

1 THE HISTORY OF AUDITING

In order to appreciate the significance of correct interpretation and application of International Standards on Auditing (ISAs), one needs to first set the historical context.

Auditing has been a worldwide profession for hundreds of years. Historically, auditing was concerned with accounting for government activities and reviewing the work done by tax collectors. In the early years of auditing, the keeping and maintaining of accounting records was done primarily to detect fraudulent activity. The industrial revolution in the mid 1700s to the mid 1800s was responsible for the increased demand in auditors because this period saw an increase in responsibility being passed from owners to managers. This led to an increased requirement for auditors who were independent of management and who were engaged not only to be alert for errors within financial records but also errors within the records. In simple terms, deliberate errors in order to achieve personal financial gain were deemed to be fraudulent activity (as is still the case today) whilst error was (and still is) unintentional.

During the early 1700s the concept of 'sampling' was introduced. Sampling is where auditors select a sample of items that make up various balances and was used where it is not economically viable to physically examine all the transactions that have taken place. This practice is still pivotal today. This is one of the main areas which this publication looks at in respect of the redrafted ISAs.

During the 1940s it was clear that the auditor's role had developed into that of providing an opinion on the financial statements and that the detection of fraud and error had taken a very much subordinate role in the objective of an audit. It developed that management were responsible for the prevention and detection of fraud and that the auditor's work should not be concerned primarily with detecting fraud but should be planned in such a way that they will detect a material fraud. This view was formalised much earlier in the United Kingdom (UK) than the 1940s, as Lord Justice Lopez in the Kingston Cotton Mill, 1896, said that the auditor's role in an entity should be that of a 'watchdog' rather than a 'bloodhound'. Lord Justice Lopez said:

It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably careful, cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or, as was said to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watchdog not a bloodhound. He is justified in believing tried servants of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and rely upon their representations, provided he takes reasonable care.

Lord Justice Lopez – Kingston Cotton Mill 1896.

The view here was that the auditor should act with such reasonable care and skill in order that their work will have a reasonable chance of detecting a material fraud and other errors. This view is still the same today with auditing standards now requiring auditors to adopt and

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maintain a degree of professional scepticism by assuming that the financial statements will contain a material misstatement due to fraud. This issue is discussed in Chapter 8.

RISK-BASED AUDITING

Since the early 1980s audit fees have increased to reflect the fact that audits need to be undertaken effectively and efficiently. Audit firms have developed a technique known as 'risk-based' auditing which involves the auditor determining the nature, timing and extent of various audit procedures. This method of auditing is based on the auditor's assessment of the risk that the financial statements of an entity contain a material misstatement.

REGULATION

In the vast majority of countries who practice audit, the auditing profession is regulated under legislation. For example, in the UK auditing is a regulated profession under the Companies Act. It is for this reason that not all professional accountants can practice audit-related work, unless they have obtained statutory auditor status.

The objective of the audit exercise is to enable the auditor to express an opinion on whether the financial statements present fairly in all material respects the entity's affairs at the reporting date as well as form an opinion on whether they have been properly prepared in accordance with the applicable reporting framework.

INTERNAL AND EXTERNAL AUDITING

Auditing predominantly takes two forms: internal and external audit. An internal audit function is usually a department that is set up within an entity which is staffed by employees of that entity who will provide internal audit functions which benefit the entity as a whole. In many cases, the role of internal audit is often outsourced. Internal audit departments will have their roles dictated by management of that organisation. Internal auditors will comply with their own set of auditing standards which are largely independent of the ISAs. Internal auditing functions by, amongst other things, examining, evaluating and reporting to management on the adequacy and effectiveness of components of the accounting and internal control systems. In other words, internal auditing exists to add value and improve an organisation's operations.

External audit, which this publication is concerned with, is usually a statutory requirement imposed on an entity. For example, in the UK, companies are required by statute to have their financial statements audited if, under the Companies Act 2006, any one of the thresholds shown in table 1.1 are breached.

Where reference to 'net' and 'gross' are made, this is in relation to intra-group trading. Gross means intra-group sales have not been eliminated, net means that elimination has occurred in accordance with the requirement of IAS 27 'Consolidated and Separate Financial Statements'.

Other jurisdictions may have their own eligibility criteria for audit and audit exemption. The auditor's opinion on the financial statements is not an opinion of absolute correctness because of the inherent limitations associated with an audit. The limitations inherent in an audit of general purpose financial statements are discussed in Chapter 4. There is often a concept

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Table 1.1 Auditing thresholds

	<i>Turnover</i>	<i>Balance Sheet (Gross Assets)</i>	<i>No. of Employees</i>
Small company	£6.5 million	£3.26 million	50
Small group	£6.5 million net	£3.26 million net	50
	£7.8 million gross	£3.9 million gross	50
Medium-sized company	£25.9 million	£12.9 million net	250
Medium-sized group	£25.9 million net	£12.9 million net	250
	£31.1 million gross	£15.5 million gross	250

Note: The table relates to accounting periods which commence on or after 6 April 2008, following the amendment by statutory instrument 393.

of perception gap because some third parties often assume that an audited set of financial statements can give absolute assurance. It is for this very reason that reference to ‘reasonable assurance’ is made within the auditor’s report.

It could also be the case that an entity is required to have a statutory audit because the members chose to have an audit when the company was incorporated. This is often the case when a company has such a condition in their Articles of Association.

External stakeholders, such as banks and financiers can also impose a requirement for audit on an entity even if they are not required by statute to have an audit undertaken on their financial statements. In an increasing number of cases, financiers do require a certain level of assurance. In today’s modern profession, there are an increasing number of assurance engagements being carried out.

ASSURANCE ENGAGEMENT

An assurance engagement is one where a professional accountant evaluates, or measures, a subject matter that is the responsibility of another party against suitable criteria, and expresses an opinion which provides the intended user with a level of assurance about that subject matter. In other words, it is an engagement to express an opinion giving assurance to a set of people on information which is the responsibility of others.

An audit can be distinguished from other assurance engagements in the following ways:

Audit engagement: the auditor provides a high, but not absolute, level of assurance that the information audited is free from material misstatement. This is expressed positively in the audit report as ‘reasonable assurance’.

Review engagement: the auditor provides a moderate level of assurance that the information subject to review is free of material misstatement. This is expressed in the form of ‘negative assurance’.

Negative assurance is where an auditor gives an assurance that nothing has come to his/her attention which indicates that the financial statements have not been prepared according to the framework. In other words, the auditor gives his/her assurance in the absence of any evidence to the contrary.

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FEATURES OF AN AUDIT

In general terms, an audit will involve the examination of an entity's financial statements and of the disclosures contained therein. As a rule, the auditor is not responsible for preparing the financial statements, though in some cases the auditors may be involved provided adequate safeguards have been implemented to maintain independence. The end result of the audit is the auditor's opinion on the financial statements as to whether the financial statements give a true and fair view, or present fairly in all material respects, the state of the entity's affairs.

In order to arrive at their opinion, the auditor must be seen to be *independent* of the entity that is being subject to audit. For the purposes of audit, 'independent' means not having any significant personal interest in the entity. Ensuring the auditor is independent also guarantees that the objective of the audit is achieved and a professional and unbiased view is taken.

Because it is highly unlikely that two audit assignments will be identical, it is important that audit assignments are undertaken in a logical and structured manner. The objective of the audit is to ensure that the financial statements of an entity give a true and fair view, or present fairly in all material aspects, the state of the company's affairs at its reporting date. It would therefore be irresponsible for the auditor to undertake an audit in a sporadic and unplanned manner.

Before any detailed audit work takes place on an audit assignment, the auditor is required to undertake a thorough programme of planning. Planning is a significant area impacted by the redrafting process of the Clarity project and is looked at in more detail in Chapter 13. Without sufficient planning, the auditor is unable to document that they have gained a sufficient understanding of the entity in order to enable an efficient audit to take place. The planning will take various forms and includes the following programme of documentation:

- the entity's background and history;
- its policies and procedures;
- key management and staff;
- significant accounting policies;
- the environment in which the entity operates;
- accounting systems;
- any problems encountered in previous audits;
- a timetable for key events;
- the audit budget;
- the audit strategy;
- meetings held with the client prior to the audit; and
- meetings of the audit team prior to the client.

A full risk assessment is also required at the planning stage and the audit strategy is then developed as a result of this risk assessment to ensure that the audit procedures adopted during the course of the audit are responsive to the risks identified at the planning stage.

A review of the entire audit process is summarised in table 1.2.

Table 1.2 shows that the initial step in the audit process is the planning of the audit. Two fundamental standards must be complied with in this respect: ISA 300 (redrafted) 'Planning an Audit of Financial Statements' and ISA 315 (redrafted) 'Obtaining an Understanding of the Entity and its Environment and Assessing the Risk of Material Misstatement'.

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Table 1.2 The Audit Process

	<i>New Audit</i>	<i>Recurring Audit</i>
Legal and ethical matters	Consider	Review
Acceptance and letter of engagement	Prepare and issue	Review and update where necessary
Obtain an understanding of the entity and its environment	Obtain and prepare	Review and update where necessary

The auditor will document their understanding of the accounting and internal control systems present at the audit client. This will also involve the auditor undertaking a risk assessment in order that the procedures the auditor adopts during the course of the detailed audit work are responsive to those risks.

The next step is for the auditor to consider the various ways in which they will generate sufficient and appropriate audit evidence (audit evidence is discussed in Chapter 18). Audit evidence can be obtained from a variety of means, but usually from either tests of controls or substantive procedures, or a mix of both. In determining whether the evidence can be gathered from tests of controls (and, therefore, reduced detailed substantive testing) the auditor must assess whether the internal controls operate effectively; in other words, ensuring that the controls will prevent, detect and correct a material misstatement within the accounting systems in a timely manner. Tests of controls are often referred to as ‘compliance tests’. Any significant deficiencies in internal controls will be notified to those charged with governance in accordance with the provisions of ISA 265 ‘Communicating Deficiencies in Internal Control to those Charged with Governance and Management’ (see Chapter 11).

The above summary highlights the primary objective of the external audit. The objective of the audit looks at the primary needs of external stakeholders of an entity, as opposed to the requirements of an entity’s management. External stakeholders usually include, amongst others, an entity’s bankers, trade payables and receivables, employees, potential investors and employees. The audit is therefore concerned with ensuring that the general purpose financial statements are objective, free from bias and manipulation and relevant to the needs of the users of those financial statements.

INDEPENDENCE

Auditors are expected to be independent of the reporting entity. The Conceptual Framework Approach to Independence identifies two aspects of independence:

- independence of mind; and
- independence in appearance.

Independence of Mind

Independence of mind enables the auditor to form an opinion without being affected by influences that would compromise the auditor’s professional judgement. Independence of mind will allow the auditor to act with integrity and exercise objectivity at all times during the course of the audit. Independence of mind will also allow the auditor to act with professional scepticism.

[IESBA Code]

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Independence in Appearance

Independence in appearance is achieved when the auditor avoids facts and circumstances that are so significant that a reasonable and informed third party would conclude that the auditor's integrity, objectivity and professional scepticism has been compromised.

[IESBA Code]

Threats to Independence

Any threats to the auditor's independence must be eradicated in totality or mitigated to an acceptable level. The auditor also has an obligation to ensure that where they identify threats to independence adequate safeguards are applied. Where the auditor concludes that adequate safeguards cannot be applied to eradicate the threat in totality or mitigate it to an acceptable level, the auditor must resign from the audit engagement or decline the audit engagement. Threats to independence could arise in the following circumstances:

- Auditor's personal interest. The auditor may fear losing the audit fee.
- Intimidation. The auditor may be intimidated by dominant or aggressive management.
- Long association. If the auditor has had a long association with the client, they may be too sympathetic to the client.
- Performing non-audit work and subsequently auditing that work (referred to as a 'self-review' threat).

Chapter Roundup

The primary objective of the audit is for the auditor to express an opinion about the truth and fairness (or whether the financial statements present fairly, in all material respects) the state of the entity's financial affairs at the end of the reporting period.

Acceptance procedures include: consideration of legal and ethical issues, preparing the letter of engagement and obtaining an understanding of the entity.

The auditor should undertake a sufficient programme of planning before the detailed audit work commences to identify key areas of the audit and to devise the audit strategy. The auditor should also review the legal and ethical issues surrounding their engagement, review and update the letter of engagement, review and update their understanding of the entity and the environment in which it operates.

The auditor must be independent in order to maintain the objectivity of the audit. Any threats to this independence should be minimised to an acceptable level. Where such threats cannot be minimised to an acceptable level, then the auditor should consider their ability to continue as auditor.

The auditor does not have a direct responsibility to look for fraud during the course of an audit, as the responsibility for the prevention and detection of fraud rests with management. However, the auditor should plan their work and their procedures with an expectation that the financial statements might be materially misstated due to fraud.