

# 1 AUDITORS, AUDITS AND OTHER TYPES OF ASSURANCE AND PASSING THE EXAM FIRST TIME

**Covering:** *The Role of Audit and Other Types of Assurance in the Economy, Accountability, Stewardship and Agency Theory, the Relationship between Auditors, Management and Shareholders, Overview of the Assurance Process from Planning to Reporting, the Style and Content of Auditing and Assurance Exams, Study Technique and Exam Technique.*

**Why do I need to read this section?**

*Because:*

- *questions on the nature and purpose of audit and assurance engagements are set regularly;*
- *of rising levels of audit exemption, particularly in Europe;*
- *of the important differences between audits, other forms of assurance, and non-assurance engagements;*
- *there are many misconceptions about audit and assurance which this short section will help you eliminate at the outset;*
- *there are many misconceptions about effective study, how examiners set papers and exam technique. This section should help you make the best use of the limited time you have to study for this paper.*

*With the exception of the material on study, exams and technique, all of the information in this section is covered in more detail in subsequent sections.*

**What is important in this section?**

*Understanding:*

- *that audit is a sub-set of assurance and that all assurance engagements are characterised by an assessment of the risk of material misstatement;*
- *the limitations of an audit as well as its benefits;*
- *that compilation and agreed-upon procedures engagements in which practitioners do not obtain any assurance at all are very different to assurance engagements such as audits and reviews.*

**What sort of questions come up in this area?**

*Questions regularly set in this area cover:*

- *the nature, purpose, advantages and disadvantages of an audit;*
- *the difference between audit and other forms of assurance such as reviews;*

- *the difference between assurance and non-assurance engagements, and what type of engagement is appropriate in a given set of circumstances.*

**How do I stand out from the crowd?**

- *Distinguish clearly between audits, reviews, other types of assurance, and non-assurance engagements.*
- *Give examples of non-audit assurance to demonstrate your appreciation of its growing importance.*
- *Use terminology accurately.*

## 1.1 THE NEED FOR AUDIT AND OTHER TYPES OF ASSURANCE

Like it or not, most of us have little choice about letting others manage our assets for us. We hand over our money to companies, banks, pension funds and governments in the hope that they will look after it and use it properly. We need auditors because we want some assurance about this. We want to be confident that the companies we invest in, the banks that look after our cash, the pension funds we hope will provide for our retirement and the governments that spend our taxes, will use the money we give them the way they ought to, the way they say they will. We also want to know that the money we donate for the education of poor people, for example, goes mostly towards school buildings rather than on the salaries of administrators, and we look to auditors for assurance about that, too.

*Audit* is a type of *assurance*. All large-scale operations need auditors because their directors need assurance that the assets and resources for which they are responsible are well-managed. Directors cannot always rely on what they are told by the employees who report to them. Employees make mistakes. Even where there are few mistakes, employees naturally seek to present their own performance in a favourable light. An *independent* view is likely to be more objective, accurate and critical. Many large bodies such as universities, hospitals and health authorities as well as companies, banks, government departments and pension funds, have *internal audit* functions for these reasons. Many of these entities are also subject to independent regulatory oversight and have *external auditors*, because the people needing assurance are not just their directors, but the people to whom the directors are directly or indirectly accountable. Companies, including banks, are accountable to their shareholders. Banks are also accountable to their depositors to some extent but the position of depositors is generally akin to that of creditors, rather than shareholders. Pension funds are accountable to the trustees who act on behalf of pensioners and governments are accountable to taxpayers and electorates. We are all at different times in our lives shareholders, depositors, taxpayers and pensioners. This means that the entities that manage our assets are accountable to us. The external auditors we appoint to them, directly or indirectly, report to us on the financial statements that their directors prepare.

**Auditors, Management and Shareholders: Fiduciary Duties, Accountability, Stewardship and Agency**

External audits of companies are performed because of the *separation of the ownership and management* of company assets.

Companies belong to their shareholders.<sup>1</sup> Shareholders pay for their shares in the hope that the company will be well-managed, pay dividends from profits and that the value of their shares will increase. They need some confidence in what the company's managers, i.e. its directors or those charged with its governance, to whom they have entrusted their money, tell them about the company's performance and position.

Company managers are *accountable* to shareholders for their *stewardship* of the company's assets. They have a *fiduciary relationship* with shareholders which means that *they must act in good faith*, for the benefit of the company and all of its shareholders, rather than running the company for their own benefit, or for the benefit of just a few shareholders.

Management accounts to shareholders by preparing financial statements showing the company's *performance*, i.e. a profit and loss account, its *position*, i.e. a balance sheet, and its *cash flows*.<sup>2</sup> If shareholders are dissatisfied with how management has performed, they can sell their shares or, if enough of them are dissatisfied, replace management.

Companies employ external auditors to report to the shareholders on the financial statements prepared by management.

*Auditors report to shareholders on whether the financial statements give a true and fair view of, or present fairly in all material respects, the financial position and performance of the company.* The audit report adds *credibility* to the financial statements.<sup>3</sup>

Management, not auditors, are responsible for the preparation of financial statements. If the financial statements do not give a true and fair view or present fairly the financial position and performance of a company (the two phrases are deemed to be equivalent), auditors qualify their audit opinion.

Auditors are the *agents*<sup>4</sup> of the shareholders who appoint them, but shareholders rarely disagree with the recommendation of management who also negotiate the auditors' terms, conditions and remuneration. The payment of auditors by the people they are reporting on creates a potential conflict of interest. For this reason, professional bodies and independent audit regulators monitor the conduct of audits.

In many jurisdictions, until fairly recently, there were statutory audit requirements<sup>5</sup> for all incorporated entities.<sup>6</sup> Audit exemption has changed this, particularly in the EU

---

<sup>1</sup> 'Stockholders' in some jurisdictions.

<sup>2</sup> Financial statements also usually include a statement of changes in equity.

<sup>3</sup> In some jurisdictions, auditors report to directors as well as, or instead of, shareholders. The phrase 'true and fair' is used in the UK. 'Present fairly' is used in the USA.

<sup>4</sup> Directors are also the agents of shareholders, appointed to manage the company's assets.

<sup>5</sup> Statutory requirements are requirements created by legislation (law).

<sup>6</sup> In some jurisdictions a large number of incorporated entities such as companies were created because of an advantageous tax regime. In others, businesses are more likely to be constituted as partnerships or other unincorporated associations for the same reason. There is now a level of uniformity within the EU because of European company law. It provides for two basic

where the vast majority of companies are exempt from audit requirements based on their size.<sup>7</sup> However, audits of smaller entities continue for several reasons. In family-owned companies, most of the shareholders may also be directors who are actively involved in the day-to-day running of the business. Owner-managers do not need auditors to report to them on their own performance. Other shareholders, however, who are not involved in the business, may want an audit. Some smaller companies are required to have an audit despite the fact that they fulfil the size criteria for exemption, because of the public interest considerations arising from the fact that they operate in the banking, insurance or other financial services sectors, to which special requirements always apply.

The position described above is the UK position. It is similar to the position elsewhere in Europe because all EU Member States are subject to EU audit legislation.

The position in the USA is somewhat different. In the UK and Europe, company audit requirements are in legislation. There are no statutory audit requirements in the USA. Audits are required by the Securities and Exchange Commission (the SEC), a securities regulator, for entities whose securities are listed on the exchanges it regulates, such as NASDAQ and the New York Stock Exchange (NYSE). Auditors in the USA generally report to directors as well as stockholders and the purpose of assurance is to promote the orderly and efficient running of the capital markets.

### **Assurance and Risk**

Audits of historical financial information benefit existing and potential owners of companies by reducing the risk they take when they invest in companies. Audits also provide assurance to employees, tax authorities, customers and suppliers, lenders, trade unions and governments, all of whom need to know that the company they are dealing with is what it appears to be on paper. For tax authorities, audits reduce the risk of collecting the wrong amount of tax. For employees, audits reduce the risk that they will be employed by an entity that cannot pay them. For customers and suppliers, audits reduce the risk that orders will not be despatched and that invoices will not be paid. For lenders, audits reduce the risk that loans will not be repaid. Audits help

---

categories of company: private and public. The basic distinction between the two is that private companies may not offer their shares or debt securities for sale to the public. In France a Société Anonyme or SA is a public company, a *Société à Responsabilité Limitée* or SARL is a private company. In Germany and other German-speaking jurisdictions, an *Aktiengesellschaft* or AG is a public company, a *Gesellschaft mit beschränkter Haftung* or GmbH is a private company. In the UK, a Public Limited Company (Plc) is a public company, a Limited Company (Ltd) is a private company.

<sup>7</sup> Size criteria for audit and accounting purposes in many jurisdictions are based on turnover, assets and number of employees. While the criteria for turnover and assets have changed, the criterion for the number of employees has not, and in the EU that number has been 50 employees for a small company for many years. These limits are dealt with in more detail in section 9.

maintain the quality of financial information on the public record used by government and trade unions in collective negotiations between employer, employees and government representatives. In these ways, the assurance provided by audits contributes to the proper functioning of the economy and society as a whole, as well as benefiting shareholders.

### Different Types of Assurance

Audit is only one type of assurance, but it remains the most widely recognised. For exam purposes, the most important distinctions are between:

- *reasonable assurance engagements*, such as *audits* of historical financial information in which the practitioners' (auditors') conclusion is in the form of a positive audit opinion;
- *limited assurance engagements*, such as *reviews* of historical financial information which consist primarily of inquiries and analytical procedures, in which the practitioners' conclusion is expressed in negative terms, on whether anything has come to their attention to indicate that the financial statements may be materially misstated;
- *engagements which do not involve assurance*, such as *compilation engagements*, in which practitioners compile financial information from information supplied, often referred to as accounts preparation engagements, and *agreed-upon procedures engagements* in which practitioners report on the factual findings of procedures they have agreed to perform.

It is important to note that the core work of practitioners in many jurisdictions continues to be accounts preparation, tax and audit work, despite the fact that much of this work is now automated. Changes in recent years mean that firms are no longer restricted to this type of work though, and an increasing number of smaller firms now specialise in providing business and systems advice. Nevertheless, all businesses, especially small businesses, are likely to continue to need professional help to comply with regulatory requirements for the foreseeable future.

In both compilation engagements and audit engagements, the financial statements, including the underlying assumptions and significant judgements made, remain the responsibility of the client.

The proprietors of many businesses assume, perhaps understandably, albeit mistakenly, that good quality accounts preparation software means that they can dispense with the services of a professional accountant. Professional accountants sometimes lose clients who decide either to prepare their own accounts, or to employ cheaper accountants without professional qualifications, only to have the client return after a few years when things have gone wrong. Rightly or wrongly, the level of technical expertise and professional judgement required to prepare even a simple set of financial statements in many jurisdictions is greater than is often expected.

The benefits of employing a professional accountant to prepare accounts or perform an audit include the fact that professional ethics require practitioners to avoid being associated with misleading information. Professional ethics also require that practitioners be objective in the case of accounts preparation engagements, and independent in the case of audit engagements. Professional accountants are subject to regulation and disciplinary arrangements and are accountable for the quality of their work not just to the client, but to a professional body and in some cases an independent regulator.

Assurance can be obtained on non-financial information such as the effectiveness of internal controls and greenhouse gas statements, and on forward-looking information such as profit forecasts and projections, as well as on historical financial information. Different types of assurance are discussed further in section 8.

### The Purposes, Benefits and Limitations of Audit

The purpose of an audit is to *enhance the confidence of intended users* in the financial statements.<sup>8</sup>

The *objectives of auditors* are to *obtain reasonable assurance* about whether the financial statements are free from material misstatement and have been prepared in accordance with the financial reporting framework.<sup>9</sup>

The *benefits* of an audit include:

- reducing the risk of management bias, fraud and error;
- enhancing the credibility of financial information through auditor independence and expertise so that:
  - customers and suppliers can confidently do business with the audited entity and banks and others can lend to it;<sup>10</sup>
  - markets can allocate capital efficiently;
- the recommendations auditors can make for improvements to internal control;
- the financial discipline imposed by an audit which helps companies grow.

The inherent *limitations* of an audit include:

- the fact that 100% testing cannot be performed;
- human error in the selection, performance and evaluation of audit procedures;
- time and cost constraints which mean that audit evidence is persuasive rather than conclusive;

---

<sup>8</sup> ISA 200 on overall objectives, paragraph 3.

<sup>9</sup> ISA 200 on overall objectives, paragraph 11.

<sup>10</sup> For very small businesses, audited financial statements are less important to banks lending to them than the security provided by attaching charges to personal and business assets, such as directors' homes, land and buildings, inventory and receivables.

- the inherent limitations of internal controls, which include the possibility of management override of controls, and fraudulent collusion in which employees collude to misappropriate assets and falsify the related records to cover it up;
- the inherent limitations of financial reporting, which include subjectivity and the need to exercise judgement in calculating estimates such as depreciation and allowances for bad debts.

An audit is not always in the best interests of a company, or even possible. Audits are not cheap. A compilation engagement may suffice if the association of a well-regarded practitioner with the financial statements is all that is required. Certain conditions must be met for any assurance to be obtained and, if they are not, audits and reviews cannot be performed. The criteria for assurance engagements are further discussed in section 8.

### The Assurance Process

Audits, reviews and other reasonable and limited assurance engagements all broadly follow the same overall process.

#### *Acceptance and planning*

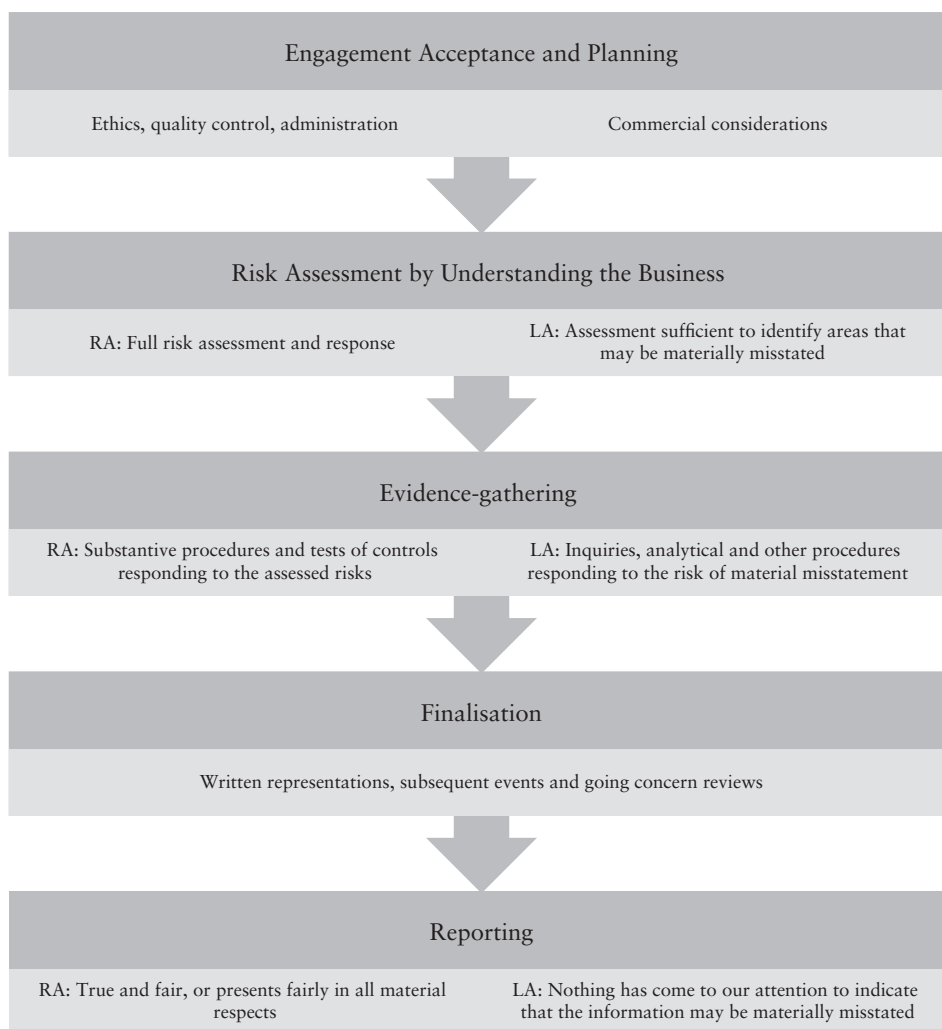
Before accepting any assurance engagement, practitioners must ensure that they have complied with ethical and quality control requirements. Ethical requirements demand that they *independent* of the entities on which they report and *competent* to perform the engagement. There must be no conflict of interests with existing clients and management must not lack integrity. *Quality control* requirements demand that the firm has in place procedures to ensure that assurance engagements are conducted in accordance with professional standards, by having proper methodologies, human resources procedures and training, for example. They also require the supervision and review of work on individual engagements. If the engagement is a new one, the firm must complete the protocols for changes in professional appointment and make inquiries of the previous practitioner about whether there is any reason the engagement should not be accepted.

Administrative requirements include the need to issue an *engagement letter* and *liaise with third parties* involved in the engagement such as internal auditors, firms appointed to other group companies, and any experts. Timetabling and allocation of staff are substantial exercises for large engagements, particularly where there are tight reporting deadlines for large listed entities.

Commercial considerations are always relevant. Has a reasonable *fee* been negotiated? Is the client *able to pay*? Firms may perform credit checks using credit rating agencies, like any other business extending credit to a new customer.

#### *Risk assessment by understanding the business*

All assurance engagements involve risk assessment. Risk assessments for reasonable assurance engagements involve extensive analysis of the risks associated with internal control, where appropriate. They go further than assessments for limited assurance engagements in which the risk analysis will only extend to determining the risks of material misstatement.



*RA = reasonable assurance engagements*

*LA = limited assurance engagements*

**Figure 1.1** Overview of the assurance process

### ***Evidence-gathering***

For reasonable assurance engagements, evidence-gathering involves responding to the assessed risks with tests of control and substantive procedures. Substantive procedures consist of tests of details and analytical procedures.<sup>11</sup>

<sup>11</sup> Tests of details involve checking individual transactions such as invoices, and balances such as receivables. Analytical procedures involve the analysis of aggregated data, such as review of expenditure on a monthly basis.



In limited assurance engagements, evidence-gathering involves addressing the risks of material misstatement with inquiries, analytical and other procedures as appropriate. There is much less emphasis on internal control and practitioners do not seek to verify or substantiate responses to queries in the way that they do for reasonable assurance engagements.

### *Finalisation*

The areas covered when finalising an assurance engagement include:

- *written representations* which are required to confirm that management acknowledges its responsibility for the information reported on and for the systems underlying it. Representations also confirm that all relevant information has been provided to practitioners. They confirm management assertions and support other evidence in material areas such as the key assumptions on which significant estimates are based;
- *subsequent events* reviews which are performed after the period-end. Some subsequent events, such as a significant bad debt or the acquisition of a significant new business shortly after the period-end, may require adjustment or disclosure in the information reported on.

### Assurance Reports

Assurance reports generally include:

- *a title and addressee* such as, ‘Independent auditors’ report to the shareholders of XYZCO;
- *an introductory paragraph* identifying the information reported on, such as the financial statements prepared in accordance with IFRS, often referring to page numbers;
- *the responsibilities of management* for the information and the assumptions on which it is based;
- *the practitioners’ responsibilities* to conduct the engagement in accordance with ethical and quality control requirements, auditing or other relevant standards and a summary of the work performed;
- *a conclusion* in the form of either *an opinion on truth and fairness/fair presentation* in a reasonable assurance engagement, or, in a limited assurance engagement, *a conclusion on whether anything has come to the practitioners’ attention to indicate that the information is materially misstated*;
- *a signature, date and location*.

In the UK, the requirement that all financial statements give a ‘true and fair view’ was first introduced in the Companies Act 1947 and amended the former phrase ‘true and correct’. The phrase ‘presents fairly in all material respects’ is more commonly used in the USA.

The ‘true and fair view’ is enshrined in the European Community’s Fourth Directive which sets out the form and content of company accounts.

### **What an Audit is Not: Common Myths about Auditing and Financial Reporting**

An audit is not a guarantee that the financial statements are not materially misstated. The audit opinion is just that, an opinion.

Auditing standards recognise that a properly performed audit may not detect a material misstatement, because of the inherent limitations of an audit, internal controls and financial reporting. Audit risk is the risk that an unmodified audit opinion is issued where a modified one is appropriate. That risk can be reduced to a quantifiable and acceptable level, but it cannot be eliminated altogether.

Some corporate collapses are the result of management fraud, but most arise from some combination of a lack of profitability, an inability to manage cash flows or excessive debt. They are rarely, if ever, *caused* by auditors.

### **A Short History**

Audits and auditors have been around for a long time. An auditor is someone who hears or listens. The Latin root of the word auditor is *auditus*, meaning ‘a hearing’. Historically, senior estate staff were said to hear accounts of the management of medieval estate assets and report back to landowners. Modern auditors came into being when companies and corporations started to proliferate in the UK, USA and elsewhere in the 19th century.

Modern companies in the UK and corporations in the USA and elsewhere are artificial legal persons. They exist in their own right independently of their directors and owners (their shareholders or stockholders). Companies and corporations have rights such as limited liability and obligations such as the requirement to prepare financial statements and, in some cases, to have them audited.

In the UK, the Joint Stock Companies Act 1844 and the Limited Liability Act 1855 facilitated collective investments in the risky, diverse and large-scale projects of the industrial revolution such as mines and railways, often overseas. The propensity of some promoters of such projects to overstate their prospects to impressionable investors, together with the need for stocks and shares<sup>12</sup> in such entities to be properly priced and traded in well-ordered markets, led to the development of the stock markets, securities legislation and companies legislation. The basic system of company registration introduced in the mid-1800s is still in place in the UK. The forbears of the professional accountancy bodies and firms were founded in the late 19th and early 20th centuries in the UK and the USA.

---

<sup>12</sup> In the UK, investors in companies hold shares. In the USA, investors in corporations hold stocks. There is little now to distinguish between the terms ‘stocks’ and ‘shares’. US business terminology is more conservative than its UK equivalent and the term ‘company’ in the USA can refer to a partnership or other unincorporated association, as it once did in the UK. Shares in the UK are traded not on London’s Share Exchange but on its Stock Exchange.

Prior to the 1844 Act, corporate bodies such as companies and corporations could only be formed by Act of Parliament or Royal Charter or other mechanisms designed for large institutions and groupings such as ecclesiastical institutions, universities, hospitals, cities, guilds and professions. The British East India Company was granted a Royal Charter in 1600. The Dutch East India Company was chartered in 1602 by the States-General of the Netherlands. Both were granted trading monopolies and administrative powers. Much general trade in goods and services in the UK and elsewhere in the world was transacted by individuals and unincorporated associations until the mid-19th century. This was administratively cumbersome because any legal or other action by the association had to be conducted in the joint names of all those involved.

Industrialisation and the development of company law in the UK and securities legislation in the USA in the late 19th and early 20th centuries changed all of this. Modern audit requirements vary enormously from jurisdiction to jurisdiction. We have seen that in the USA there is no statutory requirement for the audit of any entity and that only those with debt or equity securities listed on a US exchange are required to have an audit. By contrast, in some European countries all incorporated entities, regardless of size, are still subject to a statutory audit requirement under company law. Some jurisdictions, including some in the former Soviet Union, have introduced audit requirements conducted under international standards for the first time only fairly recently.<sup>13</sup> Some former European colonies in Africa and Asia still follow the practices of the old colonial power, but this is changing.

## 1.2 PASSING THE EXAM FIRST TIME

### Auditing and Assurance Exams and Study Technique

Auditing and assurance present nothing like the intellectual challenge of accounting for deferred tax, fair values, or complex financial instruments, but some very bright people struggle with auditing and assurance exams. There are four ways to avoid this struggle:

- ***respect the paper:*** auditing and assurance exams usually have more words than numbers. Some students leave revision for the paper until the last minute, spending more time on other papers that are genuinely more difficult. Auditing is not rocket science but it does require time and effort and it cannot be picked up overnight, *don't underestimate it;*
- ***question practice and more question practice:*** many students overdo rote learning at the expense of question practice. We learn how to sail by messing around in boats. To become a better mountaineer, it is necessary to climb a few mountains. Reading books about sailing and climbing will help, but they are no substitute for the real thing. To pass auditing and assurance exams, it is necessary to practice questions. Most students who struggle with auditing and assurance exams are not lazy, but their efforts are sometimes misdirected and *altering the learning/question practice ratio in favour of the latter always helps;*
- ***better exam technique:*** poor exam technique is probably the least common reason for failing auditing and assurance exams, but it can be important. No matter how

---

<sup>13</sup> Tax audits are still required in many jurisdictions.

well you answer questions 1 and 2, in almost all cases, it is virtually impossible to pass the paper if you do not attempt questions 3 to 5. A very small minority of students have handwriting that is so poor as to be illegible where handwritten papers are submitted but many students irritate markers with untidy handwriting, and it is generally better not to irritate your marker if you can avoid it.

- ‘. . . *my English lets me down*’, is a common worry among students whose first language is not English. It is almost always nonsense. If students make it as far as taking the exam, the quality of their written English is rarely, if ever, the problem. It is important to note that the correlation between oral and written skills is not always as close as might be expected. Some students who do not speak English particularly fluently are very articulate in writing. The fact that you cannot speak English as well as you would like does not mean that you cannot pass an auditing and assurance exam.

Markers rarely see truly incomprehensible exam scripts and those that are, are usually written by students whose first language *is* English. It is much more common for exam scripts simply not to have enough in them for a pass, and this is true regardless of whether the student’s first language is English.

Some accountancy students with a business, scientific or technical background find it difficult to articulate their thoughts and written papers can present a significant challenge. It is no exaggeration to say that some of the brightest students have problems in this area. It is often less the result of an inability to write well, and more a lack of confidence and practice. Students appearing to struggle with a question, when asked to express the answer verbally, are sometimes very well able to do so but have a mental block when it comes to writing it down. The appropriate advice in such cases may simply be to ‘write down what you are thinking’, or ‘write down what you have just said’. Such students need to be strongly encouraged to write things down, because question practice is not just ‘helpful’, it really is essential to passing the exam first time;

- ***good material and good teachers:*** there is a small amount of very poor study material around, a great deal of indifferent material and some very good material. It all claims to be the best. Give yourself a chance and use the best you can find and trust your own judgement. Read a bit of it and see. Does it make sense? Is it hard to read? Time spent trying to learn from excessively detailed materials that cover the syllabus but do not explain it, is time lost. If the study materials you have been using have not worked for you, use different material. The same considerations apply to tuition providers.

Some students fail auditing and assurance exams repeatedly, by just a few marks. The cause is almost always some combination of the factors listed above. Re-sitting auditing and assurance exams *is* avoidable.

### ***Practising questions***

It is always a great deal easier to read the book than it is to try a question but ***the key to passing auditing and assurance exams is practising questions, in full, under exam conditions.*** There are two reasons for this. Firstly, it makes neurons fire and

establishes good thinking habits. Secondly, you learn from the answer. It does not matter how badly you do, provided you *try the question without looking at the answer*, giving it a decent amount of time, and then *underline the elements of the answer you missed, and write or paste them into your own answer*. The fact that you may never look at the question again is of no importance. The action of writing or pasting the missed material into your own answer means that when you next encounter something similar, you are much more likely to remember what you missed.

No study material can cover all of the material in every possible exam. Learn from the answers to questions, particularly past exam questions, as well as the study material. There are many past papers together with answers freely available on the examining bodies' web-sites; use them.

### *Different types of question*

Questions come in many shapes and sizes.

*Short form questions* generally need answers in note form only; no marks are awarded for writing in full sentences. This type of question does need practice though because short form answers can degenerate. Markers sometimes have to decide whether the student really understands the point and deserves a mark, but has simply failed to articulate it clearly, in which case half a mark may be appropriate, or whether the student simply doesn't understand and is perhaps trying to hide the fact by being cryptic.

Consider the following part response to the question, '... give examples of requirements relating to long service applicable to key audit partners':

- (a) ethical prohibitions on engagement partners serving PIE audit clients for over 7 years;
- or*
- (b) professional ethical requirements force staff on audit clients to change so as to avoid long service

The latter point is long on form but has little content. Despite its length, it will probably attract fewer marks than the former. The former is more specific in that it refers to engagement partners rather than staff, and does not simply repeat information in the question. It gives a time period rather than simply referring to long service and it refers to PIEs rather than audit clients generally. Even if the figure given in the first point was wrong, more credit might be given for this than for simply referring to long service. The second point uses three words in referring to professional ethical requirements and uses the term 'change', which is correct, but the term 'rotate' would be better because that is the term used in IESBA's *Code*.

*Letters, reports and briefing notes:* if letters, reports or briefing notes are asked for, the format alone will often attract marks. Students sometimes waste an extraordinary amount of time trying to think of amusing names for companies or individuals which, unfortunately, can irritate markers. It is much better, albeit not as much fun, to stick with an established format and a set of names and addresses for where they are not provided in the question.

*Letters* need to look something like this:

Benco Inc 1, High Street Upton Midshire 67467	Vinco Partners 2, High Street Upton Midshire 67767
5 March 20XX	
Dear Mr X/John [Salutation appropriate to the relationship – if in doubt, be formal]	
<b>Proposed Services for Benco Inc [Subject matter]</b>	
Thank you for coming into the office last week to discuss your requirements. I have great pleasure in setting out below the different types of services we are able to offer. I also suggest below which of those service might be appropriate to your specific circumstances. [Brief, polite formalities]	
<i>[Brief summary and conclusions/recommendations if appropriate]</i>	
Details of the <i>[subject matter]</i> are included in appendix 1 to this letter	
<b>Appendix 1</b>	

*Reports* need to look something like this:

<b>Title: Vinco Partners – Developing Criteria for Engagement Quality Control Reviews</b>
<b>Report to:</b> the Partners of Vinco
<b>Partners' meeting date:</b> XX/YY/20XX
<b>Prepared by:</b> D Fraser, K Smith
<b>Principal Conclusions and Recommendations</b>
The firm is required to develop a policy for the performance of Engagement Quality Control Reviews (EQCRs) for audit clients other than listed entity audit engagements.
We <i>recommend</i> that EQCRs be conducted for the following audit clients <i>[Main headings of report]</i>
<ul style="list-style-type: none"><li>• <i>all entities in the financial services sector;</i></li><li>• <i>entities with not-for-profit status where revenue exceeds \$XXX;</i></li></ul>
<i>Time and cost budgets</i> for the performance of EQCRs in the first year are expected to be. . . .

### Detailed Recommendations/Findings/Methodology

#### Background

We are a growing firm. . . .

##### 1. Entities in the financial services sector

We currently have 16 clients in this sector ranging from. . . .

##### 2. Not-for-profit entities

We currently have a large number of smaller not-for-profit entities but very few are audit clients. . . .

#### Time and cost budgets

The principal assumptions underlying the calculations set out in appendix 1 are as follows. . . .

### Appendix 1

*Briefing notes* need to look something like this:

**Title:** Briefing Notes for Audit Team Members Not Present at the XX/YY/20XX Planning Meeting for the Audit of Timco for the period-ended. . . .

**Subject:** Discussion of the susceptibility of the financial statements to material misstatement arising from fraud and error

**Date:** XX/YY/20XX

**Prepared by:** T Evans

Summary of conclusions: the initial assessment of the risk of material misstatement due to fraud in prior years has been LOW, due to the high quality of the control environment and despite some significant high risk areas. In the current year . . .

#### Considerations relevant to the assessment

- The *financial statements* consist of a balance sheet, statement of comprehensive income, cash flow statement and statement of changes in equity. An unmodified audit opinion was issued . . .
- *Significant risk areas* in prior years have included: poorly controlled overseas subsidiaries, complex financial instruments . . .
- The overall control environment has been assessed as good in the past but there have been significant changes in management during the year . . .
- Etc.

*What do I do if . . . ?*

- ***The question seems to want the same information twice:*** it is acceptable to repeat yourself across two different questions, but it is not acceptable within one question. If in doubt as to where within a question to include material, include it at the first possible point and then refer to it the next time it seems to be relevant. The mark allocation might give some indication as to where the material fits best.
- ***The question has something in it that I can't find a use for in the answer:*** tutors spend a lot of time persuading students to answer the question that is set, rather than the question the student thinks should have been set, but sometimes it seems impossible to use what appears to be background information. If you really cannot find a use for it, maybe it is just background information. For example, the introduction to some questions refers to the name of the relevant ISA. Generally, this is genuine background information. It does, of course, mean that no credit will be given for mentioning the name of the ISA in the answer. If a question does not mention the name of an ISA, it might be appropriate to refer to it in an answer but it is unlikely that much credit will ever be given for doing so.
- ***I seem to be stating something really obvious:*** some questions seem to want you to make some very simple observations, such as the fact that profits have risen in analytical procedures questions. If the question asks you to comment on profits, you do need to make the observation, but you also need to explain its significance. It is perfectly acceptable to guess what the significance might be, but if you really have no idea, you should still make the observation.
- ***The question asks for three examples and I've got four:*** ask yourself whether you really have four, or whether two are just different aspects of the same point, and whether you can make them together as one point.
- ***The question asks for three examples but I've only got two:*** have you really only got two? Are there perhaps two elements of one example that can be separated out? If you really only have two, don't say the same thing twice just to make three points because it is usually very obvious and, once again, it irritates markers.

***Syllabus coverage: there is far too much to learn!***

All of the professional bodies revise their syllabuses regularly. Standard-setters are in the business of setting and revising standards. These revisions are often described as radical, but real change is slow. Basic questions on the audit of income, expenditure, property, plant and equipment, inventories, receivables, cash, bank, payables and long-term liabilities have been set in much the same way for many years, and continue to be set, because they remain relevant.

Examiners cannot cover the entire syllabus in one paper, but most attempt to cover it over a series of papers. This means that if an area that is not often examined came up last time, it is less likely to come up this time. If an area that is often examined has not come up for some time, it is more likely to come up next time. It really is worthwhile looking at past papers on the examining body's web-site to form your own opinion on what might come up. Examiners occasionally examine the same obscure area in quick succession, in



an attempt at raising awareness of something they think needs more attention because students did very badly in it the first time round. Many examiners also have their ‘pet’ subjects, which is another reason for looking at what has come up recently.

In a perfect world, with unlimited time to revise, students would go into an exam having thoroughly revised all areas for all papers. Working all areas in detail is ideal but most students simply will not do this. Some hard decisions have to be made about what to cover in detail, what to skim and what to leave out altogether.

Most students try to work the key areas in some detail and have an overview of the other areas. Working key areas in a lot of detail and ignoring other areas completely is another approach and it can work, but it is risky because it limits the number of questions students can attempt in the exam.

Students who choose unpopular questions stand out. Unlike many other exams, there is scope in marking auditing and assurance exams for the exercise of judgement, and for giving or withholding from the student the benefit of the doubt. Markers try not to reward students who attempt unpopular questions disproportionately, but there are fewer candidates to compare the student against, which may work in the student’s favour. This is one reason for attempting such questions but if you really know very little about an obscure area, it is probably best avoided if possible. It is better to scrape a pass on a question that everyone tries, than to fail, marginally, an obscure one!

For a variety of reasons, not all auditing and assurance standards are clear. Occasionally an error has been made, but this is very rare. Sometimes a matter is deliberately left unclear when members of a standard-setting board cannot agree, and a standard needs to be issued. Everyone goes away thinking that their position has been accommodated. Examiners tend to avoid these areas.

#### *No more knowledge-based questions?*

From time to time, professional bodies and the bodies that regulate them announce that there have been too many knowledge-based questions and not enough emphasis on higher-level skills, especially application skills. The rationale is that rote learning is not just lazy, but unnecessary because professional ethics and auditing standards are all available online, and many exams are conducted on an open-book basis. Students cannot apply what they do not know, though, and they cannot apply what they do not understand. Some basic knowledge is essential and it is still impossible to pass auditing and assurance exams without it.

#### *Terminology*

On the face of it, much of the terminology used by auditors about audits and assurance seems to be straightforward, but it should be treated with care. Many of the words used, such as ‘independence’, ‘review’ and ‘assurance’ have one meaning in ordinary English as well as a technical meaning in the context of auditing and assurance. It is important to understand and use the technical meaning properly. This is one of the reasons that some students underestimate auditing and assurance papers.

***Having a life***

There is nothing mysterious about passing auditing and assurance exams. No magic wand is required. All that is required is a plan to get through the material in the time period allotted, and a modicum of discipline in sticking to the plan. Easier said than done, of course, but not that hard. Boredom is a problem and managing distractions can be important. Getting friends and family into the habit of leaving you alone for two hours three evenings a week may be hard, but it can be done. Harder still is getting yourself into the habit of staying away from Facebook, emails, texts and TV on a regular basis, but even that can be done. If you cannot face going back to the same room to study, do it somewhere else, but not somewhere with a TV. Try moving the furniture around. If your desk faces a window, turn it to the wall. The alternative is living in a permanent state of anxiety about how much work you have not done!

**Exam Technique**

In the exam centre:

- if you can, *answer the questions on the paper in reverse order*. It means you are out of synch with everyone else and will not be distracted by what they are doing. Alternatively, just do the *easiest question first* to give yourself confidence, but be strict with the amount of time you spend on it;
- remember that if you are submitting a handwritten paper, *poor handwriting irritates markers* and you want to make the marker's life easy. Really clear handwriting is unusual and makes an exceptionally good impression;
- split answers up into *manageable chunks* that the marker can tick, but don't do so artificially because it is usually very obvious;
- highlighting and underlining can also irritate markers and are sometimes prohibited;
- *answer the question set*, not the question you think should have been set;
- *take the easy marks*: if the question asks for a letter, prepare a letter. If it asks for a report, include a title, an executive summary, a description of the work performed, etc. If brief notes are asked for, no marks will be available for anything more;
- *keep on writing*: exams are sometimes deliberately set so there is insufficient time to answer all questions on the basis that real life is like this, but there will always be questions you struggle to answer. Think about what the examiner is really looking for, but remember that if you do not write anything, you cannot earn marks. If you write something, it might earn marks.

In the vast majority of cases, examiners are looking for a very small amount of knowledge, but mostly for a lot of imagination in applying that knowledge to a given scenario.

It is impossible to memorise a complete list of tests of controls and substantive procedures, and all of the finalisation procedures for audits, reviews, compilation and agreed-upon procedures engagements, but students sometimes appear to believe that that is the right thing to do. Even the most experienced audit partners cannot do this, but what practice and experience does enable them to do is to come up with a lot of

examples. Auditing and assurance exams are often the first stages of that experience and students should have confidence that what they invent, or make up in terms of tests, has value.

*Section essentials: what you need to remember*

- *Why assurance is needed.*
- *The overall assurance process.*
- *The meaning of the terms stewardship, agency and accountability.*
- *The benefits and limitations of an audit, and alternatives to audit.*
- *The differences between audits and reviews.*
- *That you have bigger battles to fight than passing auditing and assurance exams! Make sure you get through them first time.*

## SECTION 1, QUESTION

Professional accountants can provide a wide range of assurance services including assurance on historical financial information, greenhouse gas statements and prospective financial information. They also provide non-assurance services such as compilation engagements, which are subject to different requirements.

Audits of historical financial information, together with compilation engagements, remain an important part of the service offering of many firms of all sizes.

**Required:**

**Outline briefly:**

- (a) the nature of audit and compilation engagements and the differences and similarities between them. (7 marks)
- (b) the benefits of an audit and its limitations. (6 marks)
- (c) the main stages of the assurance process. (7 marks)

**Total** (20 marks)