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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.

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.

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.

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:

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.

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

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.

1-19. Name the Big Four international audit firms and give a brief history of each.

The Big Four are: Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.

Three founders established Deloitte: William Welch Deloitte, George Touche and Admiral Nobuzo Tohmatsu. Deloitte was founded 1845 by W.W. Deloitte in a location opposite the Bankruptcy Court in Basinghall Street, London. In 1893, Deloitte opened offices in the United States. In 1990, Deloitte Touche Tohmatsu was created following a number of earlier mergers. In 2003, the names of Touche and Tohmatsu were dropped, leaving Deloitte as the firm's full name.

The founders of Ernst & Young were Arthur Author Young who had an interest in investments and banking which led to the foundation in 1906 of Arthur Young & Co in Chicago, US and A.C. Ernst, who was a bookkeeper while still in high school, joined his brother and started Ernst & Ernst in 1903. In 1989, the firms they started combined to create Ernst & Young.

KPMG was formed in 1987 with the merger of Peat Marwick International (PMI) and Klynveld Main Goerdeler (KMG) and their individual member firms. Spanning three centuries, the organisation's history can be traced through the names of its principal founding members – whose initials form the name 'KPMG'.

William Barclay Peat founded the accounting firm William Barclay Peat & Co. in London in 1870. James Marwick founded the accounting firm Marwick, Mitchell & Co. with Roger Mitchell in New York City in 1897. Piet Klynveld founded the accounting firm Klynveld Kraayenhof & Co in Amsterdam in 1917.

Dr Reinhardt Goerdeler is credited with laying much of the groundwork for the KMG merger.

In 1850, Samuel Lowell Price started an accounting business in London. In 1865, William H. Holyland and Edwin Waterhouse joined him in partnership, and by 1874 the company name changed to Price, Waterhouse & Co. The firm opened a New York City office in 1890. In 1854, William Cooper established his own practice in London, which seven years later became Cooper Brothers. The firm's history in the US began in 1898. In 1957, there was a merger between Cooper Brothers & Co (UK), McDonald, Currie and Co (Canada), and Lybrand, Ross Bros and Montgomery (US), forming Coopers & Lybrand. In 1990, Coopers & Lybrand merged with Deloitte Haskins & Sells. Finally, in 1998 Price Waterhouse and Coopers & Lybrand merged worldwide to become PricewaterhouseCoopers.

Problems and exercises

1.2 Auditing through World History

1-20. In this chapter, the history of auditing has been briefly described from an international perspective. Identify the major differences with the developments specific for your country and try to explain these based on differences in the economic system or development.

The answer to this question is specific to the country where instruction takes place. The students should identify the major differences between the developments specific for their country and to explain these in terms of differences in the economic system of their country and the general international accounting development.

1.3 The Auditor, Corporations and Financial Information

1-21. Expectations Gap. The general public thinks that an auditor guarantees the accuracy of financial statements. Is this true? Why? What other things does the public believe about audited financial statements?

An auditor does not guarantee the accuracy of financial statements. The auditor guarantees that there is no 'material' misstatement.

The public may believe audited financial statements are based on examination of 100% of the evidence, that the statements are free from fraud, that there is no questionable practice that is not disclosed. As this is not necessarily true, an expectation gap may exist between what the public expects and what auditors assure.

1.4 International Accounting and Auditing Standards

1-22. International Auditing Standards. The London, Tokyo and New York Stock Exchange, among others, require an annual audit of the financial statements of companies whose securities are listed on it. What are the possible reasons for this?

The London, Tokyo and New York Stock Exchange, among others, require an annual audit of the financial statements of companies whose securities are listed on them because:

1. To increase the confidence of investors.
2. Lend reliability and credibility to the financial statements and reports accompanying audited statements.
3. Provide a reliable and consistent basis for decision-making.
4. Provide a basis for comparison of companies in diverse industries.
5. Protect investor interests.
6. Track the spending of a department compared to the budget.
7. Check to see if internal controls on allocation of keys works.
8. Check data input and security controls on computer operations.

1-23. Describe the International Federation of Accountants (IFAC). Discuss the function of the groups within IFAC.

International Standards on Auditing (ISAs) are developed by the International Federation of Accountants (IFAC) through its International Auditing and Assurance Standards Board (IAASB). The efforts of IFAC, founded in 1977, are directed towards developing international technical, ethical and educational guidelines for auditors, and reciprocal recognition of practitioners' qualifications. The membership of IFAC member bodies represents several million accountants in public and private practice, education, academe and government service.

There are several important groups within IFAC. The IFAC Council is responsible for overall governance of IFAC. The IFAC Board oversees the management of the organisation, takes action to enhance the transparency of certain IFAC activities, and overseas expansion of its size to include more member bodies. The standard-setting activities of the IFAC are carried out by the International Auditing and Assurance Standards Board (IAASB), the Ethics Committee, the Education Committee and the Public Sector Committee with an interest in governmental financial reporting.

1.5 An Audit Defined

1-24. Objectives of an audit. Tracy Keulen, the sole owner of a small bakery, has been told that the business should have financial statements reported on by an independent Register accountant (RA). Keulen, having some bookkeeping experience, has personally prepared the company's financial statements and does not understand why such statements should be examined by a RA. Keulen discussed the matter with Petra Dassen, a RA, and asked Dassen to explain why an audit is considered important.

Required:

A. Describe the objectives of the independent audit.

An independent audit is an examination of the financial statements in accordance with certain auditing standards such as International Standards on Auditing. The objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework of other criteria. The auditor, after an objective evidence-gathering examination, expresses an opinion on the fair presentation of financial statements.

B. Identify five ways in which an independent audit may be beneficial to Keulen.

An independent audit can also be beneficial to:

- serve as a basis for the extension of credit;
- supply credit rating agencies with required information;
- determine if accounting records and reporting meet accounting standards (such as International Accounting Standards (IASs));
- serve as a basis for preparation of tax returns;
- establish amounts of losses from fire, theft and burglary;
- establish a good basis for management decision making;
- determine amounts receivable or payable under:
  a. agreements for bonuses based on profits;
  b. contracts for sharing expenses;
  c. cost-plus contracts.
- provide data for proposed changes in financial structure, or to supply proper financial data in the event of a proposed sale or merger;
- assist the company in risk assessment;
- serve as a basis for changes in accounting or recording practices;
- serve as a basis for action in bankruptcy and insolvency cases;
- determine proper execution of trust agreements;
- determine the effectiveness of information and communication systems;
- furnish estates with information in order to obtain proper settlements and avoid costly litigation;
- provide a review of many aspects of the organisation’s activities and procedures;
- help companies improve their monitoring of risk, controls and efficiency;
- establish and/or improve systems of internal control;
- provide important aid in case of tax audits and court actions;
- discourage employees from planning errors or irregularities, by making them aware of auditor presence;
- enhance the credibility of reports accompanying financial statements;
- provide industry-wide comparisons;
- provide a realistic look at inventories;

- review adequacy of insurance coverage;
- provide the professional knowledge of an external auditor, which is generally superior to the client's bookkeeping experience.

1-25. Based on ISA 200, what are the general principles governing an audit of financial statements. Discuss ethics and professional scepticism.

ISA 200 states that an auditor should comply with the Code of Ethics for Professional Accountants issued by IFAC (see Chapter 3). The ethical principles governing the auditor's professional responsibilities are: independence, integrity, objectivity, professional competence and due care.

The auditor would plan and perform the audit with an attitude of professional scepticism recognising that circumstances may exist which causes the financial statements to be materially misstated. The auditor shall exercise professional judgement in planning and performing an audit of financial statements. Professional scepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.

1.6 Types of Audit

1-26. Operational Audits. List four examples of specific operational audits that could be conducted by an internal audit in a manufacturing company. Describe how you would conduct each.

Four specific operation audits that could be conducted by an internal auditor at a manufacturing company include:

- A review of the operational effectiveness of the receiving department.
- A review of the operations of the computer system.
- An audit of the operation of production methods.
- A review of how manufacturing workers use material.
- A review of the time it takes to receive payments on accounts receivable.
- A review of the time between receiving an order and shipping the goods.
- A determination of the time it takes to handle a customer complaint.
- Review of the reliability of suppliers.

1-27. Auditing tasks. Each of the following represents tasks that auditors frequently perform:

1. Compilation of quarterly financial statements for a small business that does not have any accounting personnel capable of preparing financial statements.
2. Review of tax return of corporate president to determine whether she has included all taxable income.
3. Review of the activities of the receiving department of a large manufacturing company, with special attention to the efficiency of the materials inspection.
4. Evaluation of a company's computer system to determine whether the computer is being used effectively.
5. Examination on a surprise basis of Topanga Bank. Emphasis placed on verification of cash and loans receivable and observation of the California banking code.
6. Examination of vacation records to determine whether employees followed company policy of two weeks' paid vacation annually.

7. Audit of a small college to determine that the college had followed requirements of a bond indenture agreement.
8. Examination of financial statements for use by stockholders when there is an internal audit staff.
9. Audit of a German government agency to determine if the agency has followed policies of the German government.
10. Audit of annual financial statements to be filed with the SEC.
11. Examination of a French government grant to a private company to determine whether it would have been feasible to accomplish the same objective at less cost elsewhere.
12. Audit of a statement of cash receipts and disbursements to be used by a creditor.

Required:

A. For each of the above, identify the most likely type of auditor (independent, government or internal) and the most likely type of audit (financial, compliance or operational).

The most likely type of auditor and the type of audit for each of the examples are:

Example	Type of auditor	Type of audit
1	Independent auditor	Financial statements
2	Government auditor	Compliance
3	Internal auditor	Operational
4	Internal auditor	Operational
5	Government or independent or internal auditor	Compliance or financial statements
6	Internal auditor	Compliance or operational
7	Internal or independent or government	Compliance
8	Independent auditor	Financial statements
9	Government or independent auditor	Compliance
10	Independent auditor	Financial statements
11	Government auditor	Operational
12	Internal or independent auditor	Financial statements

1-28. Internal and External Audit. Khaled Al-Zubari, an executive recruiter, is a member of the board of directors of Mantilla Corporation. At a recent board meeting, called to discuss the financial plan for 20X4, Mr Al-Zubari discovered two planned expenditures for auditing. In the controller's department budget he found an internal audit activity, and in the treasurer's budget he found an estimate for the 20X4 annual audit by the company's external auditing firm. Mr Al-Zubari could not understand the need for two different expenditures for auditing. Since the fee for the annual external audit was less than the cost of the internal audit activity, he proposed eliminating the internal audit function.

Required:

A. Explain to Mr Al-Zubari the different purposes served by the two audit activities.

Auditing done by internal auditors is done on a continuous basis and concentrates primarily on adherence to management policies, protection against losses from fraud and inefficient performance, creation and testing of controls, assistance in inventory counts and tests of the accounting system. They perform mostly operational and some compliance audits.

B. What benefits does the audit firm doing an audit of financial statements derive from the existence of an internal audit function? (CMA adapted)

Effective internal auditors significantly reduce control risk, thereby reducing the amount of substantive testing required during the audit. The external auditor may reduce the staff time on the audit by using the work of internal auditors. Without an internal audit function the independent auditor's time and fees would be increased. External auditors typically consider internal auditors as effective if they are independent of the operating units being evaluated, competent and well trained, and have performed relevant audit tests of the internal control structure. SAS 65 and ISA 610 allow the external auditor to use the internal auditor for direct assistance in the audit.

1.7 Types of Auditor

1-29. Independent external auditor. Give reasons why the following organisations should have annual audits by an independent external auditor:

(a) The US Federal Reserve Board: The financial statements should show a true and fair view for its users. An operational audit could show how efficient and effective the organisation is, especially the control procedures. An audit might determine compliance with the laws, statutes, policies and procedures of the U.S. government. An audit of such a sensitive organisation might help protect the U.S. public against large banking disasters.

(b) A retail company traded on the London Stock Exchange (LSE): A financial statement audit could be useful to provide consistent information to prospective investors. Present shareholders need a report that monitors the company because they have limited control. The investors may want to know if the company meets LSE's Code of Best Practice.

(c) Walt Disney Company: The US Securities and Exchange Commission requires that all publicly traded companies (like Disney) be audited. Walt Disney has investors and runs operations all over the world. Stakeholders are concerned if the company complies with relevant regulations statutory requirements and that there is adequate disclosure.

(d) Amnesty International: It is a not-for-profit organisation, which raises funds internationally and must comply with certain regulations to retain a tax-free status. A financial audit might be important to people who contribute to the organisation in order to get an accurate picture of how their donations are spent. An audit of how effectively they meet their goals might be helpful to give credibility to the organisation.

(e) A small grocery store in Ponta Grossa, Brazil: Although an audit is not required for a small store, the bank which makes loans to the grocery store or the partners of the enterprise may require audited financial statements. A small company can benefit from an operational audit, for instance, to see if they have proper controls and if the inventory is handled effectively. The audit might help the company with their income tax.

(f) A local Baptist church in Lubbock, Texas: A compliance audit to determine if the church is fulfilling the criteria of a non-profit organisation which might be helpful to the tax authorities and members who make contributions. Traditionally churches have little in the way of controls, and an operational audit of controls would probably be helpful in decreasing loss of cash donations. If the church is of a major, organised religion (Baptist or Catholic, for

example) a financial audit by the district administration might be required from time to time. A compliance audit might determine if they are using their donated money for the requirements of their congregation.

1.8 Setting Audit Objectives Based on Management Assertions

1-30. Management Assertions and Audit Objectives. The following are management assertions (1 through 9) and audit objectives applied to the audit of accounts payable ((a) through (h)).

Management assertion:

1. Existence
2. Rights and obligations
3. Occurrence
4. Completeness
5. Valuation and allocation
6. Accuracy
7. Cutoff
8. Classification
9. Understandability.

Specific audit objective:

a) Existing accounts payable are included in the accounts payable balance on the balance sheet date.

b) Accounts payable are recorded in the proper account.

c) Acquisition transactions in the acquisition and payment cycle are recorded in the proper period.

d) Accounts payable representing the accounts payable balance on the balance sheet date agree with related subsidiary ledger amounts, and the total is correctly added and agrees with the general ledger.

e) Accounts in the acquisition and payment cycle are properly disclosed according to IASs.

f) Accounts payable representing the accounts payable balance on the balance sheet date are valued at the correct amount.

g) Accounts payable exist.

h) Any allowances for accounts payable discounts are taken.

Required:

A. Explain the differences among management assertions and specific audit objectives and their relationships to each other.

Management assertions are implied or expressed representations by management about the classes of transactions and related accounts in the financial statements. ISA 500 classifies three categories of assertions containing nine assertions which are stated in the problem. Specific audit objectives are determined by the auditor for each management assertion. These are done for each account balance to help the auditor determine the specific amount of evidence needed for that account to satisfy the audit objectives.

B. For each specific audit objective, identify the appropriate management assertion.

Specific audit objective	Management assertion
a. Existing accounts payable are included in the accounts payable balance on the balance sheet date.	4. Completeness
b. Accounts payable are properly classified.	5. Valuation and allocation
c. Acquisition transactions in the acquisition and payment cycle are recorded in the proper period.	7. Cutoff
d. Accounts payable representing the accounts payable balance on the balance sheet date agree with related subsidiary ledger amounts, and the total is correctly added and agrees with the general ledger.	5. Valuation and allocation 6. Accuracy
e. Accounts in the acquisition and payment cycle are properly disclosed according to IASs.	2. Occurrence 3. Rights and obligations
f. Accounts payable representing the accounts payable balance on the balance sheet date is valued at the correct amount.	5. Valuation and allocation
g. Accounts payable exist.	1. Existence
h. Any allowances for accounts payable discounts are taken.	5. Valuation and allocation

1.9 The Audit Process Model

1-31. Audit Process Model. What are the four phases of an audit? Discuss each. Determine which is the most important of the four and explain why.

The four phases of the audit are: client acceptance (pre-planning), planning and design of an audit approach, tests for evidence, completion of the audit and issuance of an audit report. Illustration 1.5 shows the four-phase audit process model and its major sub-components.

The objectives of the **Client Acceptance** phase are to determine both acceptance of a client and acceptance by a client. The procedures of client acceptance (1) Evaluate the client's background and reasons for the audit; (2) Determine whether the auditor is able to meet the ethical requirements regarding the client; (3) Determine need for other professionals; (4) Communicate with predecessor auditor; (5) Prepare client proposal; (6) Select staff to perform the audit; (7) Obtain an engagement letter.

The Objective of the **Planning** phase is Determine the amount and type of evidence and review required to give the auditor assurance that there is no material misstatement of the financial statements. The procedures of the Planning Phase are (1) Perform audit procedures to understand the entity and its environment, including the entity's internal controls; (2) Assess the risks of material misstatements of the financial statements; (3) Determine materiality; and (4) Prepare the planning memorandum and audit program, containing the auditor's response to the identified risks.

The objective of the **Testing and Evidence** phase is to test for evidence supporting internal controls and the fairness of the financial statements. The procedures include: 1) Tests of controls; (2) Substantive tests of transactions; (3) Analytical procedures; (4) Tests of details of balances; and (5) Search for unrecorded liabilities

The objective of the **Evaluation and Reporting** phase is to complete the audit procedures and issue an opinion. The procedures of the phase are: (1) Evaluate governance evidence; (2) Perform procedures to identify subsequent events; (3) Review financial statements and other

report material; (4) Perform wrap-up procedures; (5) Prepare Matters for Attention of Partners. (6) Report to the board of directors; and (7) Prepare Audit report.

INSTRUCTOR'S NOTE: Any of the four phases may be thought to be the most important, and a choice of any one of them is correct as long as the student explains it well.

1-32. Audit Process Model. Based on the standard Audit Process Model, trace the procedures an auditor would use to audit a retail clothing business (continuing client) from the initial client contact to the audit opinion.

Based on the standard Audit Process Model, the procedures an auditor would use to audit a retail clothing business (continuing client) from the initial client contact to the audit opinion are:

1. Acquire knowledge of the client and the industry.
2. Review prior years' work papers.
3. Determine the need for experts or other auditors.
4. Pick audit staff and do a budget.
5. Write and engagement letter spelling out the services to be performed.
6. Obtain more detailed company and industry information; perform procedures to obtain knowledge about internal controls. For a retail grocery store this would include examining transactions at the point of sale (cash register) and inventory.
7. Access risk and set materiality.
8. Plan the audit and design the audit programme.
9. Perform tests of control and substantive tests (including analytical procedures).
10. Do closing procedures including management representation letters and legal letters.
11. Prepare matters for the attention of partners.
12. Prepare report for board of directors.
13. Based on the evidence, develop an audit opinion and a management letter to the client.

1.10 International Audit Firms

1-33. Auditor responsibility. Four friends who are auditing students have a discussion. Jon says that the primary responsibility for the adequacy of disclosure in the financial statements and footnotes rests with the auditor in charge of the audit field work. Mai-ling says that the partner in charge of the engagement has the primary responsibility. Abdul says the staff person who drafts the statements and footnotes has the primary responsibility. Yolanda contends that it is the client's responsibility.

Required:

A. Which student is correct and why?

Yolanda is correct. The client has the responsibility for the adequacy of disclosure in the financial statements and footnotes. The financial statements are the responsibility of management – the auditor's responsibility is to lend them credibility. The partner in charge of the audit is the most responsible for the correctness of the audit. If the proper procedures are not followed it is the partner in charge who must take the blame. Even though the staff auditor may draft the wording of the disclosure footnotes and suggest modifications in the financial statements, they are not responsible for the adequacy of disclosure.

Cases

1-34. Audit objectives and financial statement accounts. Look at the financial statements of a major public company. Pick three accounts and discuss the financial statement assertions that might be associated with those accounts. For example, the financial statement assertions might be associated with 'Accrued Product Liability' are valuation, existence, completeness and understandability. Valuation relates to product liability because a judgement (estimate) must be made regarding the expected cost of defective products.

In the table is a list of typical accounts on a balance sheet and the financial statement assertions (existence, rights and obligations, occurrence, completeness, valuation and allocation, accuracy, cutoff, classification and understandability) that might be associated with those accounts. Typically, financial statement assertions are associated with balance sheet accounts, but if the student uses income statement accounts this is okay. The student should discuss why the accounts are associated with that assertion. It could be argued that all objectives should be included in all accounts.

Assets	**Assertions**
Short-term investments	All
Bank and cash	All
Inventories	All
Accounts receivable	All
less allowances for doubtful accounts	Valuation and allocation
Investments	All
Long-term loan receivables	All
Property, plant and equipment	All
Goodwill and other intangible assets	Existence, rights and obligations, occurrence, valuation and allocation
Other non-current assets	All
Liabilities	
Accounts payable	Existence, rights and obligations, occurrence, completeness, valuation and allocation
Accrued liabilities	All
Short-term borrowings	Existence, rights and obligations, occurrence, completeness, valuation and allocation
Current portion of long-term debt	Existence, rights and obligations, occurrence, completeness, valuation and allocation
Advance payments	Existence, rights and obligations, occurrence, valuation and allocation
Provision for discontinued operations	Valuation and allocation, occurrence
Accrued Product Liability	Valuation and allocation, existence and completeness
Long-term debt	Existence, rights and obligations, occurrence, completeness, valuation and allocation

Other long-term liabilities	Existence, rights and obligations, occurrence, completeness, valuation and allocation
Shareholders' equity	
Share capital	Existence, rights and obligations, occurrence, completeness, valuation and allocation
Other restricted equity	Occurrence, valuation and allocation
Treasury shares	Existence, completeness, valuation and allocation
Untaxed reserves	Valuation and allocation

1-35. At IFAC/International auditing and Assurance Standard Board's publication website *h tp: /www.ifac.org/auditing-assurance/publications-resources* find and download the latest *Handbook of International Quality Control, Auditing, Review, Other Assurance, and Related Services Pronouncements*. Pick one ISA and discuss how that standard would influence the work of the auditor.

Students may pick any of the standards and may have different things to say. This is meant as an open question to get the student familiar with the IFAC handbook. It is downloadable and free, so everyone should have a copy.

1-36. Qualifications of Auditors. From the library get a copy of the EC Eighth Company Law Directive which is about the qualifications and work of auditors.

Required:

Based on the Eighth Directive, answer the following questions.

A. How many years of work experience must an auditor have before he can receive an auditing credential?

An auditor must have 3 years of work experience before he or she can receive an auditing credential.

B. How many years of education must an auditor have before certification?

An auditor must have a university or similar level degree before certification.

C. Name some of the requirements for the work of auditors.

Examples are competence and independence.

1-37. Due Professional Care. Discuss lawsuits resulting from negligence of 'Due professional Care'.

Required:

A. Consult the library, a database like LexisNexis or the internet for lawsuits resulting from negligence of 'Due Professional Care'. Discuss at least two.

B. Describe briefly the courts final conclusion and results from the court decision.

A. & B. This case is subjective. Students may search a database such as LexisNexis, ABI Inform, etc. and may find a variety of cases. As an example, a search of LexisNexis for lawsuits resulting from negligence of 'Due Professional Care' in May 2004 yields 191 articles, some of which are below:

American Bankruptcy Institute Journal, 1995 ‘The CPA as Expert Witness – Does Liability Loom?’ *American Bankruptcy Institute Journal* 1995.

Dennis Applegate, 2004 ‘Training New Auditors’, *The Internal Auditor,* Altamonte Springs, Apr. Vol. 61, Issue. 2, p. 66.

Lawrence R. Bard, 1992 ‘Note: A Distinct-Responsibility Approach To Accountants’ Primary Liability Under Rule 10b-5’, *George Washington Law Review,* November, 1992, No. 61, p. 193.

Roger J. Buffington, 1997 ‘Note: A Proposed Standard of Common Law Liability for The Public Accounting Profession’, *Southern California Interdisciplinary Law Journal*, Summer, No. 5, p. 485.

William J. Casazza, 1985 ‘Recent Development: Rosenblum, Inc. V. Adler: Cpas Liable At Common Law To Certain Reasonably Foreseeable Third Parties Who Detrimentally Rely On Negligently Audited Financial Statements’, *Cornell Law Review*, January, Vol. 70, p. 335.

Lewis P. Checchia, 1993 ‘Accountants’ Liability to Third Parties under Bily V. Arthur Young & Company: Does A Watchdog Need Protection?’, *Villanova Law Review*, No. 38, p. 249.

Marie L. Coppolino, 1995 ‘Financial Services Regulation: A Mid-Decade Review: Note: Checkosky, Rule 2(E) and The Auditor: How Should The Securities And Exchange Commission Define Its Standard Of Improper Professional Conduct?’ *Fordham Law Review*, No. 63, p. 2227.

Faculty, 1996 The Judge Advocate General’s School, ‘Tjagsa Practice Note: Contract Law Notes’, *Army Lawyer*, p. 34.

Julie Faussie, 1994 ‘Note: Limiting Liability In Public Accounting Suits: A Desperate Appeal From A Beleaguered Profession’, *Valparaiso University Law Review*, Spring, No. 28, p. 1041.

Cathy A. Gay, 1994 ‘Note: Cenco, Inc. V. Seidman & Seidman: A Futile Attempt to Deter Management Fraud’, *Duke Law Journal*, p. 141.

Richard A. Glaser and Leslee M. Lewis, 1995 ‘Redefining the Professional: The Policies and Unregulated Development of Consultant Malpractice Liability’, *University of Detroit Mercy Law Review*, Spring, No. 72, p. 563.

Willis W. Hagen II, 1988 ‘Forum: Accountants’ Common Law Negligence Liability To Third Parties’, *Columbia Business Law Review,* p. 181.

Jack E. Karns, Edwin A. Doty and Steven S. Long 1995, ‘Accountant and Attorney Liability as ‘Sellers’ of Securities Under Section 12(2) of the Securities Act of 1933: Judicial Rejection of the Statutory, Collateral Participant Status Cause of Action’, *Nebraska Law Review*, No. 74, p. 1.

Gary Lawson and Tamara Mattison, 1991 ‘A Tale of Two Professions: The Third-Party Liability of Accountants and Attorneys for Negligent Misrepresentation’, *Ohio State Law Journal*, No. 52, p. 1309.

Jeffrey N. Leibell, 1991 ‘Note: Accountants’ Liability in The Savings And Loan Crisis: An Argument In Favor Of Affirmative Defences’, *Columbia Business Law Review*, p. 71.

Reid A. Muoio, 1994 ‘An Independent Auditor’s Suit for Wrongful Discharge’, *Albany Law Review*, Vol. 58, p. 413.

Denise M. Orlinski, 1994. ‘An Accountant’s Liability to Third Parties: Bily V. Arthur Young & Co.’ *DePaul Law Review*, Spring, Vol. 43, p. 859.

Richard W. Painter and Jennifer E. Duggan, 1996 ‘Lawyer Disclosure of Corporate Fraud: Establishing a Firm Foundation’, *Southern Methodist University Law Review*, September/ October, No. 50, p. 225.

Richard S. Panttaja, 1994 ‘Accountants’ Duty To Third Parties: A Search For A Fair Doctrine Of Liability’, *Stetson Law Review*, Summer, No. 23, p. 927.

Robert A. Prentice, 1995 'Can The Contributory Negligence Defence Contribute To A Defusing Of The Accountants' Liability Crisis?' *Wisconsin International Law Journal*, Spring, No 13, p. 359.

Robert A. Reiley, 1997 'Symposium: Environmental Law And Business In The 21st Century: The New Paradigm: ISO 14000 and Its Place in Regulatory Reform', *The Journal of Corporation Law*, Spring, No. 22, p. 535.

CHAPTER 2

The Audit Market

2.11 Questions, Exercises and Cases

2.2 Introduction

2-1. What areas that an auditor audits is the responsibility of management?

Management is not only responsible for the financial and internal control reports to investors, but also has the authority to determine the precise nature of the representations that go into those reports.

2.3 Theories on the Demand and Supply of Audit Services

2-2. What are the most important theories on the demand of audit services?

- The *policeman theory* focuses auditing on arithmetical accuracy and on prevention and detection of fraud.
- The *lending credibility theory* contends that the primary function of auditing is the addition of credibility to the financial statements.
- The *moderator of claimant's theory* holds that all those who contribute to the company's profit get the impression he or she receives a fair share of the company's income. By giving an opinion on the accuracy of the income statement, the auditor is seen as a 'moderator of the various interests represented in the amounts shown therein.
- The *quasi-judicial theory* regards the auditor as a judge in the financial information distribution process.
- The *theory of inspired confidence* addresses both the demand and the supply of audit services. According to Limperg, the demand for audit services is the direct consequence of the participation of outside stakeholders (*third parties*) in the company. These stakeholders demand accountability from the management which an audit of management information. With regard to the level of audit, the auditor should execute his or her job in such a way, that the expectations of a 'reasonable outsider' are not put to shame.
- In the *agency theory*, a company is viewed as the result of more or less formal 'contracts', in which several groups make some kind of contribution to the company, given a certain 'price'. Company management is seen as the 'agent', trying to obtain contributions from 'principals' such as bankers, stockholders and employees.

2-3. Give a brief description of the agency theory as applied to both the demand and the supply of audit services.

In the agency theory, the auditor will make a trade-off between:

- The probability of detecting errors, measured by the costs of an extra hour of work by audit personnel.
- Auditor independence, measured by the loss likely to be incurred by the auditor as a result of losing a client following the qualification of the auditor's report.

- The expected costs of an *audit failure*, measured by the loss likely to be incurred by the auditor as a result of the detection by outside stakeholders that the auditor has either failed to detect or report a (*material*) *misstatement*. These costs might include the costs of litigation and (opportunity) costs due to the loss of present or potential clients (because of bad reputation). These latter costs as a result of reputation damage have been demonstrated in several empirical studies, which showed that audit firms having suffered a public rebuke were confronted with a decline in their market share.

Demand of audit services

In many countries, audits are now legally required for at least some types of companies. E.g. in the European Community, most medium-sized or large enterprises are required by law to have their annual report audited.

Supply of audit services

The supply of audit services is currently regulated in most countries. In the European community, statutory audits, i.e. audits required by law, can only be performed by auditors who have met specific technical requirements with regard to education and experience.

2.4 Audit Regulation: International Perspective

2-4. Describe the major US and European regulations discussed in this section.

The Sarbanes-Oxley Act of 2002 was intended to establish investor confidence by improving the quality of corporate disclosure and financial reporting, strengthen the independence of accounting firms, and increase the role and responsibility of corporate officers and directors for financial statements and corporate disclosures.

EU Directive 2006/43/EC aims at high-level – though not full – harmonisation of statutory audit requirements. The objectives of this directive are requiring the application of a single set of international auditing standards, the updating of the educational requirements, the definition of professional ethics and the technical implementation of the cooperation between competent authorities of EU Member States and the authorities of third countries.

2.5 Independent Oversight

2-5. Give the names of four national or international accounting oversight boards – government or professional committees to review the work of auditors and take an active part in setting and enforcing standards.

The International Forum of Independent Audit Regulators (IFIAR) is an international accounting oversight board. Similar boards are in Australia (Financial Reporting Council), the UK (The Review Board), the Netherlands Authority for the Financial Markets (AFM), France Autorité des marchés financiers (AMF) and the USA (the Public Company Accounting Oversight Board).

2-6. Describe the activities off the International Forum of Independent Audit Regulators (IFIAR).

IFIAR activities are to:

- share knowledge of the audit market environment and practical experience of independent audit regulatory activity;
- promote collaboration in regulatory activity;
- provide a focus for contacts with other international organisations which have an interest in audit quality.

2.6 Audit Firms

2-7. What are the names of the Big Four firms?

Deloitte, Ernst & Young, KPMG and PwC.

2-8. What is meant by second tier firms?

There are a small number of *second tier firms*, which also have an international network, although not quite as extensive as the Big Five network. In 2009, the 30 largest non-Big Five firms had an annual fee income of US $21 billion, employing 165,000 people.

2.7 Legal Liability

2-9. What are four major sources of auditors' legal liability? Briefly discuss them?

There are four major sources of auditors legal liability: to clients under common law, to third parties by common law, to third parties under statutory law and criminal liability.

i. Liability to clients under common law: An example is the client sues the auditor for not discovering a theft of assets (defalcation) during the audit.

ii Liability to third parties by common law: For example, a bank sues the auditor for not discovering materially misstated financial statements.

iii. Liability to third parties under statutory law (government laws and regulations): A combined group of stockholders sue the auditor for not discovering misstated financial statements.

iv. Criminal liability: The government prosecutes an auditor for knowingly issuing an incorrect audit report.

2-10. What measures are possibilities to reduce auditors' unlimited legal liability?

- A limit or cap on claims (a maximum settlement amount) is known in advance and limits settlements. Liability is now capped in Austria, Belgium, Germany, Greece and Slovenia.
- In some countries, a system of proportionate liability is under study. In such a system, an audit firm is not liable for the entire loss incurred by plaintiffs (as is the case under joint and several liability), but only to the extent to which the loss is attributable to the auditor. The US has a system of proportionate liability, but only under the federal acts.
- To make insurance of all liability risks compulsory using new legislation was one of the recommendations of an EU commission.
- Exclude certain activities with a higher risk profile from the auditors' liability. A mechanism to achieve this outcome would be to introduce so-called safe harbour provisions by legislation.
- In order to protect the personal wealth of audit partners, some audit firms are structured as a limited liability partnership (e.g. in the UK).

2.8 Some Developments in the Audit Market

2-11. Discuss the following statement: 'Auditors perform extensive tests on a company's internal control system, in order to determine whether they can rely on that system in the course of their audit. Therefore, auditors can express an opinion on the adequacy of the audited company's internal control system'.

The COSO report envisaged creating a basis for the external reporting on the adequacy of the internal controls. This is particularly relevant, because it might lead to certification by the auditor of management's assertions regarding the quality of a company's internal control system.

ISA 400 requires the auditor to obtain an understanding of a company's accounting and internal control systems, sufficient to plan the audit and develop an effective audit approach. However, testing the adequacy of the internal controls is *not* required. If the audit objectives can more efficiently be met by substantive testing, it is acceptable not to examine the internal control structure.

The expectation gap surveys show high expectations of the auditor's role in testing whether a satisfactory system of internal control is being operated. These expectations clearly exceed the auditor's current duties, although developments such as the suggestions made in the COSO and Cadbury reports might help reduce the gap between expectations and practice.

As far as *reporting* on the effectiveness and functioning of internal controls is concerned, there has been much discussion in Europe, Canada and the United States. Support for reporting is the belief that users of financial information have a legitimate interest in the condition of the controls over the accounting system and management's response to the suggestions of the auditors for correction of weaknesses. Those who argue against reporting on controls say that such reporting would increase the cost of audit attestation, increase auditor (and director) liability, and is not a relevant information.

2-12. Describe the historical shift in the audit profession's attitude towards the auditor's responsibilities regarding fraud.

Several reasons have been given for auditors evolution away from fraud responsibilities, but the most important reasons are (1) the acceptance that the audit of the financial statements on behalf of the third parties is an art of its own and justifies the existence of auditors and (2) the acceptance that an investigation aimed at finding any kind of fraud is extremely labourious, expensive and not practical, considering the increases in size and complexity of the companies, as well as their improved self or internal controls.

The current position of the audit profession is described in ISA 240. According to this standard, the responsibility for the prevention and detection of fraud and error rests with management through the implementation and operation of an adequate system of internal control. The auditor should consider risk of fraud in the planning and audit procedure design.

2.9 Examples of Landmark Studies and Legislation that Influenced the International Audit Market

2-13. Discuss the potential impact of the Cadbury report, combined code and COSO report on the audit profession.

The Cadbury report:

The Cadbury report was published in the UK by The Committee on the Financial Aspects of Corporate Governance. Cadbury deals with the responsibilities and duties of the executive and non-executive members of the Board of Directors. The report suggests that companies should adhere to a Code of Best Practice, in which these responsibilities and duties are listed. In the published financial statements, the board should declare the adherence to this code. Further, the board should explicitly assume responsibility for the financial statements. In addition, the Cadbury report suggests that the board should report that they tested the adequacy of the company's *internal control* as well as the company's ability to continue as a going concern. The auditor's duties are derived from the responsibilities of the Board, in that the auditor should state whether the assertions made by the board with regard to the above mentioned duties are in accordance with the auditor's observations.

The combined code:

The combined code of the committee on corporate governance, which represents the Code of Best Practice of the London Stock Exchange, states in Principle D.2 that: 'The board should

maintain a sound system of internal control to safeguard shareholders' investment and the company's assets'. Provision D.2.1 states that: 'The directors should, at least annually, conduct a review of the effectiveness of the group's system of internal control and should report to shareholders that they have done so. The review should cover all controls, including financial, operational and compliance controls and risk management'.

The COSO report:

The COSO report was published by the Committee of Sponsoring Organisations of the Treadway Commission. The COSO report envisaged (1) harmonising the definitions regarding internal control and its components, (2) helping management in assessing the quality of internal control, (3) creating internal control benchmarks, enabling management to compare the internal control in their own company to the state-of-the-art and (4) creating a basis for the external reporting on the adequacy of the internal controls. Although all of these objectives might have an influence on the audit service, the latter subject is particularly relevant, because it might lead to certification by the auditor of management's assertions regarding the quality of a company's internal control system.

2-14. Discuss the following statement: 'Auditors should not be allowed to combine an audit for one client with advisory services to that client'.

Most audit firms expect that consultancy fees will become more and more important, whereas the more 'mature' audit and accounting market will stabilise at the current level. Eventually, the non-recurring tax and consultancy work might become more important than the recurring audit and accounting services, requiring significant modifications to the management and the marketing techniques of 'audit' firms.

This strategy of diversification by audit firms might jeopardise the auditor's independence, for two reasons:

- in addition to losing audit fees, the auditor might also lose consultancy fees in case of 'dismissal' as an auditor after a technical dispute with a client;
- an auditor might lose his objectivity, if he has to make a judgement, in his audit function, on ideas that were implemented on the basis of his (or his colleague's) advice.

Problems and exercises

2.3 Theories on the Demand and Supply of Audit Services

2-15. Agency Theory. Identify principals and agents in the cases mentioned below. Describe the contributions and 'prices' associated with these relationships, identify potential risks for the principal and give suggestions for limiting these risks.

A. The Pasadena Bank lends money to the Alhambra Construction Company.

B. Employee Mario Auditorio considers leaving his current job and starting a new career with Instituto Milanese.

C. Manager Yu-Chang receives an annual bonus, based on last year's profit of company Shang-Zu.

D. Supplier 'Vite et Juste' delivers goods to company 'Merci'. Payment is due 60 days after the date of the invoice.

The principals, agents, prices, principal's risks and the limitation of the risks are given for each situation A, B, C and D below:

Situation	A	B	C	D
Principals	Pasadena Bank	Current employer Instituto Milanese	Shang-Zu	Vite et Juste
Agents	Alhambra Construction Company	Mario Auditorio	Yu-Chang	Merci
Prices	Interest and loan	Salary	Bonus	Cost of goods
Principal's risks	Loan default	Poor work loss of company skills	Manipulate profits	Non-payment of amount owed
Limit risks	Contract	Contract	Internal controls	Contract

2.4 Audit Regulation: International Perspective

2-16. Comment on the following statements:

A. In most countries audits are legally required for every type of company.

In most countries audits are now legally required for some types of companies. For example, in the US and European Union, large, and in some cases medium-sized enterprises are required by law to provide audited financial statements. The European Union audit rules apply to all companies that are required to be audited by the individual countries, which may vary. In the Netherlands, companies with more than 50 employees, and/or assets greater than 3.1 million euro, and/or net sales greater than 6.2 million euro. The major bourses (including NYSE, NASDAQ, London Stock Exchange, Tokyo NIKKEI and Frankfurt DAX) have listing rules that require all listed companies to have their annual report audited.

B. The PCAOB sanctions firms but not individuals for violations of laws, regulations and rules.

The board oversees and investigates the audits and auditors of public companies and sanction both firms and individuals for violations of laws, regulations and rules.

C. The European eighth Directive objective is to register all auditors and audit firms and make such information accessible to the public.

Registering all audit firms would make audit firms more accountable, but would require a larger bureaucracy and increased cost burden on government. It is primarily a matter of does the cost exceed the benefit?

D. Three areas of audit regulation that are essential are (1) the independence of the profession; (2) opening up the audit market; and (3) creating a more integrated European market and stepping up its supervision.

These areas are suggested by EU Minister Michael Barnier. He said that the EU's first concern is the quality and credibility of auditing. Further, the independence of auditors is 'the condition sine qua non for their reports being fully trusted'. He feels that there is a need to restrict – or even prohibit – non-audit services being provided by audit firms to audited clients and that common EU rules in this area are needed. He proposed the concept of 'pure audit firms' (i.e. firms not allowed to provide services other than auditing) which would have the benefit of opening up these non-audit markets to a whole range of smaller audit firms that have no chance

faced with the predominance of the major audit firms. Barnier put it this way, 'I am not happy that the audit market is so dominated by four firms whilst there are at least as many other firms wanting to break into this market in Europe'. Barnier believes, 'It is unacceptable that an auditor has to pass additional examinations in each country where he wishes to work'. He suggests some solutions, for example, the automatic recognition of firms already licensed in other Member States, the award of a European quality label demonstrating the holder's ability to audit large companies, or by harmonising auditing standards at the European Union level.

2.5 Independent Oversight

2-17. Comment on the following statements:

A. The core principles of IFAR seem to be comprehensive. They are:

- comprehensive and well defined accounting and auditing principles and standards that are generally accepted;
- legal requirements for the preparation and publication of financial statements according to those principles and standards;
- an enforcement system for preparers of financial statements to ensure compliance with accounting standards (e.g. fines, shareholder redress or penalties on responsible managers for non-compliance);
- corporate governance arrangements and practices that support high-quality corporate reporting and auditing practice;
- effective educational and training arrangements for accountants and auditors.

B. The FRC has broad oversight for setting accounting standards in the public and private sectors.

The Financial Reporting Council (FRC), with the responsibility for the broad oversight of the accounting standard setting process for the private, public and not-for-profit sectors.

C. The Review Board is responsible for training the members of UK accounting professional bodies.

The Review Board's has limited scrutiny over the UK accounting professional bodies' authority for investigation and discipline, monitoring, training, qualification and registration of their members from the accounting profession. Its task is to monitor the operation of the regulatory system to confirm that it is fully meeting the public interest.

2.6 Audit Firms

2-18. How do the markets for the Big Four differ from second tier firms? Describe a typical audit client for each group including average revenue, global nature, number of employees, government regulation and governance mechanism.

The market for the Big Four firms is primarily entities listed on the world's public exchanges, especially large and global entities. Students may pick any company, but for illustration we will say a typical client for a Big Four firm might be Coca Cola. Their independent auditor is Ernst and Young. Although headquartered in the US, the majority of their revenue comes from outside the US. For the three months ended 31 March 2004, revenues were $5.08 billion. Finished beverage products bearing its trademarks are sold in more than 200 countries worldwide. As of December 31, 2003, our Company employed approximately 49,000 persons, compared to approximately 56,000 at the end of 2002. Government regulation applied to Coca-Cola Co. includes laws on manufacturing and distribution of beverages along with requirements of the Sarbanes-Oxley Act

and other accounting regulation in various countries. The Coca-Cola Company has a strong countervailing governance structure in place, in line with ISS criteria, that provides a satisfactory counterbalance to the combined Chairman and CEO post. There is a lead director, the board is 2/3 independent, all key committees are independent and governance guidelines are established.

The second tier firms have small to mid-sized firms as clients. A typical client might be a large family-owned and controlled firm or a start up with a large market. They depend on the second tier firm for both accounting and auditing expertise, but also management and personal advise. Second tier firms may specialise in particular industries. For example, Grant Thornton practices in consumer and industrial products; technology; financial services and institutions; not-for-profit; construction, real estate and hospitality; global public sector (including local, state, federal and international governments); health care; and private equity. A client of Grant Thornton (in 2013) is Meridian Bioscience Inc., fully integrated life science company that manufactures, markets and distributes a broad range of innovative diagnostic test kits, purified reagents and biopharmaceutical enabling technologies whose shares are traded on NASDAQ.

2.7 Legal Liability

2-19. Legal liability to third parties. Suppose you are a judge in the following civil case. Plaintiff Sue Bank, a banker, accuses auditor Big Zero of having performed a negligent audit in the financial statements of company 'Trouble'. Five months after the financial statements (with an unqualified opinion) were published, 'Trouble' filed for bankruptcy, leaving the bank with unrecovered loans amounting to $20 million.

Required:

Describe the relevant issues to be addressed in this case.

The relevant issues to be addressed in this case are:

- Can the Bank prove negligence in the audit of Trouble?
- Did the bank make the loan to Trouble based on Big Zero's audit report?

2.8 Some Developments in the Audit Market

2-20. Auditors opinion on the occurrence of fraud.

Sundback, CGR, is the auditor for Upseerin Manufacturing, a privately owned company in Espoo, Finland, which has a June 30 fiscal year. Upseerin arranged for a substantial bank loan which was dependent upon the bank receiving, by September 30, audited financial statements which showed a current ratio of at least 2 to 1. On September 25, just before the audit report was to be issued, Sundback received an anonymous letter on Upseerin's stationery indicating that a 5-year lease by Upseerin, as lessee, of a factory building which was accounted for in the financial statements as an operating lease was in fact a capital lease. The letter stated that there was a secret written agreement with the lessor modifying the lease and creating a capital lease.

Sundback confronted the president of Upseerin who admitted that a secret agreement existed but said it was necessary to treat the lease as an operating lease to meet the current ratio requirement of the pending loan and that nobody would ever discover the secret agreement with the lessor. The president said that if Sundback did not issue her report by September 30, Upseerin would sue Sundback for substantial damages which would result from not getting the loan. Under this pressure and because the work papers contained a copy of the 5-year lease agreement which supported the operating lease treatment, Sundback issued her report with an unqualified opinion on September 29.

In spite of the fact that the loan was received, Upseerin went bankrupt within 2 years. The bank is suing Sundback to recover its losses on the loan and the lessor is suing Sundback to recover uncollected rents.

Required:

Answer the following, setting forth reasons for any conclusions stated.

A. Is Sundback liable to the bank?

Yes. Sundback was a party to the issuance of false financial statements and as such is jointly liable. The elements necessary to establish an action for common law fraud are present. There was a material misstatement of fact, knowledge of falsity ('scienter'), intent that the plaintiff bank relies on the false statement, actual reliance and damage to the bank as a result. If the action is based upon fraud there is no requirement that the bank establish that there was a contractual relationship with the CGR. Moreover, if the action by the bank is based upon ordinary negligence, which does not require a showing of scienter, the bank may recover as a third-party beneficiary (an exception to the strict contractual relationship requirement). The bank will be able to recover its loss from Sundback under either common law fraud or negligence.

B. Is Sundback liable to the lessor?

No. Sundback is not liable to the lessor. The lessor was a party to the secret agreement. As such, the lessor cannot claim reliance on the financial statements and cannot recover uncollected rents. Even if he was damaged indirectly, his own fraudulent actions led to his loss and the equitable principle of 'unclean hands' precludes him from obtaining monetary damages.

2-21. Opinion on the occurrence of illegal acts.

Ostling, Auktoriserad Revisor, accepted an engagement to audit the financial statements of Sandnes Company of Göteborg, Sweden. Ostling's discussions with Sandnes's new management and the predecessor auditor indicated the possibility that Sandnes's financial statements may be misstated due to the possible occurrence of errors, irregularities and illegal acts.

Required:

A. Identify and describe Ostling's responsibilities to detect Sandnes's errors and irregularities. Do not identify specific audit procedures.

To satisfy an auditor's responsibilities to detect Sandnes's errors and irregularities, Ostling should:

- Assess the risk that Sandnes's errors and irregularities may cause its financial statements to contain a material misstatement.
- Design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.
- Exercise due care in planning, performing and evaluating the results of audit procedures, and the proper degree of professional scepticism to achieve reasonable assurance that material errors or irregularities will be detected.

B. Identify and describe Ostling's responsibilities to report Sandnes's errors and irregularities.

To satisfy an auditor's responsibilities to report Sandnes's errors and irregularities, Ostling should:

- Inform Sandnes's audit committee, or others having equivalent authority and responsibility, about material irregularities of which Ostling becomes aware.

- Express a qualified or an adverse opinion on the financial statements if they are materially affected by an error or irregularity and are not revised.
- Disclaim or qualify an opinion on the financial statements and communicate the findings to the audit committee or the board of directors if the scope of the audit has been restricted concerning a possible irregularity.
- Consider notification of outside parties concerning irregularities in certain circumstances.

C. Describe Ostling's responsibilities to detect Sandnes's material illegal acts. Do not identify specific audit procedures.

Ostling's responsibilities to detect Sandnes's illegal acts that have a material and direct effect on Sandnes's financial statements are the same as that for errors and irregularities. Ostling's responsibilities to detect Sandnes's illegal acts that have a material and indirect effect on the financial statements are to be aware of the possibility that such illegal acts may have occurred. If specific information comes to Ostling's attention that provides evidence concerning the existence of such possible illegal acts, Ostling should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

2.9 Examples of Landmark Studies and Legislation that Influenced the International Audit Market

2-22. Compare the COSO Report, Combined Code and the Sarbanes-Oxley Act on what each says about the following:

A. Corporate governance

COSO set a framework for control environment where those in corporate governance must set the 'tone' of the organisation including personnel, communications and setting an example.

SOX required CEOs and CFOs to verify that controls are effective and the financial statements present fairly in all material respects the company finances and fraud has been reported to board of directors. The board of directors needs to have a financial expert and a code of ethics.

B. Audit firms

COSO did not address audit firms specifically but set out a framework for internal control evaluation.

C. Internal controls

COSO was entirely about internal controls. It set a framework for evaluating controls and suggested 'best practice'.

Case

2-23. Legal responsibilities of auditors. Pick five countries. Assume that you are the head of an international commission to determine legal responsibilities of accountants in various countries. Use your university library and the internet to research accounting in these five countries.

Required:

A. List the country, concept of independence and functions generally not allowed.

The student may pick any five countries.

Requirement A would be a list of those companies, the applicable concept of independence and functions generally not allowed.

B. List the ethical standards, enforcement, legal liabilities and responsibility for the detection of fraud.

Requirement B, a list the ethical standards, enforcement, legal liabilities and responsibility for the detection of fraud, would resemble Chapter 3, Illustration 3.1.

C. Using the library, LexisNexis or internet find one recent legal case in each country that impacts auditor independence or resulted from fraud. Summarise each case.

Requirement C – the cases found will vary according to where the student looked and the country involved. For each country they should find and summarise one recent legal case that impacts auditor independence or resulted from fraud.

D. Write a brief comparing the recent legal case and auditor ethical standards in each country.

Requirement D – the brief comparing the recent legal case and auditor ethical standards in each country may or may not be in a specific format.

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