CHAPTER 1

# International Auditing Overview

## 1.12 Questions, Exercises and Cases

### *1.2 Auditing through World History*

**1-1. Identify and briefly discuss factors that have created the demand for international auditing.**

The practice of modern auditing dates back to the beginning of the modern corporation at the dawn of the Industrial Revolution. Companies then experienced a growth of technology, improvement in communications and transportation, and the exploitation of generally expanding worldwide markets. As a result, the demands of owner-managed enterprises for capital rapidly exceeded the combined resources of the owners' savings and the wealth-creating potential of the enterprises themselves. It became necessary for industry to tap the savings of the community as a whole. The result has been the growth of sophisticated securities markets and credit-granting institutions serving the financial needs of large national and increasingly international corporations.

The flow of investor funds to the corporations and the whole process of allocation of financial resources through the securities markets have become dependent to a very large extent upon reports made by management. One of the most important characteristics of these corporations is the fact that their ownership is almost totally divorced from their management. Management has control over the accounting systems of these enterprises. Management is not only responsible for the financial reports to investors; it also has the authority to determine the precise nature of the representations that go into those reports. To reduce the investor's potential lack of confidence about management's reports a demand for independent assurance has arisen, called 'auditing'.

**1-2. What characteristics of the Industrial Revolution were essential for the enhanced development of the audit profession?**

The Industrial Revolution created the demand of services of specialists in bookkeeping and auditing of internal and external financial reports. It started in Great Britain around 1780. This revolution lead to the emergence of large industrial companies, with (1) complex bureaucratic structures and, gradually, (2) the need to look for external funds in order to finance further expansion: the separation between capital provision and management.

### *1.3 The Auditor, Corporations and Financial Information*

**1-3. Evaluate this quote: 'Every international business, large or small, should have an annual audit by an independent auditor.' Why should an auditor review the financial statements of a company each year?**

Management can scarcely be expected to take an impartial view of this process. The financial reports measure the effectiveness of management's performance of its duties. Reports have an important influence on management's salaries, on the value of their shareholdings in the enterprise, and even on their continued employment with the company.


© Pearson Education Limited 2014

Income statements are compiled on a yearly basis. The income statement is very valuable to shareholders and other stakeholders. To increase the confidence these stakeholders in the credibility of yearly compiled financial statements, the statements must receive an independent and expert opinion on their fairness. An auditor provides the opinion on credibility.

## *1.4 International Accounting and Auditing Standards*

**1-4. How do International Financial Reporting Standards (IFRS) differ from International Standards on Auditing (ISA)?**

Financial accounting standards are unique and separate from audit standards. By its nature, auditing requires that the real world evidence of financial transactions be compared to financial standards. The standards to which an international auditor compares financial statements are generally standards in the reporting country (e.g. FAS in the US, or national standards in European Union (EU) member states, which are based on EU directives). In the future, companies and auditors in the EU and other countries will use International Financial Reporting Standards (IFRS), formerly called International Accounting Standards (IAS), which are set by the International Accounting Standards Board (IASB).

**1-5. Why is the adoption of International Auditing Standards important for developing nations?**

International Auditing Standards encourage and assist developing nations to adopt codified sets of national auditing standards. The evolution of domestic accounting standards in developing nations can be expected to flow from the work of the IASB. Many developing countries rely to a large extent on foreign investment. Foreign investors are more likely to channel funds into a developing country if they have confidence in the accounting and auditing standards in that country.

## *1.5 An Audit Defined*

**1-6. What is the objective of an audit?**

The goal, or objective, of the audit is communicating the results to interested users. The audit is conducted with the aim of expressing an informed and credible opinion in a written report. If the item audited is the financial statements, the auditors must state that in their opinion the statements ‘give a true and fair view’ or ‘present fairly, in all material respects’ the financial position of the company. The purpose of the independent expert opinion is to lend credibility to the financial statements. The communication of the auditor’s opinion is called attestation, or the attest function.

An audit is a process, a structured series of tasks, the purpose of which is to provide evidence to support the claim that the financial statements are fairly stated (give a true and fair view). To be fairly stated, the statements must conform to accepted accounting principles (whether these principles are set by government, private organisations or custom).

The audit process must be planned, staffed and carried out and the evidence must be gathered, in a manner that is consistent with professional auditing standards.

**1-7. What is the general definition of an audit? Briefly discuss the key component parts of the definition.**

An audit is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users.


© Pearson Education Limited 2014

An audit is a systematic approach. The audit follows a structured, documented plan (audit plan). In the process of the audit, the auditors using a variety of generally accepted techniques analyse accounting records. The audit must be planned and structured in such a way that those carrying out the audit can fully examine and analyse all-important evidence.

An audit is conducted objectively. An audit is an independent, objective and expert examination and evaluation of evidence. Auditors are fair and do not allow prejudice or bias to override their objectivity. They maintain an impartial attitude.

The auditor obtains and evaluates evidence. The auditor assesses the reliability and sufficiency of the information contained in the underlying accounting records and other source data by:

- Studying and evaluating accounting systems and internal controls on which he wishes to rely and testing those internal controls to determine the nature, extent and timing of other auditing procedures.
- Carrying out such other tests, inquiries and other verification procedures of accounting transactions and account balances, as he considers appropriate in the particular circumstances.

The evidence obtained and evaluated by the auditor concerns assertions about economic actions and events. The basis of evidence-gathering objectives, what the evidence must prove, are the assertions of management. Assertions are representations by management, explicit or otherwise, that are embodied in the financial statements. One assertion of management about economic actions is that all the assets reported on the balance sheet actually exist at the balance sheet date. The assets are real, not fictitious. This is the existence assertion. Furthermore, management asserts that the company owns all these assets. They do not belong to anyone else. This is the rights and obligations assertion.

The auditor ascertains the degree of correspondence between assertions and established criteria. The audit programme tests most assertions by examining the physical evidence of documents, confirmation, inquiry and observation. The auditor examines the evidence for the assertion presentation and disclosure to determine if the accounts are described in accordance with the applicable financial reporting framework, such as IFRS, local standards or regulations and laws.

**1-8. Explain the concept of materiality.**

Misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information, needs of users of the financial statements and by the size or nature of a misstatement or a combination of both. The auditor's opinion deals with the financial statements as a whole and therefore the auditor is not responsible for the detection of misstatements that are not material to the financial statements as a whole.

**1-9. Discuss the two levels of risk an auditor must consider when designing audit procedures.**

In order to design audit procedures to determine whether financial statements are materially misstated, the auditor considers the risk at two levels. One level of risk is that the overall financial statements may be misstated. The second risk is misstatement in relation to classes of transactions, account balances and disclosures. The risk of material misstatement at the overall financial statement level often relate to the entity's control environment (although these risks may also relate to other factors, such as declining economic conditions). This overall risk may be especially relevant to the auditor's consideration of fraud. The auditor also considers the risk of material misstatement at the class of transactions, account balance and disclosure level. These considerations directly assist in determining the nature, timing and extent of further audit procedures.


© Pearson Education Limited 2014

## *1.6 Types of Audit*

**1-10. How many types of audits are there? Name each and briefly define them?**

Audits are typically classified into three types: audits of financial statements, operational audits and compliance audits. *Audits of financial statements* examine financial statements to determine if they give a true and fair view, or fairly present the financial statements in conformity with specified criteria. An *operational audit* is a study of a specific unit of an organisation for the purpose of measuring its performance. Operational audits review all or part of the organisation's operating procedures to evaluate effectiveness and efficiency of the operation. A *compliance audit* is a review of an organisation's procedures and financial records performed to determine whether the organisation is following specific procedures, rules or regulations set out by some higher authority.

**1-11. What are the differences and similarities in audits of financial statements, compliance audits and operational audits?**

Audits of financial statements examine financial statements to determine if they give a true and fair view or fairly present the financial statements in conformity with specified criteria. A compliance audit measures the compliance of the client with some established criteria. The performance of a compliance audit is dependent upon the existence of verifiable data and of recognised criteria or standards, such as established laws and regulations, or an organisation's policies and procedures. An operational audit is a study of a specific unit of an organisation for the purpose of measuring its performance.

Operational audits review all or part of the organisation's operating procedures to evaluate effectiveness and efficiency of the operation. Efficiency shows how well an organisation uses its resources to achieve its goals. These reviews may not be limited to accounting. They may include the evaluation of organisation structure, marketing, production methods, computer operations or in whatever area the organisation feels evaluation is needed. Recommendations are normally made to management for improving operations.

## *1.7 Types of Auditor*

**1-12. What are the three types of auditor? Briefly define them.**

There are three basic types of auditors: independent auditors, government auditors and internal auditors. The independent auditor is an auditor who is not part of the entity being audited. Independent auditors are typically certified either by a professional organisation or the government. The independent auditor specialises in auditing financial statements, performing review assignments or doing compilations of financial statements.

A wide variety of governmental agencies at national, regional and local areas use auditors to determine compliance with laws, statutes, policies and procedures.

Many large companies and organisations maintain an internal auditing staff. Internal auditors are employed by individual companies to investigate and appraise the effectiveness of company operations for management. Much of their attention is often given to the appraisal of internal controls.

## *1.8 Setting Audit Objectives Based on Management Assertions*

**1-13. What are the financial statement assertions made by management according to ISA 500?**

According to ISA 500, financial statement assertions are assertions by management, explicit or otherwise, that are embodied in the financial statements. They can be categorised as follows:


© Pearson Education Limited 2014

1. Assertions about classes of transactions and events for the period under audit:
    - *Occurrence* – Transaction and events that have been recorded have occurred and pertain to the entity. For example, management asserts that a recorded sales transaction was effective during the year under audit.
    - *Completeness* – All transactions and events that should have been recorded have been recorded. For example, management asserts that all expense transactions are recorded, none were excluded.
    - *Accuracy* – Amounts and other data relating to recorded transactions and events have been recorded appropriately. For example, management asserts that sales invoices were properly extended and the total amounts that were thus calculated were input into the system exactly.
    - *Cutoff* – Transactions and events have been recorded in the correct accounting period. For example, management asserts that expenses for the period are recorded in that period and not in the next accounting period.
    - *Classification* – Transactions and events have been recorded in the proper accounts. For example, management asserts that expenses are not recorded as assets.
2. Assertions about account balances at the period end.
    - *Existence* – Assets, liabilities and equity interests exist. For example, management asserts that inventory in the amount given exists, ready for sale at the balance sheet date.
    - *Rights and obligations* – An entity holds or controls the rights to assets and liabilities are the obligations of the entity. For example, management asserts that the company has the legal rights to ownership of the equipment they use and that they have an obligation to pay the notes that finance the equipment.
    - *Completeness* – All assets, liabilities and equity interests that should have been recorded, have been recorded. For example, management asserts that all liabilities are recorded and included in the financial statements and that no liabilities were 'off the books'.
    - *Valuation and allocation* – Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded. For example, management asserts that their accounts receivable are stated at face value, less an allowance for doubtful accounts.
3. Assertions about presentation and disclosure.
    - *Occurrence and rights and obligations* – Disclosed events, transactions and other matters have occurred and pertain to the entity. For example, management asserts those events that did not occur have not been included in the disclosures.
    - *Completeness* – All disclosures that should have been included in the financial statements have been included. For example, management asserts that all disclosures that are required by IFRS are made.
    - *Classification and understandability* – Financial information is appropriately presented and described and disclosures are clearly expressed. For example, management asserts that all long-term liabilities listed on the balance sheet mature after one operating cycle or one year and that any special conditions pertaining to the liabilities are clearly disclosed.
    - *Accuracy and valuation* – Financial and other information are disclosed fairly and at appropriate amounts. For example, management asserts that account balances are not materially misstated.


© Pearson Education Limited 2014

**1-14. What is the existence assertion? The rights and obligation assertion? The completeness assertion?**

Existence is an assertion about account balances that assets, liabilities and equity interests exist. For example, management asserts that inventory in the amount given exists, ready for sale, at the balance sheet date. One assertion of management about economic actions is that all the assets reported on the balance sheet actually exist at the balance sheet date. The assets are real, not fictitious.

Rights and obligations is also an assertion about account balances, that an entity holds or controls the rights to assets, and liabilities are the obligations of the entity. For example, management asserts that the company has the legal rights to ownership of the equipment they use and that they have an obligation to pay the notes that finance the equipment.

Depending on whether the assertions are about classes of transactions, account balances or presentation and disclosure, the definition of completeness may differ. For classes of transactions, completeness is all transactions and events that should have been recorded and have been recorded. For example, management asserts that all expense transactions are recorded, none were excluded. For account balances, completeness is all assets, liabilities and equity interests that should have been recorded and have been recorded. For example, management asserts that all liabilities are recorded and included in the financial statements that no liabilities were 'off the books'. For presentation and disclosure completeness is all disclosures that should have been included in the financial statements and have been included. For example, management asserts that all disclosures that are required by IFRS are made.

## *1.9 The Audit Process Model*

**1-15. How can one compare the empirical scientific cycle to the financial audit process?**

One can liken the financial audit process to the empirical scientific cycle. The empirical scientific cycle is a systematic process of experimenting that starts with a research question, then a plan for an empirical test of the question is made, the test is done, feedback is analysed and the scientist makes a judgement. The scientist's opinion is that the experimental hypothesis is false or not false, or perhaps that the test is inconclusive. A financial audit is a systematic process that begins with a client's request for an audit of financial statements, followed by a plan of the audit and after testing for evidence, the process culminates in a judgement or opinion. The auditors' judgement is whether the financial statements are unqualified as to their fairness, qualified or disclaimed.

**1-16. What are the four phases of an audit process model? Briefly describe each.**

The phases of the audit are: (1) client acceptance; (2) planning the audit; (3) testing and evidence; and (4) evaluation and reporting. Illustration 1.5 shows the four-phase audit process and its major sub-components.

The process of (1) client acceptance involves evaluation of the client's background, selecting personnel for the audit and evaluate the need and requirements for using the work of other professionals.

The audit firm must (2) plan its work to enable it to conduct an effective audit in an efficient and timely manner. Plans should be based on knowledge of the client's business.

(3) The audit should be performed with due professional care by persons who have adequate training, experience and competence in auditing.

The auditor should (4) review and assess the conclusions drawn from audit evidence on which he will base his opinion of the financial information. This review and assessment involves forming an overall conclusion as to whether: (a) the financial information has been prepared using acceptable accounting policies, consistently applied; (b) the financial information complies with relevant regulations, and statutory requirements; (c) the view presented by the financial


© Pearson Education Limited 2014

information as a whole is consistent with the auditor's knowledge of the business of the entity; and (d) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

**1-17. Based on the Evaluation and Judgement phase (IV) of the audit process model the overall conclusions are formed on what judgements?**

The auditor should review and assess the conclusions drawn from audit evidence on which he will base his opinion of the financial information. This review and assessment involves forming an overall conclusion as to whether: (a) the financial information has been prepared using acceptable accounting policies, consistently applied; (b) the financial information complies with relevant regulations and statutory requirements; (c) the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity; and (d) there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

## *1.10 International Audit Firms*

**1-18. List the four basic positions within the organisational structure of an audit firm and describe the duties of each position.**

**Staff accountants (or junior assistants then senior):** Typically, the first position of someone entering the public accounting profession is that of staff accountant (also called assistant or junior accountant). The staff accountant often performs the more detailed routine audit tasks. The assistants attend training programmes that are either developed 'in house' or sponsored by the professional organisations.

**Senior accountants (or supervisor):** The senior ('in-charge') auditor or 'supervisor' is in charge of audit fieldwork and typically has two or more years' experience in public auditing. The senior is responsible for planning the audit and conducting the audit engagement at the client's place of business. The senior supervises the work of the audit staff, reviews working papers and time budgets and assists in drafting the audit report. The senior maintains a continuous record of staff hours in each phase of the audit examination, maintains professional standards of fieldwork and is responsible for preventing excessive staff hours. This work is subject to review and approval by the manager and partner.

**Managers:** The manager supervises the audits conducted by the seniors. The manager helps the seniors' plan their audit programmes, reviews working papers periodically and provides other guidance. The manager is responsible for determining the audit procedures applicable to specific audits and for maintaining uniform standards of fieldwork. Often managers have the responsibility of compiling and collecting the firm's billings to the audit client. The manager, who typically has at least five years of experience, needs a broad and current knowledge of tax laws, accounting standards and government regulations. A manager is likely to specialise in accounting requirements of a specific industry.

**Partners/Directors:** Partners are the owners of the auditing firm. For some forms a change in legal structure means that those formerly known as partners are directors. They are heavily involved in the planning of the audit, evaluation of the results and determination of the audit opinion. They maintain contacts with clients, discuss the objectives and scope of the audit work, resolve controversies that may arise and may attend the client's stockholders' meetings to answer any questions regarding the financial statements or the auditors' report. They also review the manager's audit working papers, supervise staff and sign the audit reports. Partners may specialise in a particular area such as tax laws or a specific industry. The partner is the person who must make the final decisions involving complex judgements.


© Pearson Education Limited 2014