Preface	v
	: Auditing in perspective 1 on to Part One 3
1 What 1.1 A 1.2	is an audit? 5 Auditing defined 5 Key components 5 1.2.1 Entity 5 1.2.2 Performance, position and information 6 1.2.3 Competent, independent person 6 1.2.4 The collection and evaluation of evidence 6 1.2.5 Established criteria 6 1.2.6 Reporting an opinion 7 Auditing and information 7 Types of audit 9 1.4.1 Financial statements audits 9 1.4.2 Regularity audits 9 1.4.3 Management and operational audits 9 1.4.4 Social audits 10 1.4.5 Internal audits and external audits 10
1.5	Summary 10
2 Why 2.1 2.2 2.3 2.4 2.5 2.6	audit? — the auditing environment 12 Demand and supply 12 Accountability 12 2.2.1 Stewardship relationships 12 2.2.2 Other interests 13 Economic explanations for auditing 13 2.3.1 Agency contracts 14 2.3.2 Information for decisions 14 2.3.3 Auditing as insurance 14 The auditing environment 15 2.4.1 Audit firms 16 2.4.2 Parliament, the law and regulatory agencies 16 2.4.3 The professional bodies 17 2.4.4 The courts and professional liability 20 The statutory audit requirement 20 2.5.1 Auditing provisions in company law 21 2.5.2 The historical development of the statutory audit 25 Summary 25
3 Audi 3.1 3.2 3.3 3.4	tor behaviour — independence and ethics 26 Introduction 26 The importance of independence 26 What is auditor independence? 27 Factors strengthening independence 27 3.4.1 Company law 27 3.4.2 Professional recommendations 28 3.4.3 Individual firms' rules 29

4

3.5	Factors threatening independence 30
	3.5.1 Fees 30
	3.5.2 Services 30
	3.5.3 Appointment 30
	3.5.4 Competition between audit firms 30
	3.5.5 Incorporation 30
3.6	
3.7	Monitoring proposals 31
	3.7.1 Professional rules 31
	3.7.2 Legal regulations 31
	3.7.3 Disclosure of information 31
	3.7.4 Audit committees 32
3.8	Structural proposals 32
	3.8.1 changing the tenure of audit appointments 32
	3.8.2 Separation of auditing from other services 32
	3.8.3 A regulatory agency 32
3.9	Other ethical considerations 33
_	3.9.1 Confidentiality 33
	3.9.2 Obtaining work, publicity and advertising 33
	3.9.3 Changes in appointment 33
3.10	Summary 33
	- Sammary 00
	ility and the duty of care 35
4.1	
4.2	
4.3	The state of out of the state o
	4.3.1 Guidance from cases 36
	4.3.2 Audit risk, audit failure and business failure 37
4.4	To whom is the auditor liable? 37
	4.4.1 Privity 37
	4.4.2 Proximity 38
4.5	Cases on third party liability 38
	4.5.1 Candler v Crane Christmas 38
	4.5.2 Hedley Byrne v Heller 38
	4.5.3 Scott Group v McFarlane 39
	4.5.4 JEB Fasteners v Marks, Bloom 39
	4.5.5 Twomax v Dickson, McFarlane & Robinson 39
	4.5.6 Lloyd Cheyham v Littlejohn 40
	4.5.7 Caparo Industries v Dickman 40
	4.5.8 Al Saudi Banque v Clark Pixley 41
4.6	Summary 41
Colle	ecting audit evidence 43
5.1	The need for evidence 43
5.2	Sources of evidence 43
	5.2.1 Internal evidence 43
	5.2.2 External evidence 44
	5.2.3 Auditor-generated evidence 44
5.3	Types of evidence 44
	5.3.1 Observation and physical examination 44
	5.3.2 Documentary testing 45
	5.3.3 Reperformance 45
	5.3.4 Enquiry and confirmation 45
	5.3.5 Analytical procedures 45
5.4	Desired qualities of audit evidence 46
	5.4.1 Relevance 46
	5.4.2 Reliability 46

	5.4.3 5.4.4 5.4.5	Objectivity 47 Conclusiveness 47 Comprehensiveness 47
	5.4.6	Efficiency 48
5.5		s in using audit evidence 48
0.0	5.5.1	Availability 48
	5.5.2	Quantity v quality 48
	5.5.3	
	5.5.4	Aggregation 49
5.6		pjectives 49
		Existence or occurrence 49
	5.6.2	Completeness 49
		Rights and obligations 49
	5.6.5	Valuation and allocation 50 Presentation and disclosure 50
5.7		it process 50
5.8	Planning	·
		Understanding the business 51
	5.8.3	Assessing risk and materiality 51 Understanding and evaluating internal control 52
	5.8.4	Determining audit approach and procedures 52
	5.8.5	
5.9	Collection	on of evidence 53
	5.9.1	Tests of controls 53
	5.9.2	Substantive testing 53
5.10	Forming	an opinion 54
		Aggregating evidence 54
	5.10.2	Overall review of financial statements 54
		Deciding an opinion 54
5.11	Summa	ry 54
Repo	rting an	audit opinion 56
		tion 56
6.3	A judge	es of audit reporting 56 mental opinion 57
		hip of audit reports 57
		dised reports 57
6.6		ments of the audit report 58
	6.6.1	The formal lines of communication 58 The scope of the report 58
	6.6.2	The scope of the report 58
	6.6.3	The basis of the auditor's report 58
		The content of the opinion 59
6.7		nd fairness 60
	6.7.1	The meaning of true and fair 60
	6.7.2	An overriding requirement 60
	6.7.3	Establishing truth and fairness 60
	6.7.4	The influence of accounting standards 61
6.8	Types of	fopinion 61
	6.8.1	Unqualified opinions 61
	6.8.2	Reports giving other than an unqualified opinion 62
	6.8.3	Material v fundamental 62
6.9	Other re	
	Summa	
Refer	ences an	d further reading 64

Part Two: A practical approach to an audit 65

Introduction to Part Two 67

7	Plan	ning and audit objectives 69
	7.1	Why the auditor must plan the audit 69
	7.2	Who should perform the planning 69
	7.3	Scope and nature of audit planning 69
	7.4	Phases of planning 70
	7.5	Determining the objectives of the engagement 70
	7.6	Engagement letters 71
۸.,	pendic	
ΛÞI	7.1	
	7.1	Specimen memorandum of terms of engagement for a company client 72
8	Unde	erstanding the client's business 77
	8.1	Why an auditor needs to understand the client's business 77
	8.2	What an auditor needs to know 77
		8.2.1 Introduction 77
		8.2.2 The nature of the business 77
		8.2.3 Organisation and operating characteristics 79
		8.2.4 The business strategy 80
	8.3	Learning about the client's business 80
	0.0	8.3.1 Planning the information gathering exercise 80
		8.3.2 Sources of information 81
		8.3.3 Recording and assimilating the information 83
Δъι	pendic	
~PI	8.1	Understanding the client's business — checklist 84
	0.1	onderstanding the cheft's business — checklist 84
9	Audi	t risk and materiality 89
	9.1	Introduction 89
	9.2	Nature of audit risk 89
	9.3	Nature of materiality 90
	9.4	Assessment of audit risk 91
	•	9.4.1 Overall assessment at the financial statement level 91
		9.4.2 Assessment at the account balance or class-of-transactions level 91
	9.5	Consideration of materiality 92
	0.0	9.5.1 Planning materiality 92
		9.5.2 Keeping track of errors 95
	9.6	9.5.3 Materiality at the account balance or class-of-transactions level 96 Forming an audit opinion 96
	3.0	
		F
		9.6.3 Accounting policies 97
		9.6.4 Separate disclosures 98
10	Inher	ent and internal control risk 99
		Introduction 99
		10.1.1 What this chapter is about 99
		10.1.2 Requirement to understand the internal control structure 100
	10.2	
	10.2	
		10.2.1 Importance of the control environment 100
	100	10.2.2 Effect of dominant individual 103
	10.3	Accounting system 103
		10.3.1 Importance of the accounting system 103
		10.3.2 Legal requirements 105

	10.4	Control procedures 106 10.4.1 Types of control procedure 106 10.4.2 General controls 106 10.4.3 Application controls 108 10.4.4 Controls over assets 108
		10.4.5 Security of data 109 10.4.6 Identifying and assessing controls 109
		10.4.7 Detect v prevent controls 109 10.4.8 Focus on completeness 110
		10.4.9 Outside service centre 110
		Documenting the internal control structure 111
		Walk-throughs 112 Assessing inherent and control risk 112
	10.7	10.7.1 General principles 112
		10.7.2 Preliminary assessment of inherent and control risk 113
		10.7.3 Further reduction in assessed level of inherent and control risk 114
App	endic	
	10.1	Checklist of environmental inherent and control risk factors 115
	10.2	Checklist of common control procedures 118
11	Other	r influences on audit planning 123
	11.1	Preliminary analytical procedures 123
		11.1.1 Nature of analytical procedures 123
		11.1.2 Analytical procedures in audit planning 124
		11.1.3 Examples of financial information and ratios 125
		11.1.4 Documenting preliminary analytical procedures 126
		Involvement of other auditors 126 Use of internal auditors 127
		Use of the work of specialists 128
	11.4	Ose of the work of specialists 120
12	Deve	loping an audit strategy and audit programme 130
	12.1	Strategy and detailed planning 130
	12.2	Decision levels in an audit strategy 130
		Developing an audit strategy 131
	12.4	Examples of strategies 133
	12.5	Communicating the audit plan 136 Developing audit programmes 139
		Developing addit programme
App	endic	es Audit planning memorandum — checklist 141
13		scheduling and staffing the audit 142
		Introduction 142 Work scheduling 142
		Staffing 143
	13.3	13.3.1 The main influences on staff allocation 143
		13.3.2 Scope, complexity and risks 143
		13.3.3 Timing factors 144
		13.3.4 Client's assistance 144
	13.4	Preparing audit time budgets 145
App	pendic	es
	13.1	The audit team 146
14	Tests	s of controls 149
•	14.1	Introduction 149
	14.2	Objective of tests of controls 149
	14.3	Types of tests of controls 150
		14.3.1 Observation 150

15

14.3.2 Enquiry 150 14.3.3 Inspection 151 14.3.4 Reperformance 151 14.4 Extent of tests of controls 151

	14.4.1 Assurance provided by evidence 151 14.4.2 Evidence from prior audits 152 14.4.3 Evidence obtained at an interim visit 152 14.4.4 Consistency of evidence 153
14.5	14.4.5 Sufficiency of evidence 153 Documentation 154
	tantive tests 155
	Types of testing 155
15.2	Tests of details 155
	15.2.1 Inspection of documents 155
	15.2.2 Inspection of assets 156
	15.2.3 Direct confirmation 156
	15.2.4 Reperformance of computations and reconciliations 15615.2.5 Other procedures 157
15.3	Selective tests of details 158
	Timing of tests of details 158
	15.4.1 Factors to consider 159
	15.4.2 Extending audit conclusions to the year end 159
15.5	Analytical procedures as substantive tests 160
15.6	When to use analytical procedures 160
	15.6.1 The financial statement item or assertion 161
	15.6.2 Plausibility and predictability of the relationship 162
	15.6.3 Availability and reliability of data 162
157	15.6.4 Precision of the expectation 163
15./	Identifying and investigating significant differences 164
	Documentation of analytical procedures 165 Dealing with errors 166
13.3	15.9.1 Nature of errors 166
	15.9.2 Kinds of error 166
	15.9.3 Other discrepancies 166
	15.9.4 Dealing with individual errors 167
	15.9.5 Keeping track of errors 168
	15.9.6 Prior period errors 169
	15.9.7 Aspects of materiality judgments 169
	15.9.8 Risk of further undetected error 170
	15.9.9 Resolving material differences 170
	sampling 171
	Introduction 171
16.2	Background to audit sampling 171
	16.2.1 Meaning of sampling 171 16.2.2 Sampling risk 172
	16.2.3 Non-sampling risk 172
	16.2.4 Substantive tests and tests of controls 172
16.3	When to sample 172
	How to design a substantive sample test 173
	16.4.1 Objective of the test and error definition 173
	16.4.2 Defining the population and sampling unit 173
	16.4.3 Completeness of population 173
	16.4.4 Determining sample size 174
	16.4.5 Sample selection 178
16.5	Evaluation of sample results 180
	16.5.1 Projection of errors 181

		16.5.2 Comparison of projected error to tolerable error and consideration of sampling risk 181
		16.5.3 Investigation of cause and implications of errors 182
	16.6	Tests of controls 182
17	Audit	ing accounting estimates 185
	17.1	Introduction 185
		Developing accounting estimates 186
		Internal control structure related to accounting estimates 186
	17.4	Evaluating accounting estimates 187
18		puter-assisted audit techniques 189
		Introduction 189 Computer audit software 190
		General purpose software 192
		Special audit packages 192
	18.5	Miscellaneous computer audit techniques 193
	10.0	18.5.1 Audit test data 193
		18.5.2 Test data generator 194
		18.5.3 Integrated test facility 195
		18.5.4 Embedded audit facilities 195
		18.5.5 Utility programs 195
		18.5.6 Program comparison 196
		18.5.7 Program code analysis 196
		18.5.8 System activity file interrogation 196
		18.5.9 Flowcharting 196
19		ution and control 198
	19.1	Execution 198
		19.1.1 Introduction 198 19.1.2 Briefing and supervision 198
		19.1.3 Review of working papers 199
	192	Communication 200
		Documentation 201
		19.3.1 The need for working papers 201
		19.3.2 Working paper files 201
		19.3.3 'Lead-schedule-and-pyramid' filing 202
		19.3.4 Content of working papers 204
		19.3.5 Preparation of working papers 204
		19.3.6 Ownership and confidentiality of working papers 205
	19.4	Time control 206
Αp	pendio	ces
	19.1	Development and documentation of computer models 207
20	Com	pletion reviews 209
	20.1	Review of post balance sheet events
	20.2	Types of post balance sheet events -
		20.2.1 Definitions 209
		20.2.2 Examples 209
		20.2.3 Window dressing 211 20.2.4 Infringement of borrowing powers 212
	20.0	20.2.4 Intringement of borrowing powers Audit procedures 212
	20.3	Audit procedures 212 20.3.1 General 212
		20.3.1 General 212 20.3.2 Timing of procedures 213
		20.3.3 Management representations 213
		20.3.4 Consolidated groups 214

	20.4 20.5	Subsequent discovery of errors in issued reports 214 Overall review of financial statements 215 20.5.1 Objectives of the overall review 215 20.5.2 Compliance with generally accepted accounting principles 215
		20.5.3 Adequacy of disclosures 215
		20.5.4 Compatibility with knowledge of the business 216
Ap	pendio	es Key ratios 217
	20.1	Rey ratios 217
21		t clearance procedures 220
		Objectives 220
		Points for partner attention 221 Points forward 222
		Sign-off checklist 223
		Letters of representation 223
		21.5.1 Requirement for written confirmation 223
		21.5.2 Contents of the letter 223
		21.5.3 Groups 224
	21.6	Engagement administration 224
		21.6.1 Permanent files 225
	217	21.6.2 Time and cost summaries 225 Preliminary announcements 226
	21.7	21.7.1 Introduction 226
		21.7.2 Client categories 226
		21.7.3 Audit timetable 227
	21.8	Release of accounts 227
		21.8.1 Final clearance of accounts 227
		21.8.2 No release to third parties before signature 227
Ap	pendic	
	21.1	Sign-off checklist 228 Examples of representations by management 230
	21.3	Preliminary announcements — audit clearance 232
		dudit clearance 232
22	Mana	gement letters 233
		Introduction 233
		Structure and content 233
		22.2.1 Importance of good structure and content 233
		22.2.2 Introductory paragraphs 234
		22.2.3 The body of the letter 234
		22.2.4 Restriction on distribution 236
	22.2	22.2.5 Concluding paragraphs 236
		Collection of material for inclusion 237 Input from the client 238
		Other matters 238
		22.5.1 Addressee 238
		22.5.2 Other recipients 239
		22.5.3 Multiple letters 239
		22.5.4 Timing and follow-up 239
App	endice	
	22.1	Examples of management letters 240
23	Goina	concern 246
		Introduction 246
		Identification of going concern problems 246
		23.2.1 Red flags 246

23.2.2 Infringement of borrowing limits 247

	23.3	Audit procedures 247
		23.3.1 Preliminary enquiries 247
		23.3.2 Consideration of management's plans 247
		23.3.3 Disagreement with directors 249
		23.3.4 Bank and other facilities 249
		23.3.5 Group support 249
		23.3.6 Letters of subordination 251
	23.4	Disclosures 252
		23.4.1 Accounting adjustments 252
		23.4.2 Disclosure in financial statements 253
		23.4.3 Going concern audit report references 253
		23.4.4 Directors and shadow directors — statutory penalties 254
	23.5	Checklist of procedures 255
Δnr	endic	28
74	23.1	Suggested wording for requesting audit confirmation of a letter of
	20.1	support 257
	23.2	Specimen letter informing directors of statutory penalties 258
		Speciment total transfer and tr
24		olidated financial statements 259
		Introduction 259
	24.2	Planning 260
		24.2.1 Why the auditor should plan the group audit 260
		24.2.2 The stages in planning 260
		24.2.3 Group structure 260
		24.2.4 Assessing group audit risk and group materiality 261
		24.2.5 Identification of areas of high risk, audit difficulty or accounting
		complexity 261
		24.2.6 Identification of group audit requirements 262 24.2.7 Feedback on work done 262
		24.2.7 Feedback on work done 202 24.2.8 Integrity, independence and competence 263
		24.2.9 Documenting and communicating the auditor's requirements 263
		Conducting the consolidation audit 264
	24.3	Conducting the consolidation audit 264 24.3.1 Review of working papers 265
		24.3.1 Review of working papers 233 24.3.2 Review of questionnaire responses and other returns 265
		24.3.3 Signed financial statements 266
		24.3.4 Events subsequent to the balance sheet date 266
		24.3.5 Checking the validity of consolidation calculations and the
		completeness and accuracy of consolidation adjustments 266
	24.4	Completing the consolidation audit 269
	24.4	24.4.1 Overall review of financial statements 269
		24.4.2 Group points for partner attention 270
		24.4.3 Sign-off checklist 270
	24.5	Checklist of illustrative substantive procedures 270
	2-4.0	
25	The	new audit 273
	25.1	Introduction 273
	25.2	Administrative aspects of the new appointment as auditors 273
		25.2.1 Obtaining clearance from the provious dustrial
		25.2.2 Independence 273
	25.3	Particular audit considerations in a new engagement 274
		25.3.1 Background information 274
		25.3.2 Closing figures 274
		25.3.3 Accounting policies and financial statement presentation 275
	25.4	Retirement or resignation as auditors 275
		25.4.1 Giving formal written notice of resignation 275 25.4.2 Communication with the proposed successor 275
		25.4.2 Communication with the proposed successor 275

Appendices

25.1 Specimen letters — changes in appointment 277

Part Three: Suggested procedures for specific account balances 279 Introduction to Part Three 281

Tangible fixed assets 283
Intangible fixed assets 285
Investments 287
Stock and work in progress 290
Contract work in progress 295
Trade debtors 299
Prepayments and other debtors 303
Cash and bank balances 304
Group and associated undertakings 306
Trade creditors 309
Other current liabilities 312
Taxes 314
Borrowings 319

Provisions for liabilities, financial commitments and contingencies 321 Dividends, earnings per share, capital and reserves 323

Income 325 Expenditure 326

Directors, minutes, directors' reports 329

Funds' statements 331

Trial balance, accounting records and the financial statements 332

Index 333