Study text sample pages

SECTION A

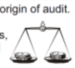
AUDIT FRAMEWORK AND REGULATION

A1

STUDY GUIDE A1: THE CONCEPT OF AUDIT AND OTHER ASSURANCE ENGAGEMENTS

Get Through Intro

To err is human. Man, in business as well as in other aspects of life, is subject to ignorance, incompetence, inefficiency and various temptations. This may lead to the occurrence of errors and fraud. All these errors and frauds may be minimised, if not completely eliminated, when the accounts prepared by one person are checked by another on the basis of well-defined principles, standards and procedures. This idea led to the origin of audit.



The most common definition of an audit is an evaluation of an organisation, system, process, project or product. Audits are performed to ascertain the validity and reliability of information, and also to provide an assessment of a system's internal control. Traditionally, audits were mainly associated with gaining information about the financial systems and financial records of a company or a business. However, recently, auditing has begun to include other\\Server\Production Team\2010 Updates\F6 Version 11\Study text\Production Folder\First PDF\For checking information about the system such as information about environmental performance. As a result, there is a need for professionals whose job is to conduct audits.

Audits are performed by a competent, independent and objective person or persons, known as auditors, who then issue a report on the results of the audit. These auditors must adhere to generally accepted standards set by governing bodies that regulate businesses. The users of financial statements, i.e. third parties and external users may be domestic or spread all over the world and may or may not have adequate accounting knowledge. An audit gives assurance to these users that the financial statements of the company 'fairly' present the company's financial condition and the results of its operations.

Learning Outcomes

a) Identify and describe the objective and general principles of external audit engagements.
b) Explain the nature and development of audit and other assurance engagements.
c) Discuss the concepts of accountability, stewardship and agency.
d) Discuss the concepts of true and fair presentation and reasonable assurance.
e) Explain reporting as a means of communication to different stakeholders.
f) Define and provide the objectives of an assurance engagement.
g) Explain the five elements of an assurance engagement.
h) Explain the level of assurance provided by audit and other review engagements.

Introduction

Case Study

John has a surplus amount of $20,000 which he would like to invest in the shares of a company. His friend, Peter, is a share broker and suggests that he should choose between two companies: Water House and Faith Ltd.

The financial manager of Water House is related to the wife of the managing director of the company whereas the financial manager of Faith Ltd is independent of the entity. John asks his friend to show him the financial statements of both the companies.

John looks at the financial statements of both the companies and decides to invest in the shares of Faith Ltd, as its financial statements have been prepared by an independent person, who is likely not to have been influenced by management. Hence, the financial statements of Faith Ltd will be more reliable and dependable than the financial statements of Water House.

The above case study illustrates the need for and importance of audited statements.

This Study Guide deals with the issues related to audit and other assurance engagements.

1. Identify and describe the objective and general principles of external audit engagements.[2]
Define and provide the objectives of an assurance engagement.[1]
Explain the five elements of an assurance engagement.[2]
[Learning Outcomes a, f and g]

An external audit can be defined, in simple terms, as an independent examination of financial information, with a view to expressing an opinion on this information. It is clear that the basic objective of auditing i.e. the expression of an opinion on the financial statements does not change, irrespective of the nature, size or form of the entity.

Before the objectives and general principles of external audit engagements are explained, the definition of an audit engagement should be examined.

Definitions

An assurance engagement in which a professional accountant in public practice expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

As defined by Code of Ethics for Professional Accountants

First of all, what is an assurance and why is it needed: an assurance is an assertion that the statements presented are correct. The need for assurance arises in every field.

Example

Jane is choosing a dress for a party that she plans to attend. She will probably ask her friend's opinion on how the dress looks before purchasing it. Jane wants to be assured that her dress is pretty before she decides to buy it.

Another example will help to clarify the concept of assurance.

Example

White Builders want to purchase a plot, where they intend to construct a shopping mall. Before they commit to buying the plot, White Builders will need to do some research on the site of the plot and its accessibility. They will certainly need to employ a surveyor to give them some more confidence and reduce the risk involved. They may ask the surveyor to look into different sites: their title, their location and whether or not the site is dispute-free.

1.1 Elements of an assurance engagement

The following are the elements of an assurance engagement:

- A three party relationship involving a practitioner, a responsible party, and intended users
- A suitable subject matter
- Suitable criteria
- Appropriate evidence
- An assurance report

In both the examples considered above, a few similar elements can be found. They are:

- Jane and White Builders – the **potential users.**
- The friend of Jane and the surveyor whom they want to rely upon – the **practitioner or expert.**
- The **responsible party** that will supply the goods or services.
- The dress and the plot that they want to buy – the **subject matter** of the transaction.
- The **subject matter information** such as the real estate agent's details of the property or the financial statements.
- The expectations or **criteria** which help the potential user to decide whether to purchase or not.

Criteria are the benchmarks used to evaluate or measure the subject matter. Criteria can be formal such as International Financial Reporting Standards, i.e. IFRS, or International Public Sector Accounting Standards. Criteria can also be informal such as an internally developed code of conduct or an agreed level of performance e.g. the time limit set for the use of a common machine to be used by different departments.

Example

High Co, an iron and steel company, has its accounts audited by Fair Brothers. There is a lot of emission of fumes during the manufacture of iron and steel. According to the rules on pollution, only 50,000 cubic metres of fumes are permitted. In other words, the criterion is for fumes emitted by High Co should not exceed 50,000 cubic metres.

There are **three separate parties** involved in the assurance agreement. They are:

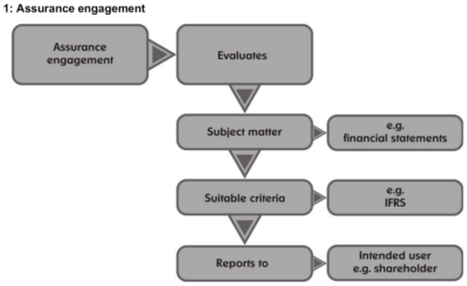
- The **intended users,** who are the person, persons or class of persons who want to purchase or for whom the practitioner prepares the assurance report e.g. the shareholders of an entity.
- The **responsible party,** who is responsible for the subject matter information and the subject matter e.g. the board of directors of a company.
- The **practitioner,** who gives assurance or who can be relied upon e.g. a professional accountant.

In summary, an assurance engagement is an engagement in which a practitioner expresses a conclusion, which is designed to increase the degree of confidence of the intended users in the subject matter and the subject matter information. **The objective of the assurance engagement is to measure or evaluate a subject matter, in compliance with the standards to express an opinion that gives a level of assurance to the intended user**.

Example

The accounts of Gear Ltd have been audited by an auditing firm, Generous Co. The audit partner of Generous Co, Harry, expresses his opinion on the financial statements of the company. The auditor's opinion gives a level of assurance to all the intended users such as shareholders of the company. This is the objective of the assurance engagement.

Diagram 1: Assurance engagement



1.2 Types of assurance engagement

Only two types of assurance engagements are permitted by the Framework. They are a reasonable assurance engagement and a limited assurance engagement.

1. Reasonable assurance engagement

Definitions

The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner's conclusion.

IFAC Glossary of terms

Objectives of an a reasonable assurance engagement

In a reasonable assurance engagement, the practitioner:

- gathers sufficient appropriate evidence,
- concludes that the subject matter conforms with the relevant criteria,
- ensures that the level of risk is exceptionally low and
- expresses the conclusion in a positive form.

In this type of assurance engagement, the practitioner obtains sufficient appropriate evidence in order to reduce the assurance engagement risk to an acceptably low level. The practitioner doesn't intend to say that everything is fully correct, but ascertains that it is materially true and fair. **The auditor is unable to obtain absolute assurance because it is impossible to check 100% of the transactions.** Even if a 100% audit is carried out; it will not provide assurance that the financial statements are free from material misstatement, because of the **inherent limitations of the audit** (which will be discussed in later Study Guides). Therefore, **the auditor cannot provide absolute assurance but can provide only reasonable assurance.** A common example of a reasonable assurance engagement is an external audit, which will be discussed later in this Learning Outcome.

Example

The audit report of Black Co includes the following statements:

- The financial statements have been prepared in accordance with the relevant accounting standards.
- In our opinion, internal control is effective in all material respects, based on levels fixed by the company.

These statements show that this is a reasonable assurance engagement.

2. Limited assurance engagement

Definition

The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner's conclusion.

IFAC Glossary of terms

Example

A retail business that produces its own financial statements but retains a practitioner for tax returns and other accounting advice is planning to open a new store. To do so, it needs to increase its existing lending facility and approach its bank with a proposal for additional funding. The bank, which has been receiving quarterly financial statements, looks very closely at the business's current financial position. It requests that the most recent financial statements be audited. The business owner is unhappy with the cost of a full audit.

Although the bank is satisfied with the client's financial position on the basis of its financial statements, before agreeing to increase the lending facility, the bank manager needs greater assurance that the financial statements are reasonably accurate.

The practitioner proposes a limited assurance engagement that looks at the financial statements overall but at a lower cost. The result is that the bank is happy with the focussed nature of the review and the level of assurance on the financial statements, and provides the additional funding. The business owner is also happy with the cost, which is lower than the full audit alternative. Hence, the practitioner has been able to suggest a review engagement, which is a practical and a cost effective solution to the conflicting demands of the bank and the client.