

H. J. Kerridge

Auditing for Accounting Technicians

AUDITORS' REPORT TO THE MEMBERS OF

Apple Pie Bakers plc.

We have audited the financial statements on pages 8 to 16 in accordance with approved auditing standards.

In our opinion the financial statements, which have been prepared under the historical cost convention as modified by the revaluation of certain assets, give on that basis a true and fair view of the state of affairs of the company and the group at 30 September, 1982, and of the profit and source and application of funds of the group for the year ended on that date, and comply with the Companies Acts 1948 to 1981.

In our opinion the abridged supplementary current cost accounts set out on pages 18 to 20 have been properly prepared, in accordance with the policies and methods set out in notes A to F, to give the information required by Statement of Standard Accounting Practice No. 16.


Certified
Bishop
30

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The M & E BECBOOK Series

Auditing for Accounting Technicians

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Preface

The aim of this book is to help students to prepare for the subject of auditing, which is Option Module 10 in the Accounting Practice Stream in the BEC Business Studies Course, and to provide useful reading and exercises for others who may have different objectives but who, nevertheless, for academic or practical reasons require knowledge and understanding of auditing.

The role and the stature of the auditor grows with each successive enactment of company law. With the coming into operation of the two latest Companies Acts, those of 1980 and 1981, the scope of company audits has widened. The principal features of both Acts affecting the accounts of companies and of significance for their auditors, have been included in this volume. Both Acts introduce features which are new to English Company Law, both follow EEC Directives aimed at securing harmonisation with the company law of other member states, and both contain much material which is domestic in origin rather than attributable to EEC influence. There is, accordingly, much for the new entrant to the profession to learn, and, for the established auditor, more than a little to forget.

The newcomer to Company Law is probably to be envied rather than pitied. He may before long have the benefit of a consolidating Act which will present the current law in one volume, albeit a large one, instead of the five separate Acts now in operation, i.e. those of 1948, 1967, 1976, 1980 and 1981, each of which, other than the first-mentioned, amends in some degree one or more of its predecessors. (Even the 1981 Act amends some parts of the 1980) But let him beware! There are further EEC Directives still to come, and let him not suppose that the final domestic reform of the company law has been accomplished.

My thanks are due to The Controller, H.M. Stationery Office, for permission to reproduce extracts from the Companies Acts, and to the Association of Certified Accountants for their permission to reproduce extracts from the Members' Handbook, these being separately identified in the text. And, to my wife, but for whose forbearance the book could not have materialised and to whom it is now dedicated.

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Audits and Auditors

CHAPTER OBJECTIVES

After studying this chapter you should be able to:

- * understand the nature and purpose of auditing;
- * recognise the benefits of an audit;
- * understand the reasons for legislation regarding auditors and auditing;
- * appreciate the importance of distinguishing between accounting work and auditing;
- * appreciate the differences between an auditor's duties and responsibilities in statutory and private audits;
- * understand the position of a company auditor as agent of the members; and
- * realise the need for continuity of audit work and the importance of professional etiquette.

INTRODUCTION

The development of auditing

Auditing, in forms appropriate to the commerce of the times, is known to have been practised in the states of the Greeks and the Romans. Its origin appears to derive from a need for some check on the disbursement of public funds. Later, people who helped to finance commercial enterprises felt a similar need concerning their own funds and so commercial auditing came into being, albeit in a form which we today might regard as primitive. The range of audit work and the scope of the auditing function have widened since those early days by reason of the increase in the volume of commercial transactions and by the increasing sophistication of the methods which the greater volume demands. Today the fundamental need is not greatly different from that of early days; people who have put their money at some degree of risk want to know that the risk is being kept to the minimum. The methods pursued by the auditor have, however, changed, and it is with the techniques employed that this volume is largely concerned.

The nature and purpose of an audit

An audit is an independent examination of any available evidence to enable the auditor to report in accordance with the requirements of his appointment or of the law. The definition could be usefully expanded by insisting that the auditor's independence is paramount, and that his examination must be such as to enable him to

form an opinion in regard to the accounts which he has examined. He must state that opinion fearlessly in his report. There must be no constraint which might inhibit the auditor from doing so.

Auditor's report

The auditor reports to those who instructed him and to whom he is bound by contract, and the form of his report will depend upon the work which he was required to do; in the case of limited companies and of some other bodies governed by statute, the outlines of the report are defined by law. The requirements for companies are specified in the Companies Acts of 1948, 1967, 1976, 1980 and 1981. They will be discussed in some detail in a later chapter.

Subsidiary benefits of an audit

Whilst the purpose of the audit is to provide for those concerned with it an independent report on the matters specified in the instructions given to the auditor, or laid down by statute, benefits accrue which are subsidiary to the main purpose. The knowledge that an audit will take place has a salutary effect on those whose work comes under review, with the result that errors and fraud become less likely. Furthermore, the expectation of a forthcoming audit often acts as a stimulus to a business to maintain its records, not only accurate, but up-to-date.

There is a popular misconception that the prime purpose of an audit is the detection of error and fraud. This is not the case, but it should be noted that an auditor has frequently been able, by his knowledge and experience of accounting and business systems, not only to detect fraud but to reveal weaknesses which might allow fraud to take place.

Evidence

Evidence generally consists of accounting records, vouchers such as invoices, receipts, order books, delivery notes, paid cheques, assets of any description, correspondence—anything, in fact, which will help to explain a transaction or enable an auditor to check on the value of an asset or on the proper amount of a provision. Virtually nothing need be ruled out as potential evidence, and, in the case of a company audit, nothing can be ruled out if it is material to a transaction of the company. Moreover, it will be seen later that the auditor to a company has a statutory right, not only of access to the company's records, but to require from the company's officers any information or explanations which he considers necessary for his purpose.

The requirement for annual audit

As far as private businesses are concerned there is no requirement amounting to legal obligation to have an annual audit, but self-interest provides the pressure on all but the smallest to obtain the benefit of a professional opinion, particularly in the case of a full audit. Audited accounts are a great help, and often a necessity, when seeking a bank overdraft. Some partnership deeds embody a requirement for annual audit, but this is a matter which concerns the partners only. Nobody outside the partnership can enforce it. The legal requirement attaches to registered companies by s.159(1) of the Companies Act 1948, and to other bodies by their relevant statutes.

A study of the history of the joint stock company highlights the reasons for such a requirement, revealing the intention of the legislature to protect those who have invested in, or have become creditors of, a company. Industry and commerce received great impetus from the introduction and legalisation of the concept of limited liability, making it possible for the public at large to invest in shares in companies and thus obtain such rewards as might accrue to them as part proprietors, whilst their loss, in the event of failure of the company, was limited to the amount of capital they had agreed to subscribe. This facility enabled the joint stock company largely to replace the small privately-owned business.

Prior to 1900 there was no legal obligation to have a company's accounts independently audited, although many companies appointed one or more of their shareholders to carry out an audit and report to the body of shareholders. Some company formations were fraudulent, and the running of some others was questionable, losses falling on their shareholders and their creditors. The Companies Act 1900, made it compulsory for every company to appoint independent auditors at the company's expense.

Successive Companies Acts have since expanded the role and the authority of the statutory auditor, whose work culminates in the report which he appends to the company's final accounts and which he addresses to the company's members. In that report he must state whether, in his opinion, those accounts show a true and fair view of the company's transactions in the period under review and of the financial position at the close of the period. The "true and fair view" concept runs right through professional auditing, and, in practice, finds wide acceptance in privately-owned firms not subject to legal obligation, as well as in companies. The several statutes concerned have added to the responsibilities of the auditor, but they have also increased his powers and authority making him independent of the directors.

It should be noted that, whilst the Companies Acts require that

companies appoint an auditor and specify matters on which he must report, they do not stipulate any method by which the audit must be carried out. This is left entirely to the judgment of the auditor.

Classification of audits

There are three broad categories of audits, namely:

(a) those undertaken on the instructions of clients who, for reasons of their own, wish to have an audit. These are usually referred to as private audits.

(b) Audits of most corporate bodies, for whom an audit is a legal requirement. These are statutory audits.

(c) Audits conducted by an employer's own staff, referred to as internal audits.

NOTE: The audit of a solicitor's accounts may be said to be statutory as far as the requirements of the Solicitors' Acts are concerned, and private as to office transactions.

A different classification may be made by grouping according to the plan adopted for carrying out the work of the audit.

(d) *Final or completed audit*; this indicates that the work is carried out in a single session.

(e) *Interim audit*; under this the audit staff would attend at intervals during the period under review and deal mainly with the day-to-day transactions which would probably constitute the bulk of the work.

(f) *Continuous audit*; as the name implies the audit work goes on more or less continuously throughout the period.

(g) *Balance sheet audit*; this is a method which has found favour in dealing with large organisations, particularly in the United States. Its object is to eliminate some of the detailed work which might be necessary under a more conventional method. It is an interesting development, and will be dealt with in more detail.

Private audits

An auditor may be instructed by an individual, who might well be a trustee or a sole trader, or by a group of individuals, possibly joint trustees or a trading partnership. The audit may be required for the personal satisfaction of the individuals concerned or it may be stipulated in the deed which establishes the trust, or in the partnership agreement, either of which could define its scope. If not subject to any such constraint, however, the instructing client is not obliged to have an audit and he is able to specify the extent of the work to be carried out, which is to say that he could call for a full or for a partial audit. He could, for example, require only a cash book audit or an audit of his sales ledger.

It is important, both to the client and to the auditor, that the extent of the work required be made clear in writing, thus avoiding any subsequent dispute on that point. Failure to define clearly the precise scope of an auditor's work has resulted in litigation. If the agreement between client and auditor is made verbally the auditor should send to the client a letter setting out what he understands to be the extent of the work required of him, and he should obtain a confirmatory reply.

Distinguishing between accounting work and auditing

In the case of a full audit the auditor should be presented with the completed final accounts, as well as with the books of account and their supporting vouchers. It is not unusual for auditors to be asked, and even expected, to perform work which is not of an auditing nature and for which no provision has been made in the agreement with the client, such as completing entries in books of account, preparing profit and loss accounts and balance sheets or attending to taxation liability. The auditor should make it clear that such work is additional to the work undertaken, being of an accounting rather than of an auditing nature. The nature of the auditing function is by no means universally understood, and, if an accountant is instructed for purposes other than that of carrying out a full audit, he cannot be held liable for not discovering fraud which a full audit might have brought to light. *Apfel v. Annan Dexter & Co.* (1926).

Auditor's Report: importance of careful wording

The auditor will report to a private client precisely in the terms envisaged in the contract between them. He should consider carefully the wording of the report. Loose wording could give a wrong impression of the nature or scope of the work carried out and of the auditor's true opinion, and an auditor whose report was imprecise or ambiguous could be in a difficult position if called upon later to defend against a charge of negligence arising from a matter which appeared, though erroneously, to have been dealt with by him.

The case of *Apfel v. Annan Dexter & Co.* reveals two points of concern to accountants, whether instructed as auditors or otherwise, namely, the importance of:

- (a) a clear understanding by client and accountant of the work which the latter is required to perform, and
- (b) stating clearly in the report the work which has been performed.

Stated briefly, the essential features of the case were that a firm of accountants was sued by the trustee in bankruptcy of their client for

damages for failing to detect fraud committed during the period covered by their work. The accountants contended that they were instructed to prepare accounts for income tax purposes and not to carry out an audit. The certificate given on the accounts appeared to uphold their contention, and the accountants were held not to blame.

Statutory audits

Under this heading come the audits of various bodies for which Acts of Parliament have stipulated the carrying-out of an audit and the matters on which the auditor is required to report. These requirements have the force of law. Each such audit is a full audit, and its scope cannot be reduced either by the business concerned or by the auditor. The auditor is given wide powers to enable him to report as required. For example, he is given the right to require from officers of the company, or other body, any information and explanations which he considers are necessary for the purpose of his audit, and a right of access at all times to the records of the business.

The most common of such audits are those of limited liability companies, each of which must conform, not only to the requirements of its own Memorandum and Articles of Association, but to the provisions of the Companies Acts 1948 to 1981. Similar provisions apply to insurance companies, building societies, friendly societies, industrial and provident societies and unit trusts, which are governed by special Acts and their own rules. These special Acts follow the Companies Acts in principle, but not in all their detail, and for practical convenience in this volume reference is to the Companies Acts unless otherwise stated.

The legislature has shown its intention in the succession of Companies Acts in this century of making companies' accounts more revealing and more intelligible to those concerned with them, with the result that the work of producing and of auditing the accounts has tended to increase. Later we shall review the techniques which the auditor to a company adopts to enable him to report as the law requires. Briefly, he must give his opinion as to whether the company's balance sheet and profit and loss account, including group accounts where applicable, have been properly prepared in accordance with the requirements of the Companies Acts 1948–1981, and whether, in his view, a true and fair view is given:

(a) in the balance sheet of the state of the company's affairs at the close of the financial year;

(b) in the profit and loss account of the company's profit or loss for its financial year;

(c) in group accounts of the state of the group's affairs and of its profit or loss so far as the interests of the company's members are concerned, the company being the holding company.

In addition to the foregoing matters which call for specific reports, the auditor is required to form an opinion as to whether:

(d) proper books of account have been kept and proper returns received from branches not visited by him; and

(e) the balance sheet and profit and loss account are in agreement with the books;

but there is no need for specific reference to (d) and (e) if the auditor is satisfied on these matters. Similarly:

(f) if the auditor has not been able to obtain all the information and explanations which he considered necessary for the purpose of his audit,

he must specifically report accordingly, and, in the absence of such qualification, his satisfaction is assumed.

Internal audits

Many of the larger business houses have created a department, or a section, whose purpose is to carry out such audit work as the management considers desirable. The scope of the internal auditor's work is an internal matter, the persons appointed to carry out the work being employees of the business acting on the instructions of management, who, and who only, have the power to define the scope and the authority of the audit staff. Clearly, they cannot have the independence which is essential to the work of the external and independent auditor, whether statutory or not.

Equally clearly, the internal and the external independent auditors work towards similar ends, and often with the same material, but it must be remembered that the former is responsible to management, whilst the latter is responsible, in the case of a company, to the shareholders to whom his report is made. Nor should it be overlooked that the responsibility is a heavy one, and an auditor cannot lessen it in the knowledge that part of his work is duplicated by the internal auditor. This does not rule out the possibility of co-operation between the two auditors, but it does mean that the statutory auditor must make a realistic assessment of the efficiency and value of the internal audit before he decides to what extent, if any, he may rely upon it.

APPOINTMENT OF AUDITOR

Private and statutory audits contrasted

Private audits

The auditor to a private firm or sole trader is appointed and accepts appointment by mutual agreement with the trader or the principals of the firm, and he undertakes to perform the work which they require of him. It has been shown that the work required of the auditor can be a full audit, or sometimes less than that, and may involve work which is accountancy rather than auditing.

Statutory audits

On the other hand the auditor accepting appointment to a company, or other statutory body, undertakes to examine and report to the members on the profit and loss account and the balance sheet, on group accounts in appropriate cases, and on the accounts maintained by the company. The scope of the audit cannot be diminished. The emphasis must be on the fact that he reports to the members, not, it must be noted, to the directors. He can accept no instructions which could reduce his responsibility or his authority, which are given by statute. The Companies Act 1948, and as subsequently amended, defines the objectives of his audit, but leaves it to the individual auditor to decide the techniques by which he achieves those objectives.

Appointment to a partnership or to a sole trader

Where a partnership is concerned the consent of all the active partners is required. If the appointment is specified in the partnership agreement the consent is implied, for the partners must have agreed to be bound by its terms. If a full audit is not required the precise limitations on the work to be done should be in writing and agreed by all the partners.

Similarly, the agreed remuneration, or the basis on which it is to be calculated, should be incorporated in a formal document, or in an exchange of letters. The more precise the agreement and the more clearly it is set out in writing, the better it is both for client and auditor.

Special partnership appointments

A limited partner may appoint an auditor, who will act for the limited partner quite independently of the firm's auditor. Such an audit is not the firm's audit.

Other special appointments sometimes are made on changes occurring in the composition of the partnership, or for safeguarding

the interests of a sleeping partner. At times an auditor may be asked to suggest the terms on which a new partner might reasonably be admitted, or to calculate the value of an outgoing partner's share or the amount due to a deceased partner's estate. These appointments are distinct from the partnership audit and are separately remunerated whether the work is done by the partnership auditor, which would be the normal course, or by some other.

Where accounts are prepared from incomplete records

It not infrequently happens that an auditor, instructed by a sole trader or a small partnership, finds that the records maintained have been too meagre for a full audit to be feasible, and in such cases special care is needed in the wording of the report which should accompany the accounts, being either written on them or referred to in them.

The use of the word "audit" would not be appropriate in such circumstances as most of the work would have been accountancy. Such accounts are often required primarily for taxation purposes, but may be used for other purposes also, and in circumstances in which the signature of a professional accountant might suggest to a third party that a greater degree of reliance could be placed on the accounts produced than the supporting records justified or was intended by the signatory.

Appointment to a limited company

The appointment of the auditor to a company is compulsory and is provided for by s. 159 of the Companies Act 1948, in the following terms:

Every company shall at each annual general meeting appoint an auditor or auditors to hold office from the conclusion of that, until the conclusion of the next, annual general meeting.

Note the reference to "every company". This means every company registered under the Companies Act, so that private, as well as public companies, are included. No class of company is exempted.

Auditor as agent of the members

It is fundamental to an understanding of his responsibilities, his rights, his authority, his approach to the work and of his conduct of the audit, always to bear in mind that the auditor is appointed by the members to act as their agent to audit the company's accounts, the preparation of which is a responsibility of the directors. The directors themselves are, in effect, the servants of the members. It follows that the auditor must be completely independent of the

directors, fearless in asserting the principle which he considers should be followed in any given set of circumstances. His duty is to the members, not to the directors. It is not unknown for the exercise of this duty of independence to bring an auditor into conflict with the directors, but, provided the auditor acts conscientiously and with reasonable care and skill, he has statutory protection from dismissal by the directors, and this applies equally in public and private companies.

Students may care to reflect upon the curious and somewhat anomalous situation where the members, as principals, have no direct contact with the auditor who is their agent.

The first auditor

Usually the first auditor is appointed by the directors to hold office until the end of the first annual general meeting. In the case of a public company this is virtually inevitable, since the auditor is required to certify those parts of the statutory report which deal with:

- (a) shares allotted;
- (b) cash received for the shares;
- (c) receipts and payments on capital account.

A copy of the statutory report is sent to every member of the company not less than fourteen days before the statutory meeting, which must be held not less than one month nor more than three months from the date at which the company becomes entitled to commence business. It follows that, in a public company, an auditor is generally appointed before the members have met in general meeting.

It will be seen below that the directors may also appoint to fill a casual vacancy in the office of auditor, though a surviving or continuing auditor or auditors may continue to act.

It must be emphasised, however, that the authority conferred on the directors in these two cases, namely, to appoint the first auditor and to fill a casual vacancy, is a concession to practical convenience and is made without prejudice to the general rule that the auditor is appointed by the members and is their agent; the directors must be regarded, in fact, as acting for the members, who, through the power conferred on them, ultimately control the appointment.

Failure to appoint

If the directors fail to appoint the first auditor the company in general meeting may do so. If, at an annual general meeting, no appointment of an auditor is made the company must, within one week, notify the fact to the Department of Trade, whereupon the Department may make an appointment to fill the vacancy. Here,