Auditing

Michael J. Pratt

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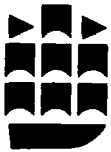

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Preface

Auditing has the potential to be one of the most stimulating of all the professional accountant's areas of study. For it combines the most interesting areas of financial accounting (accounts presentation and review) within a framework of inquiry and investigation, and involves a wide range of knowledge and sophisticated techniques. Yet it is often regarded as the most boring subject of all. I certainly found it so when I was studying, although in practice this was far from the case. When I came to teach the subject, both in a professional environment, and subsequently in public and private sector colleges, I quickly discovered that it was perhaps the most difficult of all subjects in which to maintain student interest. For there is such a vast body of knowledge that must be learned and understood. And students cannot practice their knowledge with worked examples in the same way as they can in accounting. But I found after much trial and error in the classroom that interest could be maintained by logical presentation, and by the use of plenty of case studies and anecdotes. I have tried to incorporate all of these into this book. And I have laid emphasis on logical presentation, this being so essential both for the maintenance of interest and for understanding. Without it, the subject degenerates into a huge mass of unrelated facts, with the result that learning becomes a chore, to be performed for the sole purpose of passing an examination.

The old generation of text books has, in my view, been largely responsible for perpetuating (or perhaps even perpetrating!) this unstructured approach, and this, combined with their rigid style and tortuous phraseology, has, I believe, done much to further auditing's poor student image. So I have tried to make this book as readable as possible.

'Auditing' is primarily a book for students, and the structure is such that it is suitable for all levels up to final professional. But it is particularly aimed at the student commencing his study of auditing, to take him through, comfortably I hope, to his finals. First level professional students can ignore those sections in the final chapters which are marked with an asterisk, and are advised to concentrate on aspects of internal control and testing. Final year students will profit by a thorough knowledge of the audit of final accounts, and presentation.

The book is not primarily designed for the practitioner, though he may well find the various forms and check lists illustrated to be of some interest. In addition, the practitioner who would appreciate a synopsis of current large-firm pro-

cedures may also find value in these pages.

The body of knowledge incorporated here is not original. No book on auditing can claim that. For this knowledge is based on years of research and gradual development in the profession, in both large and small firms alike. In particular I am grateful to the Institute of Chartered Accountants in England and Wales for permission to reproduce extracts from their various publications, to Deloitte, Haskins and Sells for allowing me to include many of their forms and documents and for providing much source material, and to Peat, Marwick Mitchell and Co., for allowing the inclusion of extracts from their audit documentation. But the format herein adopted, together with opinions as to likely and necessary future developments, are entirely my own. These, together with any mistakes, I take responsibility for. Some of what I have to say, even as early as Chapter 1, may well provoke controversy; but only through controversy are problems solved. So if this book helps students to approach their study of auditing with an enquiring mind, then I shall consider this a measure of success.

My grateful thanks go to Ian Marrian and D. Lawrenson of Deloitte, Haskins and Sells and to Professors J. T. Steele and I. Macgregor for kindly reading the manuscript and making helpful comments thereon. Sincere thanks also to the many generations of students with whom I have formulated the teaching approach used in this book. And finally my very best thanks to Helga, my wife, for logic checking the entire manuscript and for suggesting and helping to implement the concept diagrams which I believe to be an important feature of the book.

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I
What is an audit?

1.1 Introduction

If you were to ask the average man on a Clapham omnibus about the auditor's work, he would probably tell you that he prevents fraud. Were you to press our layman further, he may paint you a picture of a rather grey individual who buries himself in ledgers, emerging only from time to time to produce sets of figures which are not important anyway.

Such is the image that the auditor has attracted in the past. But it is inaccurate, and unfair. Inaccurate, because the auditor's primary responsibility is neither to prevent fraud, nor to produce figures. Unfair, for his is a highly skilled professional task without which the modern economy could not function.

So what does the auditor do? Well, the word audit itself, derives from Latin, meaning 'to hear'. And in times gone by the accounts of an estate were called over by those who had compiled them, and were 'heard' or audited, by those in authority. Through usage the word has come to denote the *independent* checking and validating of figures which have been produced to account for the usage of funds. The production of such 'accounts' is not part of the audit function, but is the job of the accountant; though sometimes one person will wear both hats, first producing, then checking. This is arguably not desirable in that it could involve a loss of independence – the auditor's *raison d'être*. But more to this later.

I have just stated that it is not the auditor's principal job to prevent fraud, or indeed error. This is so. But clearly where accounts contain substantial undisclosed fraud or error they will not present a reasonable picture of an enterprise's activities. And so, the auditor would be expected not to validate such accounts. Just what constitutes 'substantial' and 'reasonable' is embodied in the concepts of 'materiality' and 'truth and fairness' which will be discussed in more detail later on in the chapter.

1.2 Who needs an audit?

The need for audit is as old as business itself. For whenever owners of funds provide capital for an enterprise, there is a need for accounts. If only one person contributes to the project, then he can himself scrutinise the accounts to gain assurance that they are reasonable; he can perform his own audit, assuming that

he has sufficient skill and experience. But as soon as a group of people come together to form a joint project, it is no longer feasible for each of them to check and validate the accounts. So it makes sense to appoint one skilled person for the task. And in order that no individual entrepreneur should be accused of having an advantage over the others, it is reasonable to appoint a person independent of both the providers and users of the capital. This concept of independence is extremely important, and is examined in detail in Chapter 2.

Auditing in its modern sense, albeit in primitive form, has been with us since the sixteenth century, when the division first started to grow between those who provided capital, and those who engaged in business activity. As commercial enterprises became more sophisticated, two problems manifested themselves:

1. phony projects sprang up, the only objective of which was to relieve gullible backers of as much finance as possible;
2. the lack of a formal accounting requirement meant that the entrepreneurs of even genuine projects were able to cheat the providers of capital.

The first problem was perhaps the most serious, and was the first to be subject to a long line of legislation, culminating in the latest Prevention of Fraud (Investments) Act in 1958. The information sheets (or 'prospectuses') given to potential backers gradually became subject to stringent controls, and the information in them to independent check. Such checking is not strictly an audit, but may be regarded as an investigation. Investigations will be dealt with in detail in Chapter 22, and you should note that this area is covered in the advanced syllabuses of the professional examinations.

With the advent of 'limited liability' companies in the eighteenth century, the lack of formal accounting requirements gave rise to increasing problems. As is well known, in a limited company, the providers of capital can be called upon for no more than their original investment, to pay off the company's debts. This development enormously facilitated the growth of enterprise, in that large and small investors could safely contribute the amount of money they could afford to lose, and they could exactly quantify the amount at risk. The resulting increase in the number of people providing capital gave rise to the need for legislation to protect investors from the inefficiency and perhaps deceit of their management (who in time became known as 'directors'). Hence the need for formal accounts for the benefit of investors. But it was not until the turn of the twentieth century that a *mandatory requirement* for the audit of limited company accounts, and for the presentation of an audit report to members was finally embodied in the Companies Acts. And it was not until the 1948 Companies Act that anything like realistic accounting and audit safeguards were incorporated into the law. Even now company law lags a long way behind the requirements of the modern business environment. There are many areas of deficiency, as we shall see in Chapters 15 and 23, but the following are perhaps the two most significant:

1. Small companies.
2. The requirements of people, other than shareholders, who are interested in the accounts of business enterprises.

1. Small limited companies have exactly the same rights of limited liability as large listed companies, and in law they have similar reporting requirements in terms of audited accounts. It is arguable that small management-owned companies should only have the rights of limited liability if they have a minimum, substantial paid-up capital (such rules apply already in many European countries). However, here is not the place to discuss such a contentious aspect of company law reform. But what is relevant now is a discussion of audit requirement for such companies. As we have seen, the audit requirement for limited companies grew out of the divorce of the ownership from the usage of funds. But with certain small limited companies where the owners and managers are one and the same (and such 'proprietorship' companies constitute a large proportion of companies on register) there can be no need for an audit in the sense that is envisaged in company law. For there is obviously no need to protect owners from managers, when they are the same people. Not only is the current audit requirement illogical, it is also impractical; but more to this in Chapter 18.

2. Many different classes of people are interested in the accounts of a company, in addition to the shareholders. Creditors will usually have a substantial investment, and bankers too, while the Inland Revenue has (currently) a 52 per cent interest in the company's profits! And yet none of these people receive protection under company law. With one very minor exception (more later), they do not even get a mention. Such people have no rights to receive an audit report, nor are the accounts produced with them in mind. The accounts and audit report are produced for the members. So if things go wrong, they have no rights to sue either directors or auditors, except in very specific circumstances which will be dealt with in Chapter 21.

These two significant contemporary problems will be dealt with in Chapter 18 (The audit of small limited companies), and Chapter 23 (Contemporary developments). But it is important to appreciate these limitations in the current audit requirements, before we proceed to the detail of the book.

1.3 Why have an audit?

The answer to this question for a limited company is simple. Company law says you must, and provides for substantial penalties if you do not! But this rather begs the question. So let us look at the advantages that can ensue from having accounts audited. These advantages can be different for various types of organisation, so we will examine each in turn.

Large limited companies

The main advantage here lies in the protection that is afforded to the shareholders who, in complex organisations, will usually be divorced from management. But in addition other interested parties can gain some confidence from accounts that have been subject to independent audit, even if those accounts have not been

produced specifically with third parties in mind. Such confidence is essential to the proper functioning of the economy, for without it trade would decline and companies founder. The audit can be said to inspire the confidence which oils the machinery of business; and, as a further advantage in large companies, the auditor's experience will enable him to make recommendations for improvements in the systems of control which can make the company less susceptible to fraud by its customers, suppliers and employees. Finally the auditor can ensure that the accounts are produced in line with best practice and conform with all relevant standards; such conformity being essential to the proper interpretation of the figures produced.

Proprietorship companies

We have seen that there is no need for an audit of the accounts of small owner-run limited companies in the sense of protecting the shareholders. But banks, creditors and the Inland Revenue can gain some confidence from the audited accounts, albeit issued to the shareholders, rather than to them; although just how much use such accounts actually are is a matter of debate. This is discussed in Chapter 18. But if the bank and/or the Inland Revenue are satisfied with the shareholders' audited accounts, then clearly the audit has proved useful in minimising explanations and saving time.

Most small companies will not normally require, or practically be able to achieve, the sophisticated control systems that are necessary in larger businesses to safeguard against fraud and error. Nevertheless, the auditor will be able to advise on those checks that may be appropriate to the needs of the firm.

Finally, should the proprietor of a small company ever decide to sell his business, he will be in a much stronger position to ask a good price if he is able to produce authenticated accounts showing how the business has fared over the past few years.

Partnerships

So far we have concentrated on limited companies, and this reflects practice in professional examinations. But partnerships too can benefit from having an audit, although there is *no statutory requirement* for them so to have. All the advantages quoted above for the proprietorship company apply equally here, and in addition the following benefits may also be derived:

(a) the independent audit could minimise disputes between the partners, and such disputes are a common cause of partnership dissolution;
(b) changes in the partnership will often involve complex changes in capital and goodwill, so that an audited set of accounts will ensure that the new partnership sets out on a sound basis.

Sole traders

As with partnerships, there is no requirement for sole traders to have their

accounts audited, but the advantages quoted above in respect of the proprietorship company are equally applicable here.

Special classes

Building societies, banks, insurance companies, investment trusts, friendly societies and charities are all special classes of organisation which have their own rules, and which require the production of audited accounts. The audit principles are largely the same, but the approach sometimes different. These are largely specialist audit areas, but a general knowledge about them is required for the professional examinations, and they are, therefore, dealt with in Chapter 22 of this book.

And *in addition to the audit function*, the qualified auditor will be able to offer all his clients a wide range of professional services including accountancy, taxation, company secretarial work, management and financial consultancy, valuations, and even, should it be necessary, advice on bankruptcy proceedings. All this is largely outside the scope of this book, but some of these matters are dealt with in Chapter 22 in so far as they are relevant to the auditing syllabuses of the professional examinations.

1.4 Introduction to true and fair

Company law requires that all limited companies appoint an auditor whose task is to express an independent opinion on the reasonableness of accounts produced by the directors for stewardship purposes. But just what constitutes reasonableness is a highly subjective matter. The early Companies Acts required the auditor to certify as to the truth and correctness of accounts, the phrase 'true and correct' implying arithmetic accuracy. And this indeed is largely what early audits concentrated upon. Hence if you look back in old ledgers you will find that many or most of the entries have ticks next to them implying that they have all been individually checked for authenticity and for arithmetical accuracy. But such an approach largely ignores the overall view of the accounts, and would in any event not be feasible with the large multinational corporations of today. Further, it is not possible to certify that any one set of accounts is *the correct* set, because so many accounting areas are susceptible to a wide variety of interpretations and therefore presentations. The treatment of depreciation, stock, goodwill and deferred taxation are all obvious examples of where there are many different possible treatments, each one of which can be justified. Hence there can be no *one* correct set of accounts, and this was recognised in the 1948 Companies Act which required the auditor to express an opinion as to whether the accounts show a true and *fair* view of the state of affairs of the company (balance sheet) and of the profit or loss for the period under review. The concept of fairness is now considered to be far more important than absolute arithmetic accuracy. But just what constitutes true and fair will take us the rest of this book to discover.

However, certain points must be made at this stage. You should note that the auditor now expresses an *opinion* on the accounts; he does not certify them. This must necessarily be so, as where there is the possibility of differing treatments in many different accounting areas, there must inevitably be the possibility of disagreement over what is fair presentation. An auditor will express *his* opinion whether in *his* view the accounts are true and fair. Other people may think differently.

But before you begin to think that this sounds like a recipe for chaos, we can identify a number of important principles which go to make up the concept of Truth and Fairness.

1. *Materiality.* The concept of *materiality* is closely related to that of truth and fairness. In a paper entitled 'Materiality in Accounting', the Accountants International Study Group (see sec. 1.5) concluded that Materiality is essentially a matter of professional judgement. An individual item should be judged to be material if the knowledge of that item could reasonably be deemed to have influence on the users of the financial statement – i.e. if it alters the true and fair view. Just what constitutes materiality is the subject of further discussion in Chapter 11. But a brief word of explanation is appropriate here.

Materiality is a relative concept. What is material in one company may well not be material in another. A £1,000 error in the accounts of a corner shop would probably be material, but in the accounts of ICI Ltd it would not in any way effect the reader's view of the figures presented to him. The Accountants International Study Group states that quantitative guidelines can be identified to help in distinguishing material items, and they suggest figures of 5 to 10 per cent as being the cut-off point, when compared to an appropriate base (much less in certain specific areas).

The concept of materiality is extremely important to the auditor in that it assists him in determining whether the true and fair view has been distorted. In addition, it will indicate to him the amount of work that should be done in any particular audit area. For example, if it transpired that were the entire petty cash of a particular firm to be misappropriated, it would not be material, then little audit work would be necessary in that area for the auditor to be able to express an opinion on the accounts as a whole.

2. *Fraud and error.* Substantial fraud or error may clearly result in accounts which do not show a true and fair view – but only if the fraud or error remains undiscovered. Those that are revealed can be incorporated into the accounts, in order to show a fair picture of the activities of the company in the period under review.

It follows from our discussion of materiality that any *material* fraud or error must be discovered by the auditor, because by definition it will effect the truth and fairness of the accounts. But if a fraud or error would not be deemed to be material, then the auditor is under no obligation to bring it to light; although we will see during subsequent chapters that normal audit procedures can usually

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