

# Principles of Auditing: An Introduction to International Standards on Auditing

## Chapter 1 – International Auditing Overview

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# Historical background

- Records of auditing activity in cuneiform in early Mesopotamian times (around 3,000 BC).
- Ancient China, Greece and Rome.
  - The Latin meaning of the word ‘auditor’ was a ‘hearer or listener’ because in Rome auditors heard taxpayers.

Modern auditing dates to beginning of the modern corporation.

# Brief history of auditing

- The attitude of profit maximisation from the end of Middle Ages – merchant houses in Italy.
- Double-entry bookkeeping was first described in Italy (Pacioli 1496).
- Industrial Revolution Great Britain 1780 lead to the emergence of large industrial companies.
- In 1853, the Society of Accountants in Edinburgh was founded.

# The auditor, corporations and financial information

Investors and creditors may have different objectives than management (e.g. management prefers higher salaries and benefits (expenses), whereas investors wish higher profits and dividends). Investors and creditors must depend on fair reporting of the financial statements. To give them confidence in the financial statements, an **auditor** provides an independent and expert opinion on the fairness of the reports, called an **audit opinion**.

# **Auditor and management responsibility for financial statements**

The financial statements are the responsibility of management and the auditor's responsibility is to lend them credibility. By the audit process, the auditor enhances the usefulness and the value of the financial statements, but he also increases the credibility of other non-audited information released by management.

# The expectations of auditors

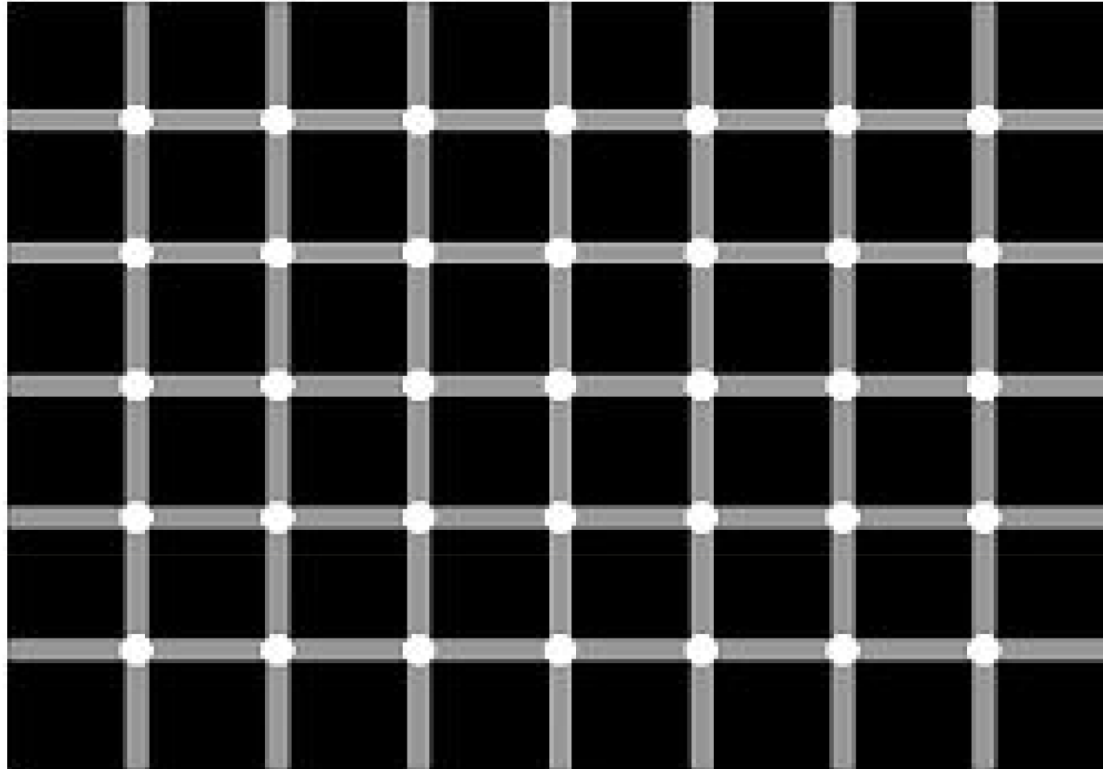
The importance of the company as a potential generator of wealth is increasingly understood, and so is the impact that a company's activities have on society and the environment. Public expectations go further and include questions such as:

- Is the company a **going concern**?
- Is it free of fraud?
- Is it managed properly?
- Is there integrity in its **database**?
- Do directors have proper and adequate information to make decisions?
- Are there adequate controls?
- What effect do the company's products and by-products have on the environment?
- Can an 'unfortunate mistake' bring this company to its knees?

# International Financial Reporting Standards

- International Financial Reporting Standards (IFRS) are the standards that are applied for financial accounting.
  - Now used by all foreign registered SEC firms
  - IFRS were formerly called International on Accounting Standards (IAS).
- The International Accounting Standards Board (IASB) has accounting standard setting responsibilities for IFRS.
  - The EU has agreed to apply most of the IFRS from 2005.
  - US to apply to foreign firms now and all SEC traded in the future.

# Auditing standards and regulation are rapidly changing



Count the black dots! :o)

# International Auditing and Assurance Standards Board (IAASB) issues:

- ✓ International Standards on Auditing (ISAs) as the standards to be applied by auditors in reporting on historical financial information.
- ✓ International Standards on Assurance Engagements (ISAEs) as the standards to be applied by practitioners in assurance engagements dealing with information other than historical financial information.
- ✓ International Standards on Quality Control (ISQCs) as the standards to be applied for all services falling under the Standards of the IAASB.
- ✓ International Standards on Related Services (ISRSs) as the standards to be applied on related services, as it considers appropriate.
- ✓ International Standards on Review Engagements (ISREs) as the standards to be applied to the review of historical financial information.

# **US GAAS for private companies and ISA now the same**

As part of the redrafting, the US Audit Standards Board converged the clarified standards with those issued by the International Auditing and Assurance Standards Board. All but one of the new standards are effective for engagements beginning on or after December 15, 2012.

## Jurisdictions using clarified ISAs already, or committed to using them in the near future (86)

**Europe (33):** Albania, Armenia, Belgium, Bulgaria, Croatia, Cyprus, Czech Republic, Denmark, Estonia, Finland, France (Experts Comptables), Georgia, Greece, Hungary, Iceland, Ireland, Kosovo, Latvia, Lithuania, Luxembourg, Malta, Moldova, Netherlands, Norway, Romania, Serbia, Slovakia, Slovenia, Sweden, Switzerland, Turkey, Ukraine, United Kingdom.

**Americas (17):** Argentina, Bahamas, Barbados, Brazil, Canada, Cayman Islands, Chile, Costa Rica, El Salvador, Guyana, Jamaica, Mexico, Panama, Puerto Rico (private companies), Trinidad and Tobago, Uruguay, USA (private companies).

**Asia Pacific (18):** Australia, Bangladesh, China, Hong Kong, India, Indonesia, Japan, Kazakhstan, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Singapore, South Korea, Sri Lanka, Thailand.

**Africa/Middle East (18):** Botswana, Ghana, Kenya, Lebanon, Lesotho, Malawi, Mauritius, Namibia, Rwanda, Sierra Leone, South Africa, Swaziland, Tanzania, Tunisia, Uganda, United Arab Emirates (Abu Dhabi and Dubai), Zambia, Zimbabwe.

# ISAs

## **100–999 International Standards on Auditing (ISAs)**

### **100–199 Introductory Matters**

120 Framework of International Standards on Auditing

### **200–299 General Principles And Responsibilities**

200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

210 Agreeing the Terms of Audit Engagements

220 Quality Control for an Audit of Financial Statements

230 Audit Documentation

# ISAs (Continued)

240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements

250 Consideration of Laws and Regulations in an Audit of Financial Statements

260 Communication with Those Charged with Governance

265 Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

## **300–499 Risk Assessment And Response To Assessed Risks**

300 Planning an Audit of Financial Statements

315 Identifying and Assessing the Risks of Material Misstatement through understanding the Entity and Its Environment

320 Materiality in Planning and Performing an Audit

330 The Auditor's Responses to Assessed Risks

# ISAs (Continued)

402 Audit Considerations Relating to an Entity Using a Service Organisation

450 Evaluation of Misstatements Identified during the Audit

## **500–599 Audit Evidence**

500 Audit Evidence

501 Audit Evidence – Specific Considerations for Selected Items

505 External Confirmations

510 Initial Audit Engagements – Opening Balances

520 Analytical Procedures

530 Audit Sampling

# ISAs (Continued)

540 Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures

550 Related Parties

560 Subsequent Events

570 Going Concern

580 Written Representations

## **600–699 Using the Work Of Others**

600 Special Considerations – Audits of Group Financial Statements (Including the Work of Competent Auditors)

610 Using the Work of Internal Auditors

620 Using the Work of an Auditor's Expert

## **700–799 Audit Conclusions And Reporting**

700 Forming an Opinion and Reporting on Financial Statements

# ISAs (Continued)

705 Modifications to the Opinion in the Independent Auditor's Report

706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report

710 Comparative Information – Corresponding Figures and Comparative Financial Statements

720 The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements

## **800–899 Specialised Areas**

800 Special Considerations – Audits of Financial Statements Prepared in Accordance with Special Purpose Frameworks

805 Special Considerations – Audits of Single Financial Statements and Specific Elements Accounts or Items of a Financial Statement

810 Engagements to Report on Summary Financial Statements

## **International Auditing Practice Notes**

IAPN 1000 Special Considerations in Auditing Financial Instruments

## **ISRE**

- **2000–2699 International Standards on Review Engagements (ISREs)**
- 2400 Engagements to Review Financial Statements (Previously ISA 910)
- 2410 Review of Interim Financial Information Performed by the Independent Auditor of the Entity

## **ISAE**

- **3000–3699 International Standards on Assurance Engagements (ISAEs)**
- 3000 Assurance Engagements Other than Audits or Reviews of Historical Financial Information
- 3400 The Examination of Prospective Financial Information (Previously ISA 810)
- 3402, Assurance Reports on Controls at a Third Party Service Organisation

## **ISRS**

- **4000–4699 International Standards on Related Services (ISRSs)**
- 4400 Engagements to Perform Agreed-upon Procedures Regarding Financial Information (Previously ISA 920)
- 4410 Engagements to Compile Financial Information (Previously ISA 930)

# Audit definition

‘An audit is a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between these assertions and established criteria and communicating the results to interested users’.

American Accounting Association

# Requirements of a financial statement audit

ISA 200 gives requirements relating to an audit of financial statements.

- The auditor is required to comply with relevant ethical requirements, including those pertaining to independence.
- The auditor shall plan and perform an audit with **professional scepticism** recognising that circumstances may exist that cause the financial statements to be **materially misstated**.
- The auditor shall exercise **professional judgement** in planning and performing an audit of financial statements.
- To obtain reasonable assurance, the auditor must obtain **sufficient appropriate audit evidence** to reduce audit risk to an acceptably low level and thereby enable the auditor to draw reasonable conclusions on which to base the auditor's opinion.

# Key definitions

- Professional scepticism – An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of evidence.
- Material misstatement – A significant mistake in financial information which would arise from errors and fraud if it could influence the economic decisions of users taken on the basis of the financial statements.
- Professional judgement – The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement.
- Sufficient appropriate audit evidence – *Sufficiency* is the measure of the quantity (amount) of audit evidence. *Appropriateness* is the measure of the quality of audit evidence and its relevance to a particular assertion and its reliability.

ISA 200 states the overall *objectives of an audit* of financial statements are:

1. to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework;
2. to report on the financial statements, and communicate as required by the ISAs, in accordance with the auditor's findings.

Terms used 'give a true and fair view' or 'present fairly, in all material respects' are equivalent terms.

# **Management is responsible for financial statements, internal controls, etc.**

An audit in accordance with ISAs is conducted on the premise that management and those charged with governance have acknowledged certain responsibilities that are fundamental to the conduct of the audit, such as financial statements, accounting methods and internal control.

- The concept of **materiality** is applied by the auditor both in planning and performing the audit, and in evaluating the effect of identified misstatements on the audit and the financial statements.
- Misstatements, including omissions, are considered to be material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.
- Judgements about materiality are made in the light of surrounding circumstances, and are affected by the auditor's perception of the financial information needs of users of the financial statements, and by the size or nature of a misstatement, or a combination of both.

# Inherent limitations in an audit of financial statements

- Certain inherent limitations in an audit affect the auditor's ability to detect material misstatements.
  - Test and sampling
  - Internal control
  - Audit evidence
  - Audit process permeated by judgement.
- Risk
  - Overall financial statements may be misstated, usually caused by poor control environment.
  - Misstatement in relation to classes of transactions, account balances and disclosures.

# Types of audit

## Audit of financial statements

Examine financial statements, determine if they give a true and fair view or fairly present the financial statements.

## Operational Audit

A study of a specific unit of an organisation for the purpose of measuring its performance.

## Compliance Audit

A review of an organisation's procedures and financial records performed to determine whether the organisation is following specific procedures, rules or regulations set out by some higher authority.

# Types of auditors

- **Internal auditors** are employed by individual companies to investigate and appraise the effectiveness of company operations for management.
- **Independent auditors** are typically certified either by a professional organisation or a government agency.

# Certification of the auditor

- Certified Public Accountant (CPA)
- Chartered Accountant (CA)
- Contador Público (CP)
- Other.

# Management assertions and audit objectives

- The audit starts with the financial statements prepared by the client and the claims or 'assertions' that the client makes about these numbers.
- It is the auditor's job to validate management's assertions. In order to do so, the auditor will identify *audit objectives*, which can be regarded as the auditor's counterpart of management assertions.

# Management assertions

Management assertions are implied or expressed representations by management about classes of transactions and related accounts in the financial statements. An example of a management assertion is that 'the company's financial statements are prepared based on international accounting standards'.

# Assertions about classes of transactions and events for the period under audit

- *Occurrence* – Transaction and events that have been recorded have occurred and pertain to the entity.
- *Completeness* – All transactions and events that should have been recorded.
- *Accuracy* – Amounts and other data relating to recorded transactions and events have been recorded appropriately.
- *Cut-off* – Transactions and events have been recorded in the correct accounting period.
- *Classification* – Transactions and events have been recorded in the proper accounts.

# Assertions about account balances at the period end

- *Existence* – Assets, liabilities and equity interests exist.
- *Rights and obligations* – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- *Completeness* – All assets, liabilities and equity interests that should have been recorded have been recorded.
- *Valuation and allocation* – Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

# Assertions about presentation and disclosure

- *Occurrence and rights and obligations* – Disclosed events, transactions and other matters have occurred and pertain to the entity.
- *Completeness* – All disclosures that should have been included in the financial statements have been included.
- *Classification and understandability* – Financial information is appropriately presented and described, and disclosures are clearly expressed.
- *Accuracy and valuation* – Financial and other information are disclosed fairly and at appropriate amounts.

# Audit process model

- Phase I – Client acceptance
- Phase II – Planning
- Phase III – Testing and evidence
- Phase IV – Evaluation and Judgement.

# Phase I Client acceptance

*Objective:* The client acceptance phase of the audit plan, Phase I, involves deciding whether to accept a new client or continue with an existing one.

*Procedures:* (1) Evaluate the client's background and reasons for the audit; (2) determine whether the auditor is able to meet the ethical requirements regarding the client; (3) determine need for other professionals; (4) communicate with predecessor auditor; (5) prepare client proposal; (6) select staff to perform the audit; and (7) obtain an engagement letter.

# Phase II Planning the audit

*Objective:* Determine the amount and type of evidence and review required to give the auditor assurance that there is no material misstatement of the financial statements.

*Procedures:* (1) Perform audit procedures to understand the entity and its environment, including the entity's internal control; (2) assess the risks of material misstatements of the financial statements; (3) determine materiality; and (4) prepare the planning memorandum and audit programme, containing the auditor's response to the identified risks.

# Phase III Testing and evidence

*Objective:* Test for evidence supporting internal controls and the fairness of the financial statements.

*Procedures:* (1) Tests of controls;  
(2) substantive tests of transactions;  
(3) analytical procedures; (4) tests of details of balances; and (5) search for unrecorded liabilities.

# Phase IV Evaluation and reporting

*Objective:* Complete the audit procedures and issue an opinion.

*Procedures:* (1) Evaluate governance evidence; (2) perform procedures to identify subsequent events; (3) review financial statements and other report material; (4) perform wrap-up procedures; (5) prepare Matters of Attention for Partners; (6) report to the board of directors; and (7) prepare audit report.

# International audit firms

## **‘The Big Four’:**

Deloitte & Touche; KPMG;  
PricewaterhouseCoopers; Ernst & Young

## **Audit staff**

Staff Accountants (or Junior Assistants then Senior)

Senior Accountants (or Supervisor)

Managers

Partners/Directors

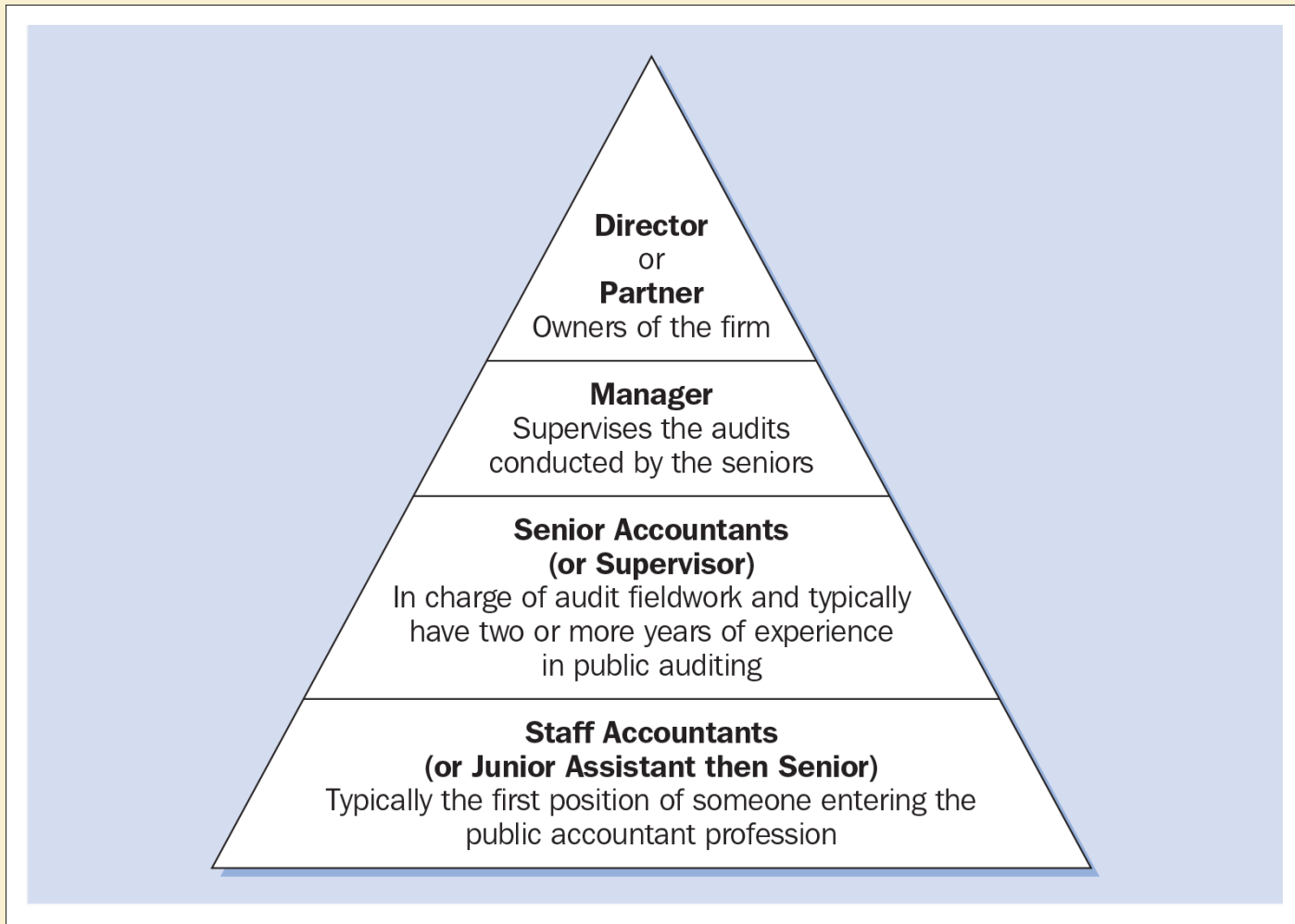


Illustration 1.7 The Organisational Hierarchy of a Typical International Auditing Firm

# Thank you for your attention

## Any Questions?