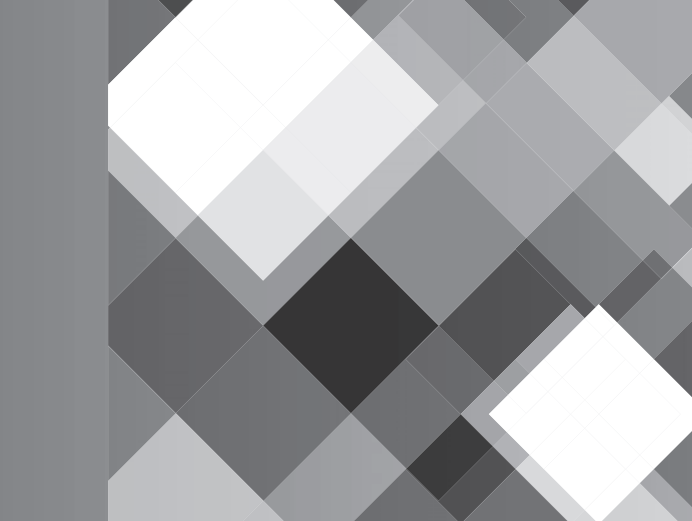


THE AUDIT PROCESS

PRINCIPLES, PRACTICE AND CASES

IAIN GRAY ▶ STUART MANSON ▶ LOUISE CRAWFORD



THE AUDIT PROCESS

PRINCIPLES, PRACTICE AND CASES

SEVENTH EDITION

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<i>Hedley Byrne & Co. vs Heller and Partners Ltd</i> [1963] A.C. 465, [1963] 2 All E.R. 575, [1963] 3 W.L.R. 101	773 and 797
<i>Irish Woollen Co. Ltd vs Tyson and Others</i> [1900] 26 Acct. L. R. 13	719 and 737
<i>James McNaughton Paper Group Ltd. vs Hicks Anderson & Co.</i> [1991] 2 W.L.R. 641, [1991] 2 Q.B. 113, [1991] 1 All E.R. 134, [1991] B.C.L.C. 163, [1990] B.C.C. 891	781
<i>Jarvis plc vs PriceWaterhouseCoopers</i> [2000] 2 B.C.L.C. 368	149
<i>JEB Fasteners Ltd vs Marks Bloom & Co.</i> [1981] 3 All E.R. 289	775 and 797
<i>Man Nutzfahrzeuge AG vs Freightliner Ltd and Ernst & Young</i> [2007] EWCA Civ 910	800
<i>Morgan Crucible Co. vs Hill Samuel Bank Ltd and Others</i> [1991] Ch 295, [1991] 1 All E.R. 148, [1991] 2 W.L.R. 655, [1991] B.C.L.C. 178, [1991] B.C.C. 82	782
<i>Re Kingston Cotton Mill Co. (No. 2)</i> [1896] 2 Ch 279	718 & 737
<i>Re Thomas Gerrard & Son Ltd</i> [1967] 2 All E.R. 525, [1967] 3 W.L.R. 84, [1968] Ch 455	719 & 737
<i>Royal Bank of Scotland vs Bannerman Johnstone Maclay and Others</i> [2002] S.L.T. 181	685 and 786
<i>Sasea Finance Limited [in liquidation] vs KPMG</i> [2000] 1 B.C.L.C. 236, [2000] 1 All E.R. 676	714
<i>Stone & Rolls Ltd (in Liquidation) vs Moore Stephens (a Firm)</i> [2009] UKHL39	719
<i>Twomax Ltd and Goode vs Dickson, McFarlane and Robinson</i> [1983] S.L.T. 98	775, 776, 797 and 798

PREFACE

Members of the following accounting bodies are permitted by company law to act as auditors of limited companies in the British Isles, so it is appropriate that auditing should occupy an important place in their examination schemes:

Association of Chartered Certified Accountants (ACCA)
The Institute of Chartered Accountants in England and Wales (ICAEW)
The Institute of Chartered Accountants in Ireland (ICAI)
The Institute of Chartered Accountants of Scotland (ICAS)

This book provides a sound basis for the study of auditing for the above bodies' examinations and also for the examinations of the Institute of Internal Auditors (IIA) and of the Chartered Institute of Public Finance and Accountancy (CIPFA).

The book will be suitable for studies of auditing at degree level and professional examinations and master's courses.

This seventh edition of this book contains references to the International Standards on Auditing (ISAs) and the International Standard on Quality Control issued by the International Auditing and Assurance Standards Board[®] (IAASB). IAASB is one of the independent standard-setting boards of the International Federation of Accountants[®] (IFAC). Generally we quote from ISAs issued by IAASB, but occasionally we refer to ISAs (UK) published by Financial Reporting Council (FRC) where they contain material with particular reference to the UK.

The ISAs are designed to support the auditor in obtaining reasonable assurance in forming their opinions. They are structured as follows:

1. The first section contains:

- an introduction
- overall objectives of the auditor
- definitions
- requirements.

2. The second section contains:

- application and other explanatory material supporting the requirements (in some cases explanatory material is contained in appendices).

The paragraph numbers in the second section are prefixed by 'A'. We quote from the first and second sections and the appendices when we believe it is appropriate to support our discussion of the audit process. Regarding the ISAs (UK) it is important to note that the paragraph numbers are identical to the ISAs published by IAASB, but that the ISAs (UK) are supplemented by sub-paragraphs.

As far as accounting standards are concerned, International Financial Reporting Standards[®] (IFRS Standards), including International Accounting Standards (IAS Standards), affecting the work of the auditor have also been adopted in the UK. Currently, standards issued by the Accounting Standards Board are titled Financial Reporting Standards (FRSs). In this book we shall quote, where necessary, from IFRS Standards and IAS Standards. Where appropriate we also refer to UK GAAP, in particular to FRS102, which is the principal accounting standard. We would mention at this point that we do not consider all

the detailed requirements of accounting standards in this book (in other words this book is not about accounting (or indeed auditing standards)). We are concerned primarily with principles and where these principles have been reflected in official standards, we quote from those standards.

In Chapter 4 we introduce students to the requirements of the Companies Act 2006, which is in force in Great Britain. Students outside of Great Britain should refer to company legislation in their own jurisdiction. We also introduce you to new EU directives and regulations where appropriate. This seventh edition has been restructured to some extent and contains a new chapter on corporate governance which we have placed towards the front of the book (see Chapter 5) because of its importance. We have also reworked the chapter on current issues (Chapter 22).

As in previous editions we have adopted the framework of the audit year of a firm of auditors auditing the financial statements of a variety of organizations. Care has been taken to ensure that the practical work of the auditor is presented as clearly and logically as possible so that the student will have a good appreciation of what the audit process is about. Students are recommended to take note of any important developments relating to international accounting and auditing standards.

One of the strengths of this book, in our view, is the carefully paced tutorial approach that has been adopted throughout, which means that it can be used as a tool in the classroom as well as for private study. We have attempted to make the book as readable and interesting as possible.

Regrettably, auditing is often seen as being deadly boring. This is not our view, and we would go so far as to say that those who believe it to be boring will tend to be unimaginative and bad auditors in consequence. Auditing affects most people in society, either directly or indirectly, and its current role is changing, and in some important areas is being extended. Our hope is that this book will prove to be a useful vehicle for providing an understanding of what auditing is about and that it will be a valuable contribution to the auditing debate.

THE FRAMEWORK OF THE BOOK

The chapters contain detailed study material illustrated by many examples, case studies and questions. Some of the questions – called tasks or activities – are within the body of the text and they involve the student in a self-learning process; they expect students to advance the argument themselves either using principles discussed in the text or by using their common sense and imagination. In each case, you should make sure that you try to answer these questions before proceeding to the next part of the text. In the case of tasks, the suggested solutions are provided at the end of each chapter, whereas for the activities the solution is provided immediately following the question.

At the end of each chapter there is a comprehensive range of self-assessment questions designed to help you decide if the material in the text has been understood. Auditing in practice requires the exercise of considerable judgement in the context of a particular set of circumstances, and some of the questions are mini-case studies aimed at giving you experience in analyzing and interpreting information and forming reasoned conclusions. Suggested solutions to some of these questions have been provided for students on the companion website. Other solutions are only available to recognized tutors on the same website, for which they need to register.

Figure 0.1 shows how the audit process flows through the contents of the study chapters. You will find it useful to look back at this diagram occasionally when studying individual chapters (right-hand column) to locate the subject you are studying within a particular stage of the auditing process (left-hand column).

Note that the chapters are not set out in strict numerical sequence. This is because some chapters are relevant to more than one stage. Some of the chapters do not fit into the process itself but are useful in that they throw light onto how auditing is viewed and on possible directions that auditing will take in the future.

FIGURE 0.1 Stages in the auditing process and how they are covered in the chapters

Setting the scene	Chapter 1 Why are auditors needed? Chapter 2 An overview of the postulates and concepts of auditing Chapter 3 The meaning and importance of auditor independence: factors affecting independence and measures to attain it Chapter 4 Audit regulation Chapter 5 Corporate governance (Part 1) Chapter 6 The risk-based approach to audit: audit judgement Chapter 7 The search for evidence explained
Starting the audit process	Chapter 6 The risk-based approach to audit: audit judgement Chapter 12 Sampling and materiality
Systems work and transactions testing	Chapter 8 Systems work: basic ideas 1 Chapter 9 Systems work: basic ideas 2 Chapter 17 Assurance engagements and internal audit Chapter 10 Testing and evaluation of systems Chapter 11 Substantive testing, computer-assisted audit techniques and audit programmes Chapter 12 Sampling and materiality
Pre-final and balance sheet date work and final work	Chapter 11 Substantive testing, computer-assisted audit techniques and audit programmes Chapter 13 Final work: general principles, analytical review of financial statements and management assertions on financial statement headings Chapter 14 Final work: non-current assets, trade receivables and financial assets Chapter 15 Final work: specific problems related to inventories, construction contracts, trade payables and financial liabilities Chapter 16 Final review: post-balance sheet period, provisions, contingencies, letter of representation
Analytical review of accounts	Chapter 13 Final work: general principles, analytical review of financial statements and management assertions on financial statement headings
Audit reporting	Chapter 18 The auditors' report Chapter 19 Fraud and going concern Chapter 17 Assurance engagements and internal audit
The auditor's liability under law	Chapter 21 The auditor and liability under the law Chapter 20 The audit expectations gap and audit quality
Critical examination of auditing and new developments	Chapter 5 Corporate governance (Part 2) Chapter 22 Issues in auditing

NOTE

Please note that official Examination Questions, together with suggested solutions, can be found on the companion website for the book.

These contain two sets of questions. The first set has been presented in the form of two examination papers, each containing six questions. Suggested solutions have been provided for the questions on these papers but of course you should first attempt to answer them by yourself. The second set contains selected questions which you can use as additional exercises to test your knowledge and understanding for yourself. Your tutors may wish to set some of these questions as a formal exercise, so check with them before attempting any. Suggested solutions to the second set of questions are available on the website mentioned above.

HOW TO USE THIS BOOK**NOTE FOR TUTORS**

The authors have prepared guidance notes for tutors to accompany this book. This guidance is available in the lecturers' section of the companion website of this title.

To use the book intelligently you need to plan your work and set aside regular time each week for study. If you have no prior knowledge of auditing, you will probably need about 150 hours of study to cover the material in this book to examination standard – say about 4.5 hours per week of concentrated study over a period of eight to nine months. Time for additional reading and for practice questions is included in this total and it is *absolutely essential* for you to devote time to these. Auditing as a subject requires both literacy and to some extent numeracy – particularly the former in the examination context – and it is vital that you gain experience in expressing yourself and writing up your solutions to the selected questions. You should not look at the suggested solutions until you have worked the questions yourself. Don't forget that frequently there may be no single 'correct' solution. If this is the case our suggested solution will make it clear.

Your approach to using the book should be something like this:

- Read the **learning objectives** at the beginning of the chapter then briefly skim through the chapter page by page to get a feel for the length and complexity of the subjects it covers. It might also be useful at this stage to have a brief look through the **summary** at the end of the chapter.
- Begin reading the chapter, following up where necessary the occasional suggestions for further reading, references to source material or cross-references to other parts of the text, and make sure you understand each section before moving on. The **marginal notes** are usually brief explanatory notes that have been devised to carry information or advice which is *not* essential to your understanding of the subject or your mastery of your own particular syllabus. Make notes in the remaining marginal space as you go along, especially on those topics featured in the learning objectives.

- When you come to each **task** or **activity** you should attempt to answer it before moving on. Check your own answers against the **suggested solutions** at the end of each chapter (in the case of tasks) and against our comments following each activity. If your answers are incorrect, make sure you understand where and why you went wrong before moving on to the next subject. Sometimes tasks will require you to think of answers which have not been specifically covered in the preceding text, but by using a combination of common sense and imagination you should still be able to answer them. These questions are designed to involve you actively in the learning process, not simply to test your knowledge; they ask you to engage in critical thought at strategic points throughout the text and this will ultimately deepen your understanding of the subject. Don't be tempted to skip them. Indeed, you may lose out if you do, since later topics often require an understanding of the areas covered by them.

At the end of each chapter you will find a series of **self-assessment questions**. These have been designed to test your understanding of the main points in each chapter so you should attempt them whenever they appear. Suggested solutions to some of these questions have been provided on the companion website in the student/lecturer section. Other solutions are only available to recognized tutors on the same website. If you answer any of the questions incorrectly, make sure you check back in the text to find out why. Often the commentary on the answers will give you a good idea of where and why you went wrong. Make sure you follow up these leads.

Occasionally it may be advisable for you to tackle one of the full examination questions. Remember that it is good practice to ask yourself, before you start the question, what area of knowledge it is designed to test. Once you have completed your answer, study the answer provided in the answers section on the student side of the companion website, noting the main points of principle and checking back if any of your answers are wrong.

At intervals in your study you will need to build in revision sessions. It may be helpful to rework the self-assessment questions in earlier chapters to identify areas needing priority revision attention.

You should aim to have completed your main studies at least one month before the examination. The final month should be the time for revision, not for initial learning. Work and rework the practice questions, noting the points of principle and remembering the vital importance of speed in examination work.

COMPANION WEBSITE

For students

- Answers to self-assessment questions (student questions)
- Additional appendix material for chapters in the book
- Related links

For tutors

- Guidance notes for tutors
- PowerPoint lecture slides
- Additional appendix material for chapters in the book

- Answers to self-assessment questions (tutor questions)
- Official examination questions with suggested solutions

RECOMMENDED FURTHER READING

This book is intended to be a good friend and counselor as you progress towards your accountancy qualification or towards satisfying the auditing component of degree and similar courses. As such, not only will it provide a framework for your study, it will give you guidance on the background information you need. It is essential that you keep yourself informed about developments in the accounting profession and in the wider world. We shall recommend additional reading both in and at the end of each chapter, as we believe that wide reading is essential to success.

The authors wish to emphasize *two* matters here:

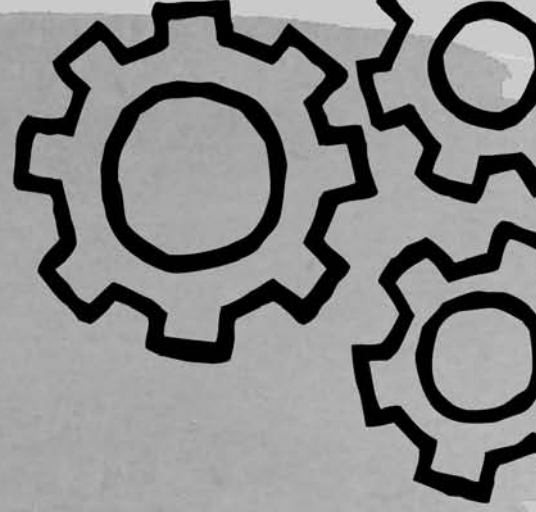
- We will not reproduce whole auditing guidelines, accounting standards, other professional statements and so on in this book. We assume that you have in your possession at least the professional material listed below and we shall be discussing and commenting on it in the text. The reason for this is that you should, even at this early stage, see yourself as a potential qualified accountant and should get used to referring to the material in the same way that a professional accountant would in practice:
 - (a) International Financial Reporting Standards (IFRS Standards) including International Accounting Standards (IAS Standards) and their UK equivalents (if you are based in the UK) – Financial Reporting Standards (FRSs)
 - (b) International Standards on Auditing (ISAs) and the International Standard on Quality Control (ISQC) and (if you are based in the UK) equivalent ISAs and ISQC (UK) issued by FRC
 - (c) *Code of Ethics for Professional Accountants* issued by the International Federation of Accountants (IFAC) or, if you are based in the UK, the *Revised Ethical Standard* 2016 issued by FRC.

What this book does is to comment on these standards and guidelines so that you will be able to appreciate their meaning and select important extracts for your own use. We have included reference to standards in the **Further reading** section of chapters where they are of general interest to the matters discussed in the chapter concerned. We have departed from this principle only to the extent that we have provided in the Appendix material to Chapter 4 (on the Cengage website) relevant sections from the Companies Act 2006 and discussed these sections in Chapter 4. It is our intention that students should think of themselves at an early stage as professional people and that professional material should be read in the original.

Additional reading is a vital feature of understanding the world in which accountants live and work. The authors recommend the following:

- (a) *economia*, published by ICAEW, *The CA Magazine* (published by ICAS), *The Certified Accountant* (published by ACCA)
- (b) *Accountancy Age*
- (c) *(Certified) Student Accountant*
- (d) a good daily and Sunday newspaper.

Teaching & Learning Support Resources



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- A password protected area for instructors with, for example, a testbank, PowerPoint slides and an instructor's manual.
- An open-access area for students including, for example, useful weblinks and glossary terms.

Lecturers: to discover the dedicated lecturer digital support resources accompanying this textbook please register here for access: login.cengage.com.

Students: to discover the dedicated student digital support resources accompanying this textbook, please search for **The Audit Process, 7th Edition** on: cengagebrain.com



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1

Why are auditors needed?

LEARNING OBJECTIVES

After studying this chapter you should be able to:

- **Understand in general terms what an audit is and to put into context some basic audit techniques.**
- **Explain what kind of person should carry out an audit.**
- **Suggest the kinds of people who will benefit from an audit.**
- **Form a view on the kind of information that might be prepared by those having control of resources held on behalf of others.**
- **Recognize that there are theoretical considerations underpinning audit practice.**
- **Explain the wider setting of audit and be aware of some of the problems currently facing the audit profession.**

OPENING REMARKS

When the authors of this book first joined the accounting and auditing profession we never imagined that auditing would become the subject of such debate about the independence and competence of auditors and even about the detailed procedures that auditors use. Auditors have of course always discussed audit matters among themselves, but since corporate scandals involving very large companies such as Enron and WorldCom started to come to light in 2000, governments and the public have begun to get involved, particularly as there have been later examples of major corporate frauds such as Parmalat in Italy and Satyam in India. The banking crisis that commenced in 2007/2008 and the continuing credit crunch have also made people query the morals and competence of top management and ask why the auditors had not recognized earlier that financial institutions were making poor lending decisions, often because the way they were being governed was inadequate, and in particular because the manner in which staff were being rewarded encouraged short-term thinking.

2 Why are auditors needed?

Auditing has become headline news not just in the business pages of newspapers but on front pages and in editorials, and in television news bulletins and discussion programmes. Even the President of the United States mentioned auditing in his State of the Union Address in 2002. Auditing has become an exciting subject. There may have been corporate scandals in the past, such as Maxwell and Polly Peck in the United Kingdom, Ultramares Corp in the United States and Cambridge Credit in Australia, but never on the scale of those in the early years of the twenty-first century and never before resulting in the collapse of a major accounting firm. The result of these events is that big question marks have been placed over the competence and independence of auditors and over the apparent failure of corporate governance.

We do not wish you to place all the blame for the debacles on the shoulders of auditors. We shall see that other reasons for the scandals include inadequate accounting standards, and boardroom cultures that encourage the manipulation of figures for company or personal gain.

In this book we will introduce you to these important issues and explain the steps taken to remedy what are seen as lapses in the conduct expected of auditors and, indeed, of company management. Much of this book will be about how a competent audit should be carried out. We shall focus, among other things, on the role of audit and explain why it is important that the audit function is seen to be carried out by competent and independent people on behalf of a number of groups interested in the performance and position of a variety of entities. In the process, we will meet up with organizations engaged in manufacture and sale of goods, in trading of various kinds and in the provision of services.

Increasing importance is being given to the concept of audit quality, and we shall describe how the profession and regulatory bodies are addressing this important concept.

Before moving on to discuss basic principles, we give brief details of the Enron, WorldCom, Parmalat and Satyam scandals to give you a flavour of the problems faced by the accounting and auditing profession:

- **Enron, US:** This company hid its real level of debt by putting \$8.5 billion of group liabilities into special purpose vehicles whose financial statements were not consolidated with those of the company. The company became bankrupt and the audit firm, Arthur Andersen, went out of business because of a loss of reputation affecting its relationship with clients and its inability to attract new clients because of revelations relating to the Enron case.
- **WorldCom, US:** This company, in an attempt to maintain stated profit levels, treated revenue costs (over \$3.8 billion) as capital expenditure. There was also understatement of loans amounting to some \$2.5 billion. Arthur Andersen were the company auditors.
- **Parmalat, Italy:** This company was a multinational dairy and food corporation which collapsed in 2003 following revelations that its total liabilities were fraudulently understated and assets overstated. It is difficult to quantify the total misstatements which have been as much as €14 billion. Like Enron, the company structure was very complex, many of its subsidiaries being registered in tax havens. The corporation had hidden the fact that significant subsidiaries were loss making, and it is claimed that one of its subsidiaries overstated its assets by as much as 38 per cent of Parmalat's total stated assets. The corporation was audited by Grant Thornton.

We discuss audit quality in Chapter 20 and corporate governance in Chapters 5 and 18.

- **Satyam, India:** This 2009 case has been described as India's Enron. It seems that over many years the Satyam corporation, which specializes in computer services, inflated its reported cash and bank balances while overstating revenues and profits and understating liabilities. The amount of the fraud is said to exceed \$1 billion. The company was audited by PwC.

There are other large companies that have manipulated their accounting figures in recent years but the four above are significant and representative.

Apart from companies which deliberately manipulated their figures, a number of banks in the UK and elsewhere in the world got into serious difficulties because of unwise borrowing and investing. Two examples in the UK are Northern Rock and RBS, brief details of which we set out below:

- **Northern Rock, UK:** This former building society, based in Newcastle upon Tyne, became a bank quoted on the London Stock Exchange in 1997. It borrowed heavily in the UK and international money markets, using these funds to provide mortgages to customers, selling these mortgages on the international money markets. However, when the demand for these so-called 'securitized mortgages' dried up, Northern Rock was unable to repay the loans raised on the money markets and was forced to seek liquidity support from the Bank of England. The result was a bank run by depositors who feared that they might lose their savings should the company go into receivership. Subsequently, a House of Lords report described Northern Rock's business plan as 'dangerously risky' and severely criticized the auditors, one of the Big Four (Deloitte, Ernst & Young, KPMG and PwC).
- **RBS, UK:** The Royal Bank of Scotland (RBS) was formed in Edinburgh in 1827 and was highly regarded for its probity for more than 150 years. However, after Fred Goodwin became its chief executive in 2000, this changed and the bank embarked on expansion by acquisition, acquiring the National Westminster Bank, among others, in 2000. In 2007, it became clear that the company had made many very unwise investments, including its share of the acquisition of the Dutch bank, ABN Amro. RBS was so weakened that it had no option but to accept a government bail-out. One of the Big Four was auditor in this case also.

You may be asking yourself why the above cases have caused problems for the auditing profession. You will be in a better position to answer this question later in your studies, but note at this point that auditors are there to give an opinion on whether the company's financial statements tell the truth and are fair. In these cases for one reason or another the auditors failed to warn that the financial statements did not do that, and the auditors have been criticized for that reason.

These cases show that it is not only in the US that major scandals affecting companies and auditors have taken place. However, some leading accountants in the British Isles did claim at one time that the various accounting and auditing disasters could not happen here for a variety of reasons. The authors are not so sanguine, particularly in the light of the banking crisis, and, later in the book, we discuss the background to some of the problems encountered and discuss further what steps might be appropriate to, at least, reduce the likelihood that they will not recur.

Later in this chapter we define audit and we introduce you to truth and fairness in accounting.

See Chapter 22.

4 Why are auditors needed?

So when you are reading about the audit process in this and later chapters, please do not assume that auditors always get the right answer, nor that companies are always assiduous in applying accounting standards in the desired manner. Bear in mind, too, that it seems that Enron had been applying the strict letter of the US accounting rules concerning the special purpose vehicles.

It is worth mentioning that after Andersen's collapse, the Supreme Court in the US overturned the 2002 criminal conviction of Andersen for obstruction of justice. Note too that it is extremely difficult for auditors to discover carefully hidden fraud carried out by senior managers. We discuss this matter further in Chapter 19.

In addition, you should note that the spate of accounting and auditing scandals has focused attention on the purpose of audit. What is the value of audit? Why are auditors employed at great cost to society? Should there be fundamental changes to the way that companies are managed – that is, how should they govern themselves to the greater benefit of society as a whole? We are likely to see greater emphasis on the function of audit and how the independence of the auditor can best be achieved. We discuss independence and professional ethics generally in Chapter 3. The Arthur Andersen example should be in the forefront of all our minds. As students you should be aware of the major issues affecting the accounting and auditing professions. We shall cover these issues in this book, including the impact that the scandals have had on the way that auditors plan their work, the techniques they use in the performance of their duties and the relationship between the auditor and management of client companies. We want you to be fully aware of what is happening in the auditing world today.

We shall shortly use a simple case to introduce you to some basic principles of auditing, but, before we do so, you should note that the professional accounting and audit bodies and regulators *and* the audit firms play an important role in the field of auditing. We shall discuss how the audit profession is organized in the UK and Ireland in Chapter 4. Note too that there are a variety of firms in the external audit market, both in the private and public sectors. These vary from sole practitioners with small clients, providing mainly accounting and taxation services, to the Big Four firms, that operate on both the national and international stage, providing a huge range of services. To give you an idea of the size and global reach of these firms, we set out below some statistics relating to PwC for the year ended 30 June 2017, extracted from PwC's Global Annual Review 2017:

Partners (of which 19% are female)	11 181
Client service staff	188 090
Practice support staff	36 964
Total	<u>236 235</u>
Located in:	
Western Europe	72 265
Australasia and Pacific Islands	8 308
Americas	70 982
Middle East and Africa	13 974
Asia	60 255
Central and Eastern Europe	10 451
	<u>236 235</u>

Key facts and trends for the UK accountancy profession are published annually by the Financial Reporting Council. Among other data, the Big Four (PwC, Deloitte, EY and KPMG) audit 97 per cent of the top 350 listed UK companies. In terms of diversity, and similar to the global statistics reported for PwC, less than 20 per cent of partners in UK Big Four firms are female.

Total revenue amounted to:	US\$ millions
Assurance services	15 965
Advisory/consulting services	12 253
Tax	9 462
	<u>37 680</u>

In between the two extremes there are firms with a small number of partners through medium-sized firms to large firms other than the Big Four. In this book we give prominence to the importance of auditing to user groups and society in general. At the same time you must bear in mind that it is audit firms that perform audits, so their role is of great importance. We introduce you to the way that firms are best structured to perform audits efficiently and effectively in Chapter 3. We also discuss the role of the accounting bodies in the regulation of the accounting profession in Chapter 4.

We suggest a structure of a typical audit firm in Figure 3.3.

BASIC PRINCIPLES: INTRODUCTION THROUGH A SIMPLE CASE

Clearly, the cases referred to above involve very large companies, but at this stage we are introducing you to the circumstances of a very small business, but a business nevertheless, that will, we think, help you to understand what an audit is, how it might be carried out and some of the principles that apply to all audits. Later in the chapter we suggest a brief formal framework of an average audit that will show how an audit is planned and conducted. The scene for the small business is set in Case Study 1.1 (Erin and Lee, Part 1), which you should now read.

We shall see in Chapter 4 that small businesses that meet certain criteria relating to size are not legally required to have an audit, even where such businesses have the benefit of limited liability.

Work Activity 1.1 before returning to this paragraph.

CASE STUDY 1.1

Erin and Lee, Part 1

On 1 May 2017 Erin and Lee, two old friends in their early thirties, had recently been declared redundant, each having received £10 000 in redundancy pay. Lee said that he felt like using the money on travel to see the world, but Erin had seen a notice in the local newspaper, advertising the sale of bankrupt stock and suggested that the two of them go into business together. Her further suggestion was that they should buy an old lorry she had seen for sale for £8000 by a second hand motor vehicle dealer and to travel from place to place in the North of England selling the

bankrupt stock at a good mark-up. Erin thought that they might be able to sell for £2.50 what had cost them £1.00.

Lee allowed himself to be convinced that this was a marvellous idea; they bought the lorry for £8000 and on 1 May 2017 spent £12 000 on bankrupt stock. On 2 June, Lee fell off the back of the lorry, breaking an arm and a leg. Erin visited him in hospital and told him not to worry; she would look after their joint venture and would only take 10 per cent of the profits for her trouble before sharing the proceeds of the venture equally between them. On 1 December, having spent the whole summer and autumn touring from place to place in the north of England, Erin appeared on Lee's doorstep, Lee in the meantime having recovered the use of his limbs. Erin took a wad of banknotes from her bag, informing Lee that this represented his share of the joint venture, which had just been wound up, and that Lee's share amounted to £12 960.

An accountant would say that the estimated gross margin was 60 per cent, calculated as:

$$\text{Gross profit} \times 100/\text{Sales} = 1.50 \times 100/2.50 = 60\%$$

6 Why are auditors needed?

ACTIVITY 1.1

Try to answer the following two questions before reading on:

- 1 What was Lee's position in relation to that of Erin in the summer and autumn of 2017?
- 2 If you were Lee, what would you now do?

Regarding the first question, Lee is clearly a provider of capital, as indeed is Erin. The difference between them is that Erin is an owner/manager, whereas Lee has been forced to take a passive role. Erin is similar to a director of a limited company (holding shares therein) and Lee is similar to a shareholder who had entrusted his funds to the directors of such a company.

Regarding question 2, Lee finds himself in a curiously uninformed position. It looks as if the return in six months is £2960 on an initial investment of £10 000. The return looks very good – some 59 per cent per annum – much better than he could have got from a building society, particularly in the aftermath of the credit crisis; nevertheless, how does he know that Erin has calculated her share properly or even whether she has deliberately cheated him? Let us assume that he now asks you for your advice on how Erin has calculated the £12 960, mentioning that businesses usually prepare financial statements. (Lee has not been wasting his six months' enforced rest. He has bought a book on accounting.)

Erin is somewhat surprised when you appear on the scene with Lee, but after a lot of prevarication she produces a somewhat dog-eared piece of paper from her bag and shows you the financial statements that she has prepared. The financial statements are in the form of a simple receipts and payments account and contain the information in Case Study 1.1, Part 2, which you should now review before working Activity 1.2.

CASE STUDY 1.1

Erin and Lee, Part 2

Erin and Lee joint venture: 1 May to 31 October 2017

	£	£
Cash introduced	20 000	
Purchase of lorry		8 000
Purchase of bankrupt stock		12 000
Motor expenses		5 000
Other purchases		26 000
Sales	54 000	
Interest to John		200
Sale of lorry to Erin	6 000	

Continued

CASE STUDY 1.1 (Continued)

	£	£
Balance	<u>80 000</u>	<u>28 800</u>
	28 800	<u>80 000</u>
Less: 10% wage	<u>2 880</u>	
	25 920	
Half to Erin	12 960	
Half to Lee	12 960	

ACTIVITY 1.2

On the basis of your review, make a list of the matters you would like to raise with Erin on Lee's behalf.

The following are the principal points we believe you should raise with Erin on Lee's behalf:

- Erin has purchased the lorry from the business herself. How was the price calculated and what is she going to do with it anyway?
- What is the payment of interest of £200 to John for?
- Erin has not calculated her wage on the profit but on the total cash on hand in the business.

Assuming the other figures are all right, the profit is calculated as follows:

	£	£
SALES		54 000
Purchase of bankrupt stock	12 000	
Other purchases	<u>26 000</u>	
COST OF SALES		<u>38 000</u>
GROSS PROFIT	(29.63%)	16 000
Motor expenses	5 000	
Interest to John	200	
Depreciation of lorry	<u>2 000</u>	<u>7 200</u>
Net profit		<u>8 800</u>

On this basis Erin's 'wage' should only be £880.

8 Why are auditors needed?

Doing calculations for yourself before you talk to managers (in this case Erin) gives you information that will enable you to get more information. You could ask Erin why the profit is less than expected and this would force her to give a precise answer. We would say that 'information breeds information'.

- Remember that Erin had said in May that they could expect a gross return of 60 per cent of sales. However, the gross profit percentage shown in the above statement is only 29.63 per cent, less than half of that expected (£32 400, 60 per cent of £54 000).
- The payments of £8000 for the lorry and £12 000 for the bankrupt stock are in order as Lee was present when the payments were made and he would therefore be prepared to accept them.
- You may wonder – as no doubt Lee would also – if there were any inventories at the end of the period and, in particular, if Erin intends to sell the remaining inventories (if any) using the lorry she has purchased from the business.

Let us assume that you have discussed the above points with Lee in your capacity as professional adviser and that, armed with this information, you manage to elicit further information from Erin, as shown in Part 3 of Case Study 1.1.

CASE STUDY 1.1

Erin and Lee, Part 3

- The lorry had been used for six months and a reduction of £2000 seemed reasonable. ('Yes, but second hand prices for that make and age of lorry are currently £7000, according to published information used by the motor vehicle trade; also has Erin adjusted for vehicle licence fee and insurance paid in advance?') 'No', says Erin, 'but they only amount to £800'.

Getting information about lorry prices in this way is a good example of obtaining reliable evidence from an independent source. Questioning whether the road tax and insurance have been adjusted is a good example of the professional accountant at work.

- Payment of interest to John was in respect of a loan of £4000 that John had made to the business because, after buying the lorry and bankrupt stock, there was no money left to pay the other expenses. The loan had been repaid on 31 October 2017. (You may decide to accept this, although at 10 per cent per annum in current circumstances this is somewhat high.)
- Erin admits that the calculation of the wage at the end of the venture was a mistake. At this stage, of course, you may be somewhat concerned that Erin may have made more unwitting mistakes.

Note that anyone who is interested in finding out if accounting and other information has been properly prepared, will wish to know if the person preparing it is competent.

- Erin agrees that she had originally said that they could make a bigger profit, but this was because the profit on the other purchases had been much lower. Also, the lorry had not been secure and she thinks there had been some theft of stock. 'Yes, but can you make an estimate of inventory losses?' asks Lee. 'Perhaps £4000', suggests Erin. 'And what kind of margin did you get on the other purchases?' Lee persists. 'Well, I thought I could get about 50 per cent on cost, the way you are doing it, it would be 33 per cent on sales. The inventory losses were all of items bought after the bankrupt inventory had been sold'.

Erin implies that gross margins have not met expectation because of the differing sales mix (in that there have been sales at two differing rates of gross profit) and because of loss of assets. It would be normal for business people to take precautions to safeguard the assets of their organization and this we discuss in Chapters 8 and 9.

Continued

CASE STUDY 1.1 (Continued)

- Erin says there was no inventory on hand at the end of the period, apart from some insignificant items which she disposed of in a closing down sale. She says that she purchased the lorry so that she could calculate the amount due to each partner.

Following your discussions with Erin and Lee, you decide to compare the revised expected gross profits with those obtained by Erin. This calculation is done on the basis of what Erin has told you so far:

There is an important matter of principle regarding the belief in the honesty or integrity of management. It is not really possible to carry out an audit where there are serious doubts about management integrity, and auditors will in practice take steps to form views about the honesty of people from whom they are obtaining information.

ISA 200 – *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* suggests in para 15 that auditors should adopt an attitude of professional scepticism in their work. This means being wary about assuming honesty and integrity of management and those charged with governance. The characteristics of attaining and maintaining professional scepticism are elaborated in ISA 200 paras A20–A24. IFAC set up a professional scepticism working group in 2015 entitled *Toward Enhanced Professional Skepticism* to explore how the audit, ethics and education standard setting boards could ‘contribute to strengthening the understanding and application of the concept of professional scepticism as it applies to an audit’ (we discuss this further in Chapter 2).

	£	£	
			Revised expected gross profit
Sales		54 000	
Purchases: bankrupt inventory	12 000		18 000 (150% of £12 000, 60% of £30 000)
Other	26 000		13 000 (50% of £26 000, 33% of £39 000)
Less: Inventory losses at cost	<u>– 4 000</u>		– 2 000 (50% of £4 000, 33% of £6 000)
Cost of sales		<u>34 000</u>	
Gross profit		<u>20 000</u>	<u>29 000</u>

At this stage you might suggest that £9000 seems to be unaccounted for. ‘Well, I had to live’, says Erin, who clearly does not appreciate the difference between drawings and charges against profits. You explain that anything she had withdrawn for her own personal expenditure could not be regarded as a legitimate expense of the business she was running on behalf of Lee and herself. You then ask her two related questions that are both good auditors’ questions: ‘How did you run the business?’ and ‘What kind of system did you have?’ Erin then says that she had a bag on the lorry and any takings went into the bag; she took out of the bag anything she needed for meals and other personal expenditure and banked the rest from time to time. The £54 000 was what she had banked.

At this stage you believe you can prepare financial statements that better reflect what has really occurred. You would be unwise to suggest that the financial statements will be accurate, as much of the evidence you have collected is very subjective, with a large element of estimation. In any event, your knowledge of accounting suggests that it is by nature judgemental and that the most that can be expected is a reasonable picture. The financial statements are set out in the final part of the Case Study (Part 4).

This is a system, however bad it seems to be. It would have been better if Erin had used a pre-numbered cash receipts book and given receipts for all money received. A professional accountant might have made such a recommendation, coupled with the proposal that all sales proceeds be banked intact.