
AUDITING

Principles & Practice

F Clive de Paula & Frank A Attwood

Sixteenth Edition

Auditing: Principles and Practice

Auditing

Principles and Practice

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PITMAN BOOKS LIMITED
128 Long Acre, London WC2E 9AN

PITMAN PUBLISHING INC
1020 Plain Street, Marshfield, Massachusetts 02050

Associated Companies

Pitman Publishing Pty Ltd, Melbourne
Pitman Publishing New Zealand Ltd, Wellington
Copp Clark Pitman, Toronto

© F Clive de Paula and Frank A Attwood 1982

Sixteenth edition 1982

British Library Cataloguing in Publication Data
De Paula, F Clive

Auditing principles and practice —16th ed

1 Auditing

I Title II Attwood, Frank A

657' 45 HF5667

ISBN 0-273-01716-0

ISBN 0-273-01778-0 (pbk)

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Text set in 10/12 pt VIP Times, printed and bound
in Great Britain at The Pitman Press, Bath

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Preface to the sixteenth edition

In April 1980 the first Auditing Standards and Guidelines, developed by the Auditing Practices Committee of the Consultative Committee of Accountancy Bodies, were published by the Councils of the English, Irish and Scottish Institutes of Chartered Accountants and by the Association of Certified Accountants. The Standards do not herald any change in fundamental objectives: they do no more than codify best practice such as we have described in previous editions of this text. They do however serve as a useful and timely reminder of the requisite basic procedures, and we seek in this new edition to provide the auditor with practical assistance in implementing the underlying principles.

In dealing with the Auditing Standards and Guidelines, we have drawn on the booklet which we were asked to write for the English Institute entitled *Auditing Standards: from Discussion Drafts to Practice*, which was published by the Institute immediately after the issue of the First Discussion Drafts of the Auditing Standards. This booklet was intended to give practical illustration of how the Standards might work and thereby assist the debate which led up to the finalization of the definitive Standards.

Accordingly we hope the book will be of assistance both to the practitioner wishing to review his audit procedures against the requirements of the Standards, and to the student preparing for his professional examinations in auditing.

This new edition also provides us with the opportunity to bring our text up to date in respect of the numerous changes in legislation and professional pronouncements with which the auditor must be concerned: viz. the recent Companies Acts and important Statements of Standard Accounting Practice dealing with Stocks and Work-in-Progress, Group Accounts, Deferred Taxation, and Current Cost Accounting. The auditor is only beginning to appreciate what this latest accounting convention is going to imply, but we hope we are able to be of practical assistance in highlighting the areas where attention will be required. For this, and for many other illustrations of procedural documentation which we have used, we are indebted to the partners of Robson Rhodes, who have allowed us to draw freely upon documentation used within the firm's own practice, and in particular we are

grateful to Mr P. R. Lemanski, MA, FCA, for his assistance with the chapter dealing with computer auditing. Any failings of the book, however, remain our responsibility.

It also gave us great pleasure to have been writing much of this book during the centenary year of the Institute of Chartered Accountants in England and Wales. To mark the achievement in reaching this proud age the Institute has published 'Accounting Thought and Education: Six English Pioneers', by J. Kitchen and R. H. Parker, and one of those pioneers chosen was the late F. R. M. de Paula, CBE, FCA, the original author of this book. To see him described as 'a standard bearer in the movement for fuller disclosure and greater comprehensibility in financial reporting' has given us heart in our task.

In this edition, we have broken new ground by the inclusion of a chapter on the subject of Audit Committees. There has been a good deal of public and professional discussion about these committees, which have become a familiar part of the public company scene in North America; but, so far, not much practical guidance as to the role which they might play in UK companies, or as to how they might set about their work. We have therefore drawn on practical experience of Audit Committee work in the UK in the hope that this may be helpful to anyone venturing into what is, for all of us, a very new field

Finally, the book contains numerous references to the material contained within the Members' Handbook of the English Institute and we are grateful for permission to quote from this and also to reproduce in full as an appendix the Auditing Standards. We would also like to express gratitude to the Controller of Her Majesty's Stationery Office for permission to reproduce the relevant parts of the Companies Acts.

1 Introduction to auditing

Historical Development

The practice of auditing, in a primitive form, can be traced back to ancient times, but auditing as it exists today was established only in the latter part of the nineteenth century.

In this country, during the nineteenth century, industrial enterprise was greatly expanded and the evolution of the mechanized factory involved the provision of finance far in excess of that required by industry under the old-fashioned hand methods.

Originally individual concerns were owned and financed by either a sole proprietor or a partnership, and naturally under this type of organization the finance and credit available was limited to that which the owners themselves could provide and influence. For this reason, therefore, the capital available for industry was strictly limited.

The introduction of the joint stock company greatly widened the possibility of raising capital for industry. As the liability of each shareholder was limited, it was possible to offer shares to the public and thus there became available to industry and commerce a vast new supply of capital. Thus in course of time the joint stock company largely took the place of the small privately owned business.

Under the company form of organization the shareholders as a body delegate the management of the undertaking to a board of directors, and periodically the board submits to the shareholders the accounts of the company in order that the members may see the financial position and the profit or loss of the undertaking in which they are interested.

In these circumstances the need arose for some means by which the shareholders as a body might be satisfied that the accounts, presented to them by their board of directors, did show an objective view of the financial position and results of the company. It was for this reason, therefore, that the practice developed of appointing auditors whose duty it was to verify on behalf of the shareholders the accounts of the directors and to report thereon to the shareholders. Obviously it is impracticable and impossible for every shareholder of a company to examine the books and records of a

company and therefore the shareholders as a body appoint auditors to act for them.

Under the early Companies Acts, the auditors appointed were one or two of the shareholders of the company. As, however, the chosen auditors commonly had no technical qualifications, they were probably not able to carry out a very effective audit — nor were they paid anything for the work they did, although a later Act did provide for them to employ a clerk to do some work, whose remuneration should be provided by the company.

It was the Companies Act 1900 which first made it legally compulsory for every company to appoint independent auditors, as we now know them, and provided for their remuneration. It was undoubtedly the rapid increase in the number of joint stock companies which took place at this time and the compulsory professional audit thus provided for in the Companies Act 1900 that gave a great impetus to the development of the accountancy profession.

Position of Auditors under the Companies Acts

Pursuant to the Companies Acts 1948 and 1967, every company in this country is required to have its accounts audited by professional accountants. Their appointment, and removal, are provided for in the Companies Acts: 1948 — Sections 159 to 161; 1967 — Section 13; 1976 — Sections 13 to 17. The appointment is made by the shareholders as a body and the auditor is, therefore, acting as their agent to audit the accounts of the directors, who themselves are merely agents of the shareholders, on whose behalf, and for whose benefit, the directors carry on the business. This fact must be clearly appreciated and borne in mind by the auditor. For, though in the course of his work he is constantly brought into contact with the directors, who conduct the business, he is not acting for them at all. He is appointed to act as a check upon the directors and to ensure on behalf of the shareholders, who are the proprietors of the business, that the directors carry on the undertaking honestly for the benefit of the shareholders and render to them true and fair accounts.

It is, however, of interest that, although the auditor is appointed by the shareholders, for whom he acts, the shareholders themselves appear to have no right of communication with the auditor whom they have appointed. If a shareholder has any question on the accounts upon which the auditor has reported, the shareholder cannot discuss the matter with the auditor. The law provides only for the shareholder to receive the auditor's report. There is, therefore, the slightly unusual situation of a 'principal' and 'agent' between whom there is no form of communication (other than the auditor's report).

The directors of a company, or the company in general meeting, are empowered to appoint auditors to fill a casual vacancy, and, failing this, the

power to make the necessary appointment rests with the Trade Secretary. In these cases, the auditor acts as the agent of the shareholders in exactly the same way as if he had been appointed at the annual general meeting.

Section 14(1) of the Companies Act 1976 provides that 'every company shall at each general meeting of the company', where accounts are laid before the company, 'appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next general meeting of the company' where accounts are received. An auditor, however, may be removed during his term of office by ordinary resolution of the company.

Section 15 further provides that if a resolution is to be proposed at a general meeting of a company appointing as auditor someone other than the retiring auditor, special notice must be given to the company. The company must in turn send a copy of the notice both to the newly proposed auditor and to the auditor who is to retire or be removed. The latter may then make written representations which the company (unless the representations are defamatory) should distribute to its members; or if the distribution is not made, the auditor can have the representations read out at the general meeting. The auditor is entitled to attend the meeting and to receive all notices about any such meeting to which a member would be entitled.

If an auditor wishes to resign, he must under Section 16 give the company written notice, which must include either 'a statement to the effect that there are no circumstances connected with his resignation which he considers should be brought to the notice of the members or creditors of the company, or a statement of any such circumstances'.

The auditor has further powers under Section 17 in that he can deposit a written requisition with the directors of the company to convene an extraordinary general meeting to discuss the circumstances of his resignation and to send his resignation statement to all members entitled to attend the meeting. If the statement is not so sent it should be read out at the meeting. The auditor may attend the meeting himself and should continue to receive notices of, and be able in his capacity as auditor to speak at, other meetings of the company. Directors failing to take reasonable steps to convene the meeting within twenty-eight days of the auditor's requisition are liable to a fine.

In the past, cases arose in which conscientious auditors who carried out their duties properly, and in consequence came into conflict with the directors, were not re-elected at the annual general meeting, the directors nominating someone else for the appointment without giving any notice beforehand to anyone.

The position of auditors in relation to directors who wish to displace them was usefully brought out in The City of London Real Property Co. Ltd affair in 1963. A difference of opinion arose between the board of that company and its auditors and the directors proposed to replace the auditors by another firm.

The Institute of Chartered Accountants in England and Wales considered that the proposal raised issues of such fundamental importance that it issued a statement dealing with the displacement of auditors and, *inter alia*, emphasizing:

‘The auditors of a company are appointed to represent the shareholders in accordance with the requirements of the Companies Act and have a statutory duty to make a critical review of the accounts submitted by the directors and to report to the shareholders whether those accounts show a true and fair view and comply with the requirements of the Act.

If the auditors disagree with such accounts to any material extent their duty is to say so in their report and to specify the material respects in which they disagree.

The fact that the auditors disagree, if they do so, is not a justification for their displacement unless the reasons for their disagreement are such that the *shareholders* no longer have confidence in the judgement, competence or conduct of the auditors as their representatives.

Confidence between directors and auditors, whilst obviously desirable, is not indispensable for the adequate performance by the auditors of their onerous duties on behalf of the shareholders; indeed in some circumstances the performance of those duties may lead inevitably to differences of opinion between the directors and auditors and to a report to this effect by the auditors to the shareholders.

The existence of such a possibility is among the reasons why auditors are appointed. The work of auditors and their freedom to perform it with a sense of complete independence can only continue as long as it is generally accepted that the issue by auditors of a report expressing disagreement with the directors of a company of which they are auditors does not of itself provide a reason for the removal of the auditors from office. The purpose implicit in the appointment of auditors under the Companies Act would be defeated if there were to grow up a practice of displacing auditors whenever a disagreement between them and the directors of a company occurs on a matter of accounting principle.’

Subsequently in 1963 the board of The City of London Real Property Co. Ltd, in the light of the considerable opposition aroused, withdrew its resolution. The Companies Act 1976 has now strengthened the relationship between shareholders and auditors.

The remuneration of the auditors, in the same way as their appointment, rests entirely with the shareholders, except where, as a matter of convenience, the directors act for the shareholders in the case of the appointment prior to the first annual general meeting, or where a casual vacancy occurs. Again in these latter circumstances the remuneration fixed by the directors only holds until the next annual general meeting. Nevertheless, it is common practice for shareholders in general meeting each year to delegate to the directors the power to fix the remuneration of the auditors.

Qualifications of an Auditor

Section 161 of the Companies Act 1948, and Section 13 of the Companies Act 1976, provide that an auditor, legally competent to exercise a company audit function, must be a member of a recognized body of accountants. Section 161 further specifies that none of the following persons shall be qualified for appointment as auditor of a company:

- (a) An officer or servant of the company.
- (b) A person who is a partner of, or in the employment of, an officer or servant of the company.
- (c) A body corporate.

The principle underlying these provisions is that an auditor shall be in an independent position, and so no director or officer of the company can be appointed, or be in a position to exert influence over an auditor.

The above provisions now apply to all limited companies, since the Companies Act 1967 abolished the status 'exempt private company'. These companies were previously allowed to have unqualified auditors or auditors who were partners of directors.

It was not uncommon in the past to find, say, one partner of a firm of accountants acting as director or secretary of the company, and another partner as auditor. In these circumstances the auditor might find himself in conflict with his partner who was a director of the company. The provisions of Section 13 now make such appointments illegal.

Although an officer of the company cannot be appointed as auditor, it is of interest that an auditor appointed under Section 159 of the Companies Act 1948 becomes an officer of the company, and as such has responsibilities and liabilities which are considered in later chapters.

Qualifications required by an auditor are many and varied. First of all, he must have a complete and thorough knowledge of bookkeeping, accountancy and costing. An auditor in course of time is called upon to deal with many different systems of bookkeeping in many different businesses, and unless he understands exactly how such accounts should be prepared, he cannot audit them. Therefore, he must know his subject and be able to apply his knowledge to any set of circumstances. He must thoroughly understand practical business, and be able to grasp the technical details and the business methods of any concern whose accounts he is called upon to audit. A knowledge of accountancy is essential, but that alone will not make a competent auditor, for the art of auditing is quite apart and distinct from accountancy. Many beginners seem to think that, provided they are able to follow the system of bookkeeping and that the trial balance agrees, everything must be in order, and the auditor has only to check the preparation of the profit and loss account and balance sheet and to sign his report. The

agreement of the trial balance in itself proves nothing, not even the arithmetical accuracy of the books.

In addition to his technical knowledge, he must be above all things a man possessed of both strength of character and tact. He must not be easily led and influenced by others but, knowing what his duty is, he must do it in spite of direct or indirect pressure. In the long run the reputation he will thus gain for absolute integrity will prove of far greater value to him. An auditor must also be methodical and painstaking and he must be endowed with considerable perseverance, for it is essential that the work should be thoroughly and carefully done. He must never pass any item unless he understands its nature and is absolutely satisfied that it is in order. If he is not, he must make intelligent and exhaustive inquiries until he has ascertained the exact state of affairs. One of the greatest dangers is to pass entries which are not completely understood, because the auditor is fearful of displaying ignorance by asking questions. If he cannot ascertain for himself, he should, without fail, ask for the necessary information. Should he affect to possess knowledge which, in fact, he does not, he inevitably will make mistakes which will be far more damaging to his reputation than would be the case if he asked for information upon, for instance, technical details of which he has not had previous experience. An auditor must be practical, and if asked for professional advice, must appreciate the practical requirements and circumstances of the business, and thus avoid making recommendations which, though perhaps theoretically perfect, are entirely unfitted to the circumstances of the particular business. However, the auditor cannot insist upon his recommendations being carried out; his only sanction is his report.

Finally to revert to the question of independence: it has already been mentioned that the development of the accountancy profession has partially resulted from the shareholders' need for an objective review of the accounts prepared by the directors, and it has been explained how the Companies Acts seek to regulate the appointment and protect the position of auditors so that their independence may be assured. This is a subject which has received considerable attention first in the United States of America, and now within this country, both from the professional bodies and from individual firms within those bodies. It is also one which has seemed the more urgent following other criticisms of auditors, to which we refer later. In consequence, the Institute of Chartered Accountants in England and Wales issued in October 1979 a revised 'Guide to Professional Ethics', which stipulates that 'a member in practice should be, and be seen to be, free in each professional assignment he undertakes of any interest which might detract from objectivity'. No doubt this will serve to help clarify the attitudes required of an auditor, but there is far more to independence than can ever be ensured by regulation or legislation, for it is a function of the professional ethics of the individual auditor.