public interest to promote quality and confidence in corporate reporting.

Independent regulation

Regulatory activities of the professional accountancy bodies are monitored by the Professional Oversight Board in respect of training, professional development, ethical matters, professional conduct and discipline, registration and monitoring. This review also includes ensuring that the professional bodies take appropriate action with respect to decisions by the Accountancy and Actuarial Discipline Board, such as removal of a member's practising certificate where recommended by that Board. In addition, firms auditing listed and other public interest entities are subject to direct monitoring by the Audit Inspection Unit of the Professional Oversight Board.

A further source of regulation is through the monitoring of published financial statements by the FSA and FRRP as referred to earlier in the chapter. If the Panel finds auditors failing to encourage adherence to financial reporting standards where appropriate it may raise the matter with the auditors' supervisory body or the Accountancy and Actuarial Discipline Board, with a view to possible disciplinary action being taken.

A significant, additional regulatory mechanism occurs through the courts where an accountant may face a lawsuit for negligence and incur costs and damages for failure to comply with the profession's standards of practice. This aspect is considered in Chapter 4.

All these forms of regulation are important. They are interrelated and aspire to the overall objective of improving the quality of audit practice. However, each uses a different means to achieve the desired objective. Each acts as a sieve in detecting substandard practice and preventing audit failure.

LEARNING CHECK

- The regulatory framework to ensure quality service includes the system of standard setting and regulations.
- The standard setting process provides quality control standards with which auditors should comply.

- Regulatory controls exist within firms, in the profession's own regulatory procedures in terms of memberships, standards, behaviour and quality, and through independent bodies such as the FRC's Professional Oversight Board and at an international level, IFAC.

SUMMARY

This chapter has provided an overview of the auditing environment. Auditing practice has evolved over the last century from a relatively straightforward activity of checking books and accounts to a dynamic role of enhancing the credibility of financial information by way of audit and other assurance services. The development of audit practice has demonstrated a shift in public expectations, especially in terms of the auditors' role. The chapter also briefly described the impact of such changes on auditor independence and audit liabilities. With a number of complex factors influencing the scope and responsibilities of auditors, a trend towards having to satisfy the information needs of users has become the key topical issue.

As the market becomes more sophisticated, so, too, appear to be the information needs of users. The expertise and competence of auditors are sought for a variety of financial services, requiring the auditors to give different levels of assurance. The traditional conformance role of auditing is no longer seen to be relevant, and auditors are now expected to be able to add value to their clients' functions.

The collapse of Enron has also focused attention on the regulation of the audit function. In restoring public confidence the former regulatory role of professional accountancy bodies with respect to standard setting and monitoring has been transferred to independent bodies such as the Financial Reporting Council. Moreover, in the interests of facilitating European and global investment, standards on financial reporting and auditing set by international standard setting bodies are replacing standards set nationally so as to reassure investors as to the consistency of financial reporting and auditing worldwide.

NOTES

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2 *London and General Bank* (1895) 2 Ch. 673.
3 *Kingston Cotton Mill Co.* (1896) 2 Ch. D279.
4 *Thomas Gerrard & Son Ltd* (1967) 2 AER 525.
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7 **IAASB** *International Framework for Assurance Engagements*, April 2005.
8 **Miller, R.I.** and **Young, M.R.** (1997) Financial reporting and risk management in the twenty-first century. *Fordham Law Review*, **65** (5), 1987–2064.
9 **Schelluch, P.** and **Gay, G.** (1997) Assurance services and the profession. *CPA Communique* No. 80 (October).

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11 **Bell, T., Marrs, F., Solomon, I.** and **Thomas, H.** (1997) *Auditing Organisations through a Strategic-Systems Lens: The KPMG Business Measurement Process*. KPMG Peat Marwick LLP, Chicago, IL.
12 Taken from the foreword to the research monograph cited in Note 11. It was made by William R. Kinney, Jr (Charles and Elizabeth Prothro Regents Chair in Business, and Price Waterhouse Auditing Fellow, Graduate School of Business, University of Texas, Austin) in commenting on the new scope of work involved in financial statement audits as a result of changes in information technology and the extensive acceptance of nonfinancial dimensions of business reporting.
13 **ISA 315** *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*.
14 **ISA 240** *The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements*.
15 Sarbanes–Oxley Act 2002.
16 **Wallman, S.M.H.** (1996) The future of accounting, part III: reliability and auditor independence. *Accounting Horizons*, **10** (4), 76–97.
17 EU Directive 2006/43/EC on Statutory Audits of Annual and Consolidated Accounts (Eighth Company Law Directive) – The Statutory Audit Directive.
18 **ICAEW (2004)** *Internal Control: Revised Guidance for Directors on the Combined Code (October 2005)*, http://www.frc.org.uk/corporate/internalcontrol.cfm (accessed 1 August 2008).
19 **IAPC (1995)** *The Audit Profession and the Environment*. Discussion Paper Issued by the International Federation of Accountants, New York.

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MULTIPLE-CHOICE QUESTIONS

Choose the best answer for each of the following. (*Answers are on p. 639*)

1.1 What was the predominant objective of an 'audit' before 1900?
(a) To ensure that the financial statements were free from all material errors.
(b) To detect fraud.
(c) To ensure that all internal controls were operating effectively.
(d) To check all transactions of the company.

1.2 What would *not* be described as part of the conformance role of auditing?
(a) Evaluate reasonableness of business plans.
(b) Check that the organization complies with statutory matters.
(c) Ensure the organization conforms with policies and procedures correctly.
(d) Ensure that all material errors have been detected.

1.3 What is the main concern of the accounting profession in relation to an increase in the level of assurance required for audits?
(a) Their time budgets will become tighter.
(b) It will increase their exposure to liability.
(c) It is not what an audit is designed to achieve.
(d) It will not sufficiently satisfy users' needs.

1.4 What provides the highest level of assurance?
(a) Audit.
(b) Agreed-upon procedures.
(c) Review.
(d) It depends on the nature of the engagement.

1.5 What has been the primary growth area in recent years for the public accounting profession?
(a) Auditing services.
(b) Consulting services.
(c) Taxation services.
(d) Insolvency services.

1.6 The primary objective of a financial statement audit is to:
(a) ensure that the company is free from all fraud.
(b) provide assurance about the future viability of the entity.

(c) express an opinion on the truth and fairness of the accounts.
(d) ensure the company complies with all aspects of the Companies Act.

1.7 When hiring a new staff member, what should the firm consider to comply with quality control standards?
(a) The person should have a broad range of interests to ensure that they become 'well-rounded employees'.
(b) The person should have adequate qualifications.
(c) The person should have proven skills in working within a team environment.
(d) The person should have high morals to ensure that they will comply with all ethical standards.

DISCUSSION QUESTIONS

1.1 Compare and contrast the conformance and enhancing roles of auditing.

1.2 Discuss reasons why responsibility for setting standards for financial reporting and auditing is being transferred from the profession to independent nongovernmental bodies.

1.3 Explain the concept of assurance and locate audits within an assurance framework.

1.4 Compare and contrast the functions of internal and independent auditors.

1.5 Describe assurance services offered by public accountants other than financial statement audits.

PROFESSIONAL APPLICATION QUESTIONS

(Suggested answers are on pp. 651–652)

1.1 ***Audit objectives***

You have obtained employment in the accounting firm of Dickens & Partners as an audit assistant. You have heard that the firm is not very modern in its approach. On the first day at work, Mr Dickens calls you into his office and hands you a copy of *Auditing: A Practical Manual for Auditors* by Lawrence Dicksee, published by Gee & Co. of London in 1892. The partner proudly claims 'This is the Bible of auditing.' You open the book (after blowing the dust off the cover) and read the following statement on p. 7: '. . . The detection of fraud is a most important portion of the auditor's duties. Auditors, therefore, should assiduously cultivate this branch of their activities.'

From your limited audit knowledge, this does not appear to be 'current practice'.

Required

Write a brief memo to the audit partner, Mr Dickens, discussing major changes that have occurred in the objectives of auditing since the publication of Dicksee's book in 1892.

1.2 *Types of audit and auditors*

After performing an audit, the auditor determines that:

1. The Department of Transport is in violation of an established government employment practice.
2. The supervisor is not carrying out the responsibilities that have been assigned.
3. The accounts clerk has not been stealing from the company.
4. A company's receiving department is inefficient.
5. The company's financial statement presents a true and fair view.
6. The company has an adequate provision to fill the mine pit at the expiration of the lease term.
7. Controls over the sales invoicing system are operating effectively.
8. A department is not meeting the company's prescribed policies concerning overtime work.
9. The tax office is complying with government regulations and its financial statements are stated fairly.

Required

1. Indicate, for each of the above, the type of audit that is involved: (i) financial, (ii) compliance, (iii) value for money, (iv) environmental or (v) internal.
2. Identify the type of auditor most likely to be involved: (i) independent, (ii) internal or (iii) government.