

The

AUDIT

Process

**PRINCIPLES
PRACTICE
AND CASES**

**Iain Gray and
Stuart Manson**



Van Nostrand Reinhold (International)

The Audit Process

Principles, practice and cases

IAIN GRAY

*Department of Accountancy and Financial Studies
Sheffield City Polytechnic*

STUART MANSON

*Department of Accounting and Financial Management
University of Essex*



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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:

Chartered Association of 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 also complement studies of auditing at degree level where theoretical studies need to be underpinned by a practical knowledge of auditing.

It adopts as a framework the audit year of a firm of auditors auditing the financial statements of medium-sized 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.

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

Part One: Study chapters

Part One provides the main teaching component of the book. It contains detailed study material illustrated by many examples, case studies and questions.

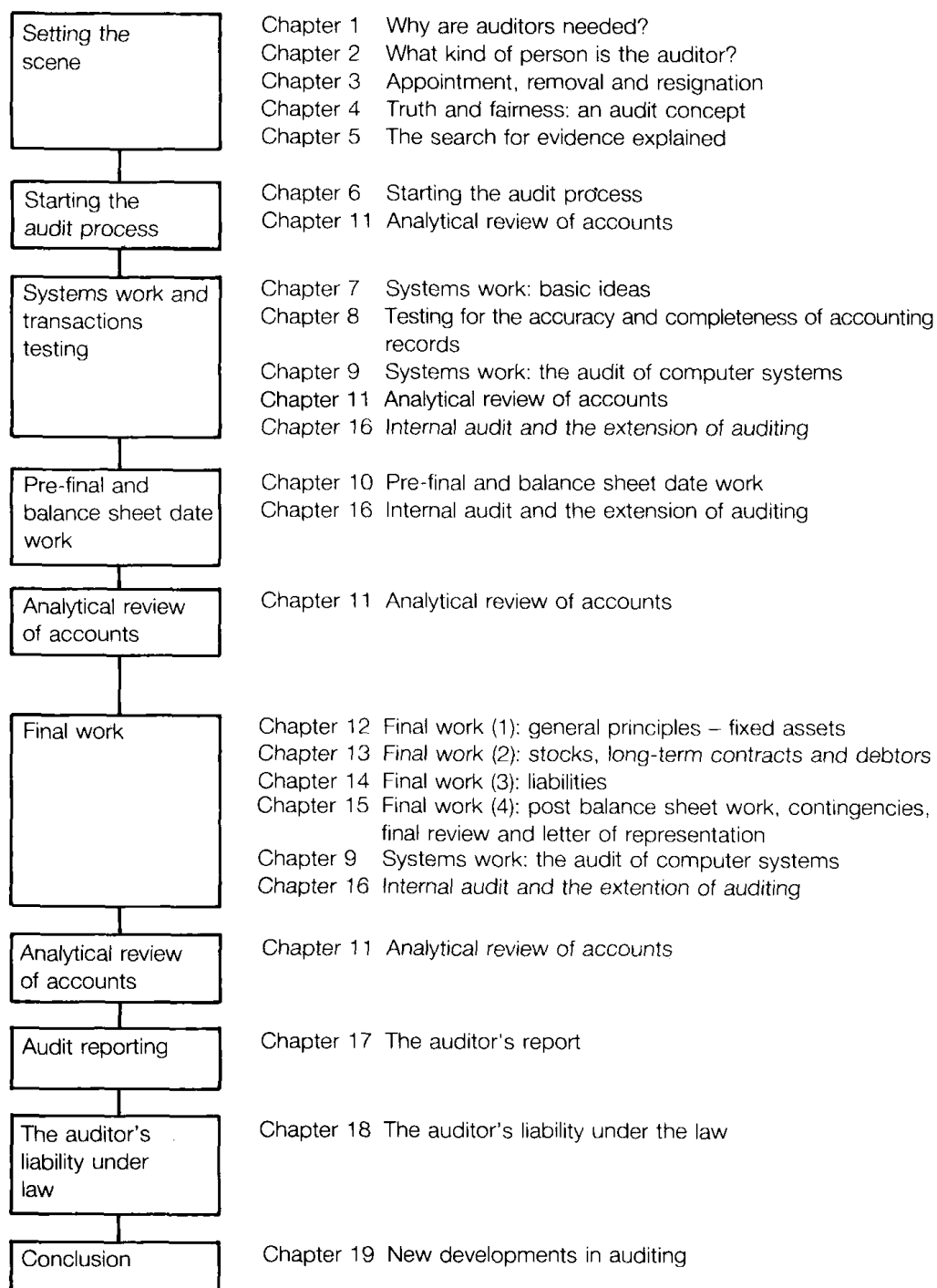


Figure 1.1 Stages in the auditing process and how they are covered in the study chapters. Note that the chapters are not set out in strict numerical order. This is because some chapters are relevant to more than one audit stage.

Some of the questions – called **tasks** – 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. You should

make sure that you try to answer these questions before proceeding to the next part of the text. Suggested solutions to tasks are provided at the end of each chapter.

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 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 analysing and interpreting information and forming reasoned conclusions. Suggested solutions to these questions are provided at the end of Part One.

Figure 1 shows how the auditing 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).

Part Two: Examination questions and answers

This part contains two sets of questions, both sets being taken from recent papers of the accounting bodies in the British Isles. The first set (called *examination papers*) have been presented in the form of two examination papers, each containing seven 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 (called *questions without answers*) contain selected questions which you can use as additional exercises to test your knowledge and understanding for yourself. Your tutor may wish to set some of these questions as a formal exercise, so check with him or her before attempting any.

How to use this book

To use the book intelligently you need to plan your work and set aside regular times 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 8 to 9 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 which 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. They carry information, warnings, hints and advice which should *enhance* your understanding of the subject and your ability to pass the examination or score well in other formal assignments. 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** you should attempt to answer it before moving on. Check your own answers against the **suggested solutions** at the end of each chapter. 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. Answers to all of them are provided at the end of Part One (starting on page 445). 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 in Part Two. 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 in Part Two (starting on page 505), noting the main points of principle and checking back in Part One 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.

Recommended further reading

This book is intended to be a good friend and counsellor 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) Statements of Standard Accounting Practice
- (b) Auditing Standards and Guidelines
- (c) Ethical Guidelines of the ACCA, ICAEW, ICAI or ICAS.

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 departed from this principle only to the extent that we have provided (at the end of Chapter 3) relevant sections from the Companies Act 1985 which are discussed in Chapters 2 and 3. 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) *Accountancy* (published by ICAEW), *The Accountants' Magazine* (published by ICAS), *The Certified Accountant* (published by ACCA);
 - (b) *Accountancy Age*;
 - (c) *The (Certified) Students Newsletter*;
 - (d) A good daily and Sunday newspaper.

One final matter

Auditors may, like most other professional people, be either male or female. In order to avoid clumsy usages such as 'he/she' and 'her/him',

we have adopted the convention of using masculine and feminine pronouns in alternate chapters. The only exception to this rule is where we are quoting official material such as Auditing Guidelines which solely use the masculine form.

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PART ONE

Study chapters

Why are auditors needed?

1

Learning objectives (p 3) • Introduction to basic principles through a simple case (p 3) • Summary of the principles (p 8) • Definition of an audit (p 9) • Summary (p 10) • Further reading (p 10) • Self-assessment questions (p 11)

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.

Introduction to basic principles through a simple case

To help you gain some understanding of what an audit is, and to show you how an audit might be carried out, we start by looking at a more or less realistic case. The scene is set in Case study 1.1, Andrew and James, Part 1, which you should now read.

When you have done this, try to answer the following two questions before reading on:

- ☐ What was James's position in relation to that of Andrew in the summer of 1990? *James is partner and owner*
- ☐ If you were James, what would you do now? *He is a shareholder and a director*

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

Regarding question 2, James finds himself in a curiously uninformed position. It looks as if the return in six months is £1430 on an initial investment of £5000. The return looks very good – some 57% per annum – much better than he could have got from a building society; nevertheless,

CASE STUDY 1.1

Andrew and James, Part 1

On 1 March 1990 Andrew and James, two old friends, met each other by chance. Both men were in their early thirties and had recently been declared redundant, each having received £5000 in redundancy pay. James said that he felt like using the money on travel to see the world but Andrew 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. His further suggestion was that they should buy an old lorry he had seen for sale for £4000 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. Andrew thought that they might be able to sell for £2.50 what had cost them £1.00.

James allowed himself to be convinced that this was a marvellous idea. They bought the lorry for £4000 and on 1 April 1990 spent £6000 on bankrupt stock. On 2 April, James fell off the back of the lorry, breaking an arm and a leg. Andrew visited him in hospital and told him not to worry; he would look after their joint venture and would only take 10% of the profits for his trouble before sharing the proceeds of the venture equally between them.

On 1 October, having spent the whole summer touring from place to place in the North of England, Andrew appeared on James's doorstep. James in the meantime had recovered the use of his limbs. Andrew took a wad of banknotes from his bag and informed James that this represented his share of the joint venture which had just been wound up, and that this amounted to £6480.

An accountant would have said that the estimated gross margin was 60%, calculated as:

$$\frac{\text{Gross profit} \times 100}{\text{Sales}} = \frac{1.50 \times 100}{2.50}$$

how does he know that Andrew has calculated his share properly or even whether he has deliberately cheated him? He asks Andrew if he can see how he calculated the £6480:

'Don't businesses usually prepare accounts?' (James had not been wasting his six months of enforced rest. He had bought a book on accounting.)

After a lot of prevarication Andrew produces a somewhat dog-eared piece of paper from his bag and shows James the accounts that he has prepared. The accounts are a very simple receipts and payments account and contain the information in Case study 1.1, Part 2, which you should now take a careful look at and ask yourself what you notice in relation to what you already know about the venture. Try to form your own conclusions first (and when you are doing this try to put yourself into the position of a professional person advising James) and then read on.

The following are the principal points we believe James should raise with Andrew:

- ☐ Andrew has purchased the lorry from their business himself. How was the price calculated and what is he going to do with it anyway?
- ☐ What is the payment of interest of £100 to John for?

CASE STUDY 1.1**Andrew and James, Part 2**

Andrew and James Joint Venture: 1 April to 30 September 1990

	£	£
Cash introduced	10 000	
Purchase of lorry		4 000
Purchase of bankrupt stock		6 000
Running expenses including motor expenses		2 500
Other purchases		13 000
Sales	27 000	
Interest to John		100
Sale of lorry to Andrew	<u>3 000</u>	
	40 000	
	<u>25 600</u>	<u>25 600</u>
Cash on hand	14 400	
Less: 10% wage	<u>1 440</u>	
	<u>12 960</u>	
Half to Andrew	<u>6 480</u>	
Half to James	<u>6 480</u>	

- ☐ Andrew has not calculated his wage on the profit but on the total cash on hand in the business. Assuming the other figures are all right the profit is £14 400 – £10 000 (original capital) = £4400, so that Andrew's 'wage' should only be £440.
- ☐ Remember that Andrew had said in March that they could expect a gross return of 60% of sales. The gross profit percentage using Andrew's figures on this basis would be as set out in Part 3 of the Case study. From this you can see that the actual percentage is half of that originally expected. We can go further and calculate what the gross profit would have been if Andrew had achieved a return of 60% on sales:

£27 000 at 60% = £16 200

CASE STUDY 1.1**Andrew and James, Part 3**

Calculation of gross profit percentage

	£	£
Sales		27 000
Purchase of bankrupt stock	6 000	
Other purchases	<u>13 000</u>	
		<u>19 000</u>
Gross profit		<u>£ 8 000</u>
% gross profit on sales		<u>29.63%</u>

CASE STUDY 1.1

Andrew and James, Part 4

Note that getting information about lorry prices in this way is a good example of obtaining reliable evidence from an independent source.

Questioning whether the road fund tax and insurance have been adjusted is a good example of the imaginative professional accountant at work.

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.

Note that Andrew implies that gross margins have not met expectation because of 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 Chapter 7.

James knew Andrew had been living on the back of the lorry.

- ☐ The lorry had been used for six months and a reduction of £1000 seemed reasonable. ('Yes, but second-hand prices for that make and age of lorry are currently £3500, according to a second-hand car dealer friend of mine,' says James. 'Also have you adjusted for vehicle licence fee and insurance paid in advance?' 'No,' says Andrew, 'but they only amount to £400.')
- ☐ Payment of interest to John was in respect of a loan of £1000 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 30 September 1990. ('Seems reasonable,' thinks James, 'even though a rate of 20% seems a bit steep.')
- ☐ The calculation of the wage is a mistake. Andrew readily admits he was wrong to calculate it in the way he did. (At this stage, of course, James is somewhat concerned that Andrew may have made more unwitting mistakes.)
- ☐ Andrew agrees that he had originally said that they could make a bigger profit than in fact they had, but this was because the profit on the other purchases had been much lower. Also, the lorry had not really been all that secure and he thinks there had been some theft of stock. 'Yes, but can you make an estimate of stock losses?' asks James. 'Perhaps £2000,' suggests Andrew. ('And what kind of margin did you get on the other purchases?' James persists. 'Well, I thought I could get about 50% on cost, the way you are doing it, it would be 33% on sales. The stock losses were all of stock bought after the bankrupt stock had been sold.')
- ☐ Andrew says there was no stock on hand at the end of the period, apart from some insignificant items which he had disposed of in a closing-down sale. He says that he purchased the lorry so that he could calculate the amount due to each partner. James is now in the position to make a further calculation as follows:

	£	Expected profit	£
Sales		27 000	
Purchases: Bankrupt stock	6 000		9 000
Other	13 000		6 500
Less: Stock losses at cost	(2 000)		(1 000)
		17 000	
		<u>£10 000</u>	<u>£14 500</u>

James suggests that £4500 seems to be unaccounted for. 'Well, I had to live,' says Andrew. 'What!' says James, almost unbelievably. 'At £750 per month, that's not living, it's "living it up". In any event, it looks as if you have had drawings of £4500 which you took out of takings. What kind of system did you have?' Andrew then says that he had a bag on the lorry and any takings went into the bag;