

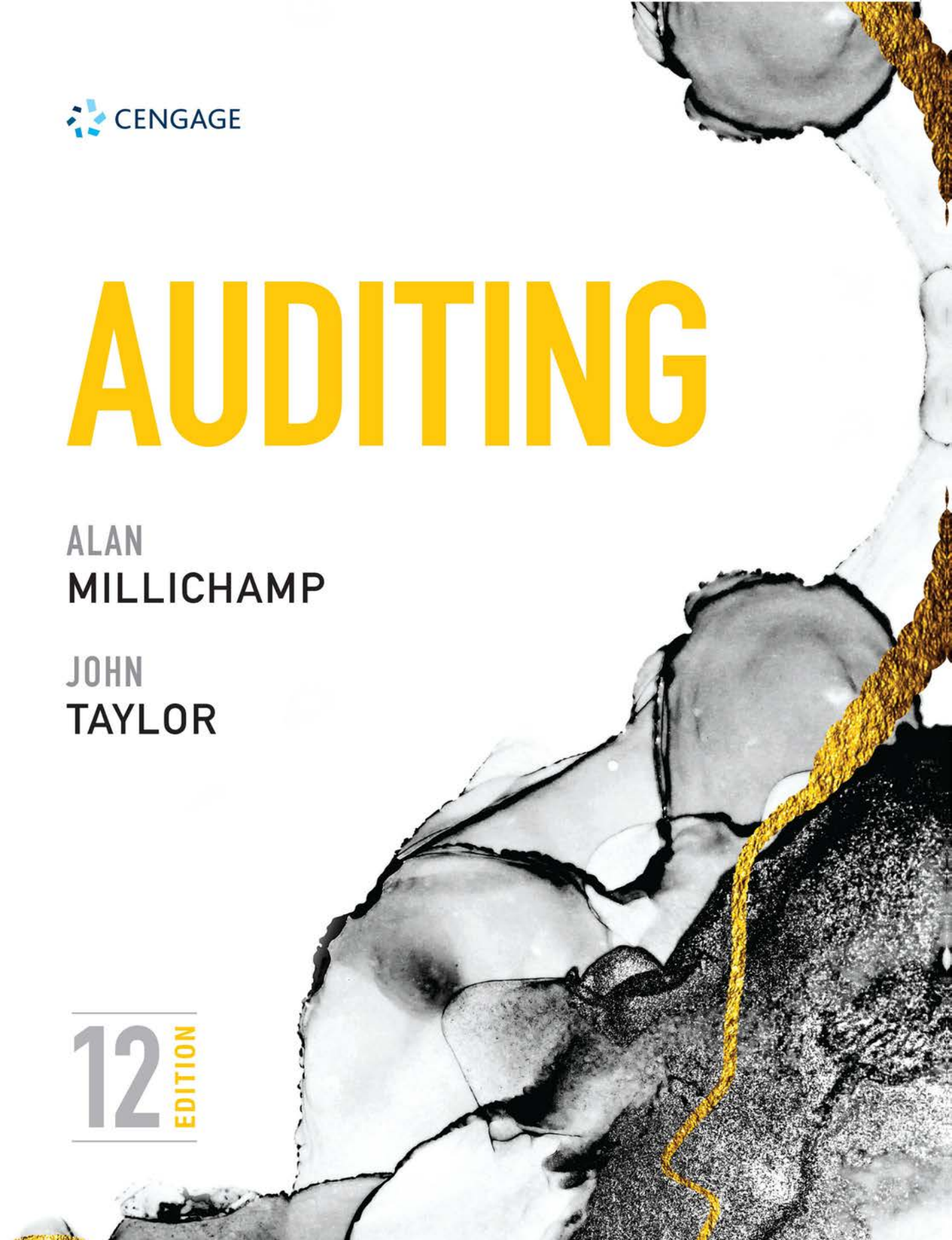
 CENGAGE

# AUDITING

ALAN  
MILLICHAMP

JOHN  
TAYLOR

12  
EDITION



---

**12** EDITION

---

# AUDITING

ALAN  
MILLICHAMP

JOHN  
TAYLOR



---

Australia • Brazil • Canada • Mexico • Singapore • United Kingdom • United States

This is an electronic version of the print textbook. Due to electronic rights restrictions, some third party content may be suppressed. Editorial review has deemed that any suppressed content does not materially affect the overall learning experience. The publisher reserves the right to remove content from this title at any time if subsequent rights restrictions require it. For valuable information on pricing, previous editions, changes to current editions, and alternate formats, please visit [www.cengage.com/highered](http://www.cengage.com/highered) to search by ISBN#, author, title, or keyword for materials in your areas of interest.

Important Notice: Media content referenced within the product description or the product text may not be available in the eBook version.

**Auditing, 12th Edition**  
**Alan Millichamp & John Taylor**

Publisher: Annabel Ainscow

List Manager: Birgit Gruber

Marketing Manager: Helen  
Seymour

Content Project Manager:  
Touseen Qadri

Manufacturing Buyer: Eyvett Davis

Typesetter: Straive

Text Design: Straive

Cover Designer: Jonathan Bargas

Cover Image(s): @Shutterstock Inc.

© 2022, Cengage Learning EMEA

WCN: 02-300

ALL RIGHTS RESERVED. No part of this work may be reproduced, transmitted, stored, distributed or used in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior written permission of Cengage Learning or under license in the U.K. from the Copyright Licensing Agency Ltd.

The Authors have asserted the right under the Copyright Designs and Patents Act 1988 to be identified as Authors of this Work.

For product information and technology assistance, contact us at  
**emea.info@cengage.com**

For permission to use material from this text or product and for permission queries, email **emea.permissions@cengage.com**

*British Library Cataloguing-in-Publication Data*

A catalogue record for this book is available from the British Library.

ISBN: 978-1-4737-7899-3

**Cengage Learning, EMEA**

Cheriton House, North Way  
Andover, Hampshire, SP10 5BE  
United Kingdom

Cengage Learning is a leading provider of customized learning solutions with employees residing in nearly 40 different countries and sales in more than 125 countries around the world. Find your local representative at: **www.cengage.co.uk**.

To learn more about Cengage platforms and services, register or access your online learning solution, or purchase materials for your course, visit **www.cengage.co.uk**.

Printed in the United Kingdom by Ashford Colour Press Ltd  
Print Number: 01      Print Year: 2021

## **John R. Taylor** ***MSc, FCA***

John Taylor has taught accounting and auditing at Leeds Beckett University and before this was a professional auditor for many years. He is the author of various successful auditing, accounting and finance books and currently works as a freelance writer and lecturer in auditing, accounting and management.

## **The late A. H. Millichamp** ***BA, MSocSc, FCA, FCCA, ATII***

Alan Millichamp taught at the Universities of Wolverhampton and Birmingham, at the Open University Business School and in the private sector. He was a former examiner and assessor in auditing to the Association of Chartered Certified Accountants and was also a member of the examining panel of the ACCA.

# BRIEF CONTENTS

<i>Preface – Aims of the Book</i>	<i>xi</i>
<i>Acknowledgements</i>	<i>xvii</i>
<b>1</b> Introduction to Auditing – the Why of Auditing	1
<b>2</b> Corporate Governance	22
<b>3</b> The Statutory Framework for Auditing	35
<b>4</b> Accounting Requirements of the Companies Act 2006	52
<b>5</b> Auditing and Accounting Standards and Guidelines	64
<b>6</b> Ethical Standards and Rules of Professional Conduct	71
<b>7</b> Quality Control in Audit Firms	91
<b>8</b> Accepting Appointment as Auditors	100
<b>9</b> Accounting Systems and Internal Controls	108
<b>10</b> Audit Planning, Audit Risk and Materiality	129
<b>11</b> Audit Evidence and Using the Work of an Expert	163
<b>12</b> Audit Testing, Sampling and Analytical Review Procedures	178
<b>13</b> Systems-Based Auditing	203
<b>14</b> Risk-Based Auditing	224
<b>15</b> The Audit of Assets	243
<b>16</b> The Audit of Liabilities	273
<b>17</b> Auditing and Computers	286
<b>18</b> Audit Working Papers	302
<b>19</b> Internal Audit	319
<b>20</b> Errors, Fraud and Unlawful Acts	327

<b>21</b>	Related Parties	347
<b>22</b>	Use of Service Organizations	357
<b>23</b>	Subsequent Events and Going Concern	364
<b>24</b>	Management Representations	380
<b>25</b>	The Final Review Stage of the Audit	388
<b>26</b>	Auditor's Reports to Shareholders	401
<b>27</b>	Auditor's Reports to Directors and Management	432
<b>28</b>	Group Accounts	448
<b>29</b>	Auditor's Liability	464
<b>30</b>	Review Engagements and Non-Audit Assurance Assignments	480
<b>31</b>	Public Sector Audit and Value for Money Auditing	509
<b>32</b>	Performance Evaluation, Environmental Reporting and Corporate Social Responsibility Reporting Assignments	531
<b>33</b>	Current Issues	545
	<i>Appendix 1</i>	557
	<i>Appendix 2</i>	565
	<i>Appendix 3</i>	566
	<i>Glossary</i>	569
	<i>Index</i>	581

# CONTENTS

<i>About the Authors</i>	<i>iii</i>	Companies Act 2006	30
<i>Preface – Aims of the Book</i>	<i>xi</i>	Audit Committees	30
<i>Acknowledgements</i>	<i>xvii</i>	Sarbanes–Oxley (2002)	31
<b>1 Introduction to Auditing – the Why of Auditing</b>	<b>1</b>	<b>3 The Statutory Framework for Auditing</b>	<b>35</b>
Introduction	2	Introduction	36
Agency Theory	2	The Companies Act 2006	36
Why Is There a Need for an Audit?	4	Requirement to Have Auditors	36
The Audit Process	8	Who Can Be an Auditor?	37
International Pressures and Globalization	8	The Rights and Duties of an Auditor Under the Companies Act 2006	38
Objectives of Auditing	10	Appointment of Auditors	38
Directors’ Responsibilities	10	Remuneration of Auditors	39
Auditor Responsibilities	11	The Removal of an Auditor	40
Types of Assignment	12	Resignation of Auditors	40
Advantages and Disadvantages of an Audit	13	Auditor’s Duties	41
Auditing Theory, Postulates and Concepts	13	Auditor’s Rights	42
The Expectation Gap	17	The Auditor’s Report	43
		Auditor’s Rights to Attend Meetings	45
		Powers of an Auditor	45
		Recognized Supervisory Bodies	46
		Recognized Qualifying Bodies	46
		Professional Body Rules	47
<b>2 Corporate Governance</b>	<b>22</b>	<b>4 Accounting Requirements of the Companies Act 2006</b>	<b>52</b>
Introduction	23	Introduction	53
What is Corporate Governance?	23	Accounting and Accounting Records	53
Principles of Corporate Governance	23	Statutory Books	55
‘Comply or Explain’ – Framework Versus Legislative Approaches	24	Accounting Requirements	55
UK Corporate Governance Code	25		
Private and Unlisted Companies	27		
The Wates Principles	28		
Value of Good Corporate Governance	28		
Substance over form	29		



Accounting Principles	57	<b>8 Accepting Appointment as Auditors</b>	100
Content – Disclosure Requirements	58	Introduction	101
True and Fair Override	58	Client Screening	101
Procedure on Completion of the Financial Statements	58	Other Considerations	101
Period Allowed for Filing Accounts	59	Preconditions for an Audit	102
Abridged or Filled Accounts	59	Professional Etiquette	102
Publication of Accounts	60	Letters of Engagement	103
Dormant Companies	61		
<b>5 Auditing and Accounting Standards and Guidelines</b>	64	<b>9 Accounting Systems and Internal Controls</b>	108
Introduction	65	Introduction	109
Role of the Financial Reporting Council ('FRC')	66	Internal Control	109
International Standards on Auditing ('ISAs')	66	Limitations of Internal Controls	112
Practice Notes	67	Internal Control Systems	113
Accounting Standards	67	Control Procedures	115
The Relevance of Accounting Standards to Auditing	68	Control Activities in Specific Areas of a Business	117
<b>6 Ethical Standards and Rules of Professional Conduct</b>	71	<b>10 Audit Planning, Audit Risk and Materiality</b>	129
Introduction	72	Introduction	130
Principles-Based or Rules-Based Approach?	73	Objectives	130
Fundamental Ethical Principles	74	Meeting Audit Objectives	130
Ethics – General Rules	76	Required Procedures	131
General Ethical Threats	77	Influences on an Audit	132
Threats to Independence	78	Planning the Audit	140
Provision of Non-Audit Services	80	Internal Control System Review	143
Commissions and Fees	82	Audit Strategies	149
Conflicts of Interest	82	Planning the Audit Work	152
Advertising and Publicity	84	Analytical Review Procedures	155
Ethics and Quality Issues	84	The Timing of Audit Work	156
Ethical Standards – Smaller Companies	85	<b>11 Audit Evidence and Using the Work of an Expert</b>	163
Insider Dealing	85	Introduction	164
Money Laundering	86	Professional Scepticism	164
Whistleblowing	87	Assertions	166
<b>7 Quality Control in Audit Firms</b>	91	Reliability of Audit Evidence	168
Introduction	92	Basic Techniques for Collecting Evidence	169
Audit Firm Organization	92	Using the Work of an Auditor's Expert	171
Planning, Controlling and Recording Individual Audits	94	<b>12 Audit Testing, Sampling and Analytical Review Procedures</b>	178
Reviews of Audit Firms' Procedures in General and of Particular Audits	95	Introduction	179
		Relationship to Audit Risk and Materiality	179

Forms of Audit Testing	179	Finance Lease Liabilities	276
Audit Sampling	183	Bank Overdrafts and Short-Term Loans	277
Sampling Approaches	187	Amounts Due to Group and Related Companies	278
Sampling Methods	189	Long-Term Liabilities	278
Analytical Review Procedures	193	Share Capital and Reserves	278
<b>13 Systems-Based Auditing</b>	<b>203</b>	Unrecorded Liabilities	278
Introduction	204	Contingent Liabilities	280
Testing System Components	204	Auditing Accounting Estimates	281
The Purchases and Expenses System	205	<b>17 Auditing and Computers</b>	<b>286</b>
The Revenues (Sales) System	208	Introduction	287
The Payroll System	213	Auditors and Management Information Systems	287
Significant Deficiencies	216	Audit Risk and IT Systems	289
The Audit of Small Entities	217	The Control Environment	290
<b>14 Risk-Based Auditing</b>	<b>224</b>	The Audit Approach to Computerized Systems	295
Introduction	225	<b>18 Audit Working Papers</b>	<b>302</b>
External Risks	226	Introduction	303
Internal Risks	229	Purposes	304
The Client's Approach to Risk	231	Evidence of Work Carried Out	305
Evaluating the Organization's Risk Assessment Process	234	Nature and Content of Working Papers	306
Why Use a Business Risk Approach to Auditing?	235	Departure from Basic Principles	306
Understanding the Business Risk Approach	236	Content of Working Papers	306
The Implications of the Business Risk Approach for the Audit	237	Sample Working Papers	307
<b>15 The Audit of Assets</b>	<b>243</b>	Professional Judgement	309
Introduction	244	The Audit Programme	310
Aspects to be Verified	245	Standardization of Working Papers	313
Verification of Non-Current Assets	245	Finalization	313
Current Assets	251	Smaller Audits	313
Inventory and Work in Progress	252	Ownership of Books and Papers	313
Cut-off	256	Accountant's Lien	314
Receivables	260	Retention of Working Papers	314
Accounting Estimates	264	<b>19 Internal Audit</b>	<b>319</b>
Bank Balances	265	Introduction	320
Loans	266	Role of Internal Audit	320
Cash	267	Differences Between Internal and External Audit	321
<b>16 The Audit of Liabilities</b>	<b>273</b>	Public Sector	322
Introduction	274	External Auditors and Internal Audit	322
Verification Procedures	274	Outsourcing Internal Audit Services	323
Trade Payables	274	<b>20 Errors, Fraud and Unlawful Acts</b>	<b>327</b>
Cut-off	275	Introduction	328
Accruals	275	Errors and Misstatements	328
Provisions	276	Fraud and Other Irregularities	329

Bribery and Corruption	331	<b>24 Management Representations</b>	380
Responsibility for Prevention and Detection of Fraud and Error	332	Introduction	381
The Audit Approach	333	Contents of a Letter	381
Audit Tests and Fraud	335	Reliance on Letter of Representation	382
Reporting and Disclosure	336	Auditor Responsibilities	383
Small Companies	338	Example of a Management Representation Letter	383
Unlawful Acts of Clients and Their Staff	338	Refusal to Co-operate	385
Audit Issues Arising From Non-Compliance	340		
<b>21 Related Parties</b>	347	<b>25 The Final Review Stage of the Audit</b>	388
Introduction	348	Introduction	389
Disclosure	349	Opening Balances and Comparative Figures	389
The Auditor's Duties to Related Parties	350	The Auditor's Interest	390
Detailed Audit Procedures	351	Uncorrected Errors or Misstatements	392
Unusual Transactions Outside the Normal Course of Business	352	Final Accounts Review	393
Control of the Entity	353	Procedures	393
Smaller Organizations	353	Auditors' Duties in Respect of Compliance with the UK Corporate Governance Code	394
Modified Audit Reports	354	Directors' Remuneration Disclosure	396
<b>22 Use of Service Organizations</b>	357	<b>26 Auditor's Reports to Shareholders</b>	401
Introduction	358	Introduction	402
Why Do Firms Outsource?	358	Report on the Directors' Responsibilities for the Financial Statements	402
Audit Planning Issues	358	Auditor's Responsibilities	403
Accounting Records	360	Bannerman Wording	403
Audit Evidence	360	The Auditor's Opinion	405
Reports by Service Organization's Auditors	361	Going Concern	407
Ethical Threats	361	Key Audit Matters	408
<b>23 Subsequent Events and Going Concern</b>	364	Basis of Opinion	409
Introduction	365	When is an Unmodified Report Appropriate?	409
Subsequent Events	365	Contents of an Auditor's Report	410
Adjusting and Non-Adjusting Events	366	Additional Reporting for Listed Companies	415
Audit Tests for a Subsequent Events Review	367	Modified Audit Reports	416
Going Concern	368	Sample Wording of Modified Audit Reports	420
Consequences of Going Concern	369	Listed Companies – Special Provisions	425
Directors' Duties	370	Emphasis of Matter Reports	426
The Auditor's Procedures	371	Audit Reporting – Special Circumstances	427
Specific Audit Procedures	372	Auditor's Liability in Respect of Audit Reports	427
If Events Are Identified	374	<b>27 Auditor's Reports to Directors and Management</b>	432
Effect on Audit Reports	374	Introduction	433
Specific Considerations about Going Concern and Small Organizations	376	Communication with Those Charged with Governance	433

Significant Deficiencies in Internal Control Reporting Where Part of the Audit Is Carried out by Another Firm	435		
Listed Companies and Others Applying the UK Code of Corporate Governance	436		
Reporting to the Audit Committee of PIEs	436		
The Management Letter	437		
Response by Management	441		
The Report and Third Parties	441		
Example of a Management Letter	441		
<b>28 Group Accounts</b>	<b>448</b>		
Introduction	449		
Audit Considerations	450		
Planning Issues	451		
Component Auditors	452		
Communication	453		
Auditing Investments in Subsidiaries and Other Undertakings	454		
Auditing the Consolidation	455		
Modified Auditor's Reports	456		
Overseas Subsidiaries	456		
Joint Audits	456		
Support Letters to Subsidiaries	457		
Transnational Audits	459		
<b>29 Auditor's Liability</b>	<b>464</b>		
Introduction	465		
Criminal Law	465		
Civil Liability Under the Common Law	466		
Duty of Care	467		
Liability for Negligence	469		
Minimizing Risk to Audit Firms	473		
Limited Liability Partnerships (LLPs)	474		
Limiting Auditor's Liability	474		
The Future	475		
<b>30 Review Engagements and Non-Audit Assurance Assignments</b>	<b>480</b>		
Introduction	481		
Review Engagements	481		
Direct Reporting Engagements	486		
Negative Assurance	487		
Prospective Financial Information	492		
Forensic Auditing	496		
Assurance Engagements	496		
Levels of Assurance	501		
<b>31 Public Sector Audit and Value for Money Auditing</b>	<b>509</b>		
Introduction	510		
Supreme Audit Institutions (SAI)	512		
Public Sector Auditing – UK	512		
UK Government Departments	513		
Local Public Bodies	515		
England	515		
Scotland	519		
Wales	520		
Northern Ireland	520		
Auditing Issues	521		
Internal Audit	522		
Value for Money	525		
<b>32 Performance Evaluation, Environmental Reporting and Corporate Social Responsibility Reporting Assignments</b>	<b>531</b>		
Introduction	532		
Performance Evaluations	532		
Environmental Reporting	533		
Corporate Social Responsibility Reporting	539		
<b>33 Current Issues</b>	<b>545</b>		
Introduction	546		
The Future of Regulation	546		
The Future Structure of Audit Firms	546		
Dominance of the 'Big 4'	547		
The Role of the Auditor	548		
The Future of Audit Reporting	548		
The Future of Internal Control Reporting	550		
Risk Disclosure	551		
Audit Challenges	551		
Cryptocurrencies and Blockchains	552		
New Opportunities, New Problems	553		
<i>Appendix 1</i>	<i>557</i>		
<i>Appendix 2</i>	<i>565</i>		
<i>Appendix 3</i>	<i>566</i>		
<i>Glossary</i>	<i>569</i>		
<i>Index</i>	<i>581</i>		

# PREFACE – AIMS OF THE BOOK

The primary aim of this book is to provide a simplified but thorough approach to the understanding of auditing theory and practice. It is intended for those with little or no knowledge of the subject, however, some knowledge of financial accounting, company law and information technology would be an advantage.

Students who will find this book useful will include those studying auditing as part of an accounting or business course in a university or HE college as well as students studying for the professional examinations of the accountancy bodies such as the ACCA or the Institutes of Chartered Accountants.

This book will provide the student with a clear and succinct exposition of the subject and will, hopefully, be sufficiently interesting to encourage even the least conscientious student to proceed in easily digestible stages!

## STRUCTURE OF THE BOOK

The book has been designed with several uses in mind:

- as a textbook, on its own, for specific examinations
- for use with a lecture
- as a revision text for those who are taking or retaking examinations.

The case studies, student self-testing questions and examination questions are particularly useful for those taking exams.

At the end of each chapter is found:

- Summary of the chapter.
- Points to note – these are used for emphasis and clarification of points which students often misunderstand.
- Short case studies – the objective of the case studies is to illustrate the material in the chapter. Readers may find it helpful to ponder on the case study while reading the chapter.
- Questions – these are a mixture of:
  - short questions to test comprehension and learning of the material in the chapter and as an aide-memoire
  - exercises
  - examination standard questions where appropriate.

In addition, the case studies can be seen as questions. Answers to the exam questions are available on the digital support resources for the book.

## DIGITAL SUPPORT RESOURCES

The digital support resources contain:

- additional questions and case studies
- answers to the exam questions and some discussion on the case studies
- mock exam questions and answers
- PowerPoint slides
- downloadable figures and tables from the book.

## NOTES TO THE 12TH EDITION

The 12th edition now takes account of:

- the revised International Auditing Standards issued by the Financial Reporting Council and applying to all audits on or after 15 December 2021. The text also includes up-to-date references to other official pronouncements, practice notes, bulletins and other practice statements extant at the time of writing
- the relevant Financial Reporting Standards and other accounting standards issued by the Financial Reporting Council
- public sector auditing
- illustrative real world auditing examples.

In addition, the opportunity has been taken to revise the text, rewrite some chapters completely and introduce new material. The final chapter considers current issues which the audit profession is currently debating and which are likely to have a significant impact on auditing practice in the future.

The test questions have also been updated and revised.

Words or phrases in **bold type** have been highlighted because their meaning has been included in the Glossary at the back of the book.

## CHAPTER ORDER

The chapter order follows a logical sequence. The chapters are self-contained and can be read in any order, although some chapters do take account of what has gone before. If this is the case previous chapters have been referred to in the text.

## HOW TO PASS AUDITING EXAMINATIONS

Some students have difficulty in passing auditing exams, often because auditing exams involve a lot of writing rather than calculations or amending or preparing financial statements. This can be quite off-putting to some people. However it needn't be. Experience shows that some of this is simply due to a lack of preparation, but it can also be due to a lack of exam technique. We have begun the book with suggestions on how to pass auditing exams. This has been written from our experience as teachers and examiners in auditing. We hope it will be helpful!

There is no simple formula for success. If there were then everybody would be successful. However, there are many ways in which you can increase your chances of success.

These include:

- Being well prepared – there is no real substitute for hard work and application. However, reading is not enough. You must practise exam questions. At the end of each chapter there are student self-testing questions, exam questions and the case studies. The best way to learn is to write out answers to these in full. It is only by being faced with having to write things down that you discover the gaps in your knowledge and understanding. The professional institutes also make available past exam papers and answers which can be used for additional practice. The ACCA is particularly good at this.

- Knowing the syllabus and what you should know – guidance on this is obtained by reading the relevant course content syllabus and any other information available from the examiners. This book is intended to be comprehensive so there may be aspects of it which will not be included in the syllabus for a particular course. It is as helpful to know what you do not need to study as it is what you do.
- Exams are now becoming increasingly computer-based – both ICAEW and ACCA exams are computer-based but other professional bodies are, at the moment, sticking with traditional paper-based assessments. However, the computer is simply a way of delivering the answer – it does not help with the content so the same principles apply whether the exam is computerized or paper-based.
- Time – should be used efficiently and profitably. Specific points here are:
  - Answer all the questions that you are asked to answer. Given a choice, never spend time finishing a question when there is still a question unanswered. The first few marks on a question are always easy but the last few are always hard to earn. This is as true of short questions as long ones.
  - Give proper weight to each question and part of a question. There is no point in providing a very comprehensive answer to part of a question which earns you two marks. Similarly writing two lines on a 20-mark question is clearly not enough. It is a good idea to consider how much time you can allocate to each task. For example, in a three-hour, 100-mark exam, you should not spend any more than *nine* minutes per *five* marks so a 25-mark question requires you to think and write for 45 minutes. That will provide you with some indication of the size and detail of the answers required. Anyone who finishes the examination in under two hours has probably failed it!
  - One advantage of some computerized exams is that they present you with a clock counting down the remaining time. This can lead to panic, but shouldn't do if you have been watching how much time you have spent on each question using the formula set out above.
  - Be ruthless with time. Watch the time on each question. Once you have spent your allotted time – say 45 minutes – stop and move on, otherwise you can find you've spent 65 minutes on it and have less time for the next one. When answering practice questions at home, try to answer them in the time allotted. Don't ramble on!
  - Many examinations are deliberately designed to put candidates under time pressure. This encourages candidates to be succinct and relevant.
- Never omit parts of a question. Even if you do not know the answer, guess and write something – you never know, it may get you a mark or two!

## Reading through the paper

Many students have a moment of panic when they first see the paper. This will pass when you realize how easy the paper really is! If possible students should read through all the questions briefly first, concentrating on the requirements of each question. As you do this, note down any thoughts that occur to you as soon as you can, otherwise, if you find yourself under time pressure, you may spend fruitless time trying to remember a fact you have now forgotten.

## Tackling a question

Here are some general points:

- Plan the answer briefly – this is time well spent once you've worked out what the question is asking.
- Answer the question asked – this is a vital point. It is no good answering the question you would have preferred. Many examiners report that weak candidates simply write down everything they know about a topic rather than *relating what they know to the question being asked*. You do not get any marks for irrelevant detail. This means reading the question carefully and noting exactly what is required. A good way of doing this is to underline significant words in the question in a paper-based exam or making notes in a computerized one.
- Don't waffle – questions are not marked by weight, so droning on with irrelevant detail will not get you any marks even if it fills up the page. Use bullet points and keep it brief but relevant.
- Make points – this is the most important thing of all. Some questions say '*List four procedures . . .*'. Obviously four points are wanted. Some say '*State the audit tests that you . . .*'. What is wanted in such questions is as many tests as you can think of. It does not want long descriptions of two tests or a general answer. Relate the requirements of

the answer to the marking scheme – if the question asks for four key points and the value of that answer is 12 points it does not take a genius to work out that each point is worth three marks, so requires some detail but not pages.

- Use all the data given in the question – many auditing questions have long scenarios before the requirement. This information is not just for idle reading. The examiner expects you to use it in your answer. It probably contains lots of clues to the answer required.
- Auditing examiners expect intelligent answers – try to see the implications in a question. For example, a question about audit risk may want a general answer and if so that is what it will ask for. Specific points about particular audit risks in the particular case will be in the scenario and these are what the examiner is looking for, so don't waffle on about matters which are not included in the scenario.
- Keep the answers as short and succinct as possible – when you have made a point using one sentence consider whether you really need more sentences. Write legibly and use short sentences and paragraphs. Tabulating and listing is usually acceptable, using bullet points, and this helps the marker see what you have said.
- Label each part of your answer – if a question has four parts, a, b, etc., make sure each part is clearly labelled as such.
- Explain your terms – suppose you are faced with a question like '*Explain why external auditors seek to rely on the proper operation of internal controls wherever possible*'. First, briefly define 'external auditor' and 'internal controls'. You may get marks for it, but in any case it will give you clues to how to answer it.
- Apply lateral thinking – in the internal controls example think about what an external auditor is trying to do or the context in which internal controls are designed or what they are designed to prevent or ensure. Don't just drone on about what internal controls are and why they are really, really important – relate it to the work the auditors do and explain why internal controls are relevant to that work.

## How to answer a question

It all depends on the question, but here are some general ideas:

- Read the question.
- Read it again.
- Underline important words in the question if you can or make notes.
- Make sure you know *exactly* what the examiner requires you to do.
- Note down the points you want to make, add to these points others as you think of them even while writing out the answer.
- Stop and think for a moment.
- Draft an outline plan of your answer with the key points, if possible.
- Write your answer referring back continually to the requirements of the question. Take plenty of room, use short sentences and paragraphs. Number your points if you think it appropriate.

## Tackling a question – specific ideas

With many questions, you may be faced with making points but not being able to think of many. Here are a few ideas which may trigger points you can make:

- What Auditing Standards are involved? Is it new material and recent revisions?
- What Accounting Standards are involved?
- What Companies Act accounting or auditing requirements are involved?
- Is business or audit risk relevant?
- Does the question have any relevance for the Letter of Engagement?
- Does the question have any relevance for the Auditor's Report?
- What assertions about a figure in the financial statements are implied?
- Does the question have any relevance to the idea of misstatements in the financial statements?
- Is materiality worth mentioning?
- Do ethics have any relevance?
- What types of audit tests may be applied?



- What working papers may be needed?
- What errors or frauds could occur?
- Is going concern an issue?
- Is internal audit involved?

## Reviewing your answer

Some students like to finish early and then proof read their answer. This is unlikely to add many marks unless:

- you think of new points or
- you realize you haven't answered the question properly

mainly because you have probably put down everything you know already.

Polishing the grammar, spelling and punctuation is very unlikely to add many marks to your score and can waste time. If you finish very early either you are extremely able or you have not answered all the questions properly.

## Common faults in auditing answers

Here are some common faults:

- Not obeying the questioner's requirements – if it says *set out, list, tabulate, to what extent, examine the truth of, state, state concisely, what are the principal matters, discuss, comment on, describe, write a short essay*, then do what it says!
- Not reading the question carefully – for example, students on being asked to audit a partnership will refer to company-based information such as the Memorandum and Articles.
- Not making enough points – this is very hard to overcome, but one good technique is to try to break the question down into sections and list specific points relevant to each part of the question.
- Not being specific – an audit test stating '*check sample transactions in the cash book*' will not often do; '*check a sample of the entries in the cash book with available supporting documents such as . . .*' might do.
- Being irrelevant – tied up with not obeying instructions and not reading the question carefully.
- Lack of planning, coherence and logic – planning an answer should cure this.
- Lack of balance – if the examiner asks for five points they do not want four pages on point one and one line each on the others.
- Handwriting, grammar, spelling, punctuation – do not waste your time and opportunities by presenting your work badly or with avoidable errors, even in the case of computerized assessments.
- Confusing the role of auditor with that of accountant, tax consultant, etc. – if asked what the auditor should do in certain circumstances, never say, for example, '*Alter the accounts*' because producing accounts is not the auditor's function. Neither should you advise an action which would save your client tax; you must say what you would do as *auditor*.

## Layout and wording of answer

- Use the wording of the question wherever you can.
- Answer the question in the sequence requested.
- Obey instructions on layout, e.g. tabulate.
- State any assumptions you make in answering the question; however, do not make assumptions which change the question to suit your knowledge.

## End of exam procedure

- Have a very quick look at each answer, checking for repetitions, irrelevancies, grammatical errors and badly formed letters. Add any new points if you can think of them.

## Conclusion

Good technique plays a large part in examination success; this is a fact. Refuse to be panicked, keep your head, and with reasonable preparation you should make it.

*Finally – remember – you don't have to score 100 per cent to pass.*

## USEFUL ABBREVIATIONS

Auditors, like most professionals, use a lot of abbreviations as a kind of shorthand. Here is a list of the most common abbreviations – there are others but these are the ones you may come across most frequently. We refer to these in the text and explain them fully and, for quick reference, further details of many of them are contained in the Glossary at the end of the book.

ACCA – Association of Chartered Certified Accountants  
AGM – Annual General Meeting  
CA 2006 – Companies Act 2006  
FCA – Financial Conduct Authority  
FRC – Financial Reporting Council  
GAAP – Generally Accepted Accounting Practice  
HMRC – HM Revenue & Customs  
IAASB – International Auditing and Assurance Standards Board  
IAS – International Accounting Standard  
ISA – International Standard on Auditing  
ICAEW – Institute of Chartered Accountants in England & Wales  
IFAC – International Federation of Accountants  
ISA – International Standard on Auditing  
NED – Non-executive director  
PIE – Public Interest Entity

## LIST OF USEFUL WEBSITES

Details of sources and additional reading are set out at the end of each chapter. However, there are some websites which contain lots of useful information and technical updates. Here is a list of the most useful and ones which can be referred to for technical updates and research:

[www.accaglobal.com](http://www.accaglobal.com)  
[www.accountancyage.com](http://www.accountancyage.com)  
[www.frc.org.uk](http://www.frc.org.uk)  
[www.ft.com](http://www.ft.com)  
[www.icaew.com](http://www.icaew.com)  
[www.icaew/insights](http://www.icaew/insights)  
[www.icaew.com/en/technical/audit-and-assurance](http://www.icaew.com/en/technical/audit-and-assurance)  
[www.ifac.org](http://www.ifac.org)  
[www.ifac.org/iaasb](http://www.ifac.org/iaasb)  
[www.iaa.org.uk](http://www.iaa.org.uk)  
[www.legislation.gov.uk/ukpga/2006](http://www.legislation.gov.uk/ukpga/2006)  
[www.nationalcrimeagency.gov.uk](http://www.nationalcrimeagency.gov.uk)

# ACKNOWLEDGEMENTS

## EXAMINATION QUESTIONS

We are grateful to the Association of Chartered Certified Accountants (ACCA) for permission to reproduce past examination questions. The suggested solutions in the exam answer bank have been prepared by us, unless otherwise stated.

## REVIEWERS

Particular thanks are due to those reviewers who gave their thoughtful comments on the strengths and weaknesses of the previous editions and the proposals for the 12th edition:

- Lynn Bradley, University of Glasgow
- Dinisa Kandasamy, Birmingham City Business School
- Karen McFarlane, Glasgow Caledonian University
- Kudzanai Munongi, University of Sunderland
- Dhru Shah, Nottingham Trent University
- Richard Tawiah, University of Strathclyde
- Dinusha Weerawardane, University of West London

## IFRS STANDARDS

This publication contains copyright material of the IFRS® Foundation in respect of which all rights are reserved. Reproduced by Cengage Learning (EMEA) Ltd. with the permission of the IFRS Foundation. No permission granted to third parties to reproduce or distribute. For full access to IFRS Standards and the work of the IFRS Foundation please visit <http://eifrs.ifrs.org>

The International Accounting Standards Board®, the IFRS Foundation, the authors and the publishers do not accept responsibility for any loss caused by acting or refraining from acting in reliance on the material in this publication, whether such loss is caused by negligence or otherwise.

## ISA AND FRC STANDARDS

This publication contains copyright material of the Financial Reporting Council Ltd (FRC) which is adapted and reproduced with the permission from the FRC ([www.frc.org.uk](http://www.frc.org.uk)).

# Teaching & Learning Support Resources

Cengage's peer-reviewed content for higher and further education courses is accompanied by a range of digital teaching and learning support resources. The resources are carefully tailored to the specific needs of the instructor, student and the course. Examples of the kind of resources provided include:



A password-protected area for instructors with, for example, a test bank, PowerPoint slides and an instructor's manual.



An open-access area for students including, for example, useful weblinks and glossary terms.

Lecturers: to discover the dedicated teaching digital support resources accompanying this textbook please register here for access: [cengage.com/dashboard/#login](https://cengage.com/dashboard/#login)

Students: to discover the dedicated learning digital support resources accompanying this textbook, please search for *Auditing*, 12th Edition on: [cengage.co.uk](https://cengage.co.uk)

Learn more at [cengage.co.uk](https://cengage.co.uk)





# CHAPTER 1

# INTRODUCTION TO

# AUDITING – THE WHY

# OF AUDITING

## **Learning Objectives**

After studying the material in this chapter you should be able to:

- understand the difference between ownership and control
- understand the principles of Agency Theory
- understand why auditing plays a key role in equalizing the information imbalance between directors and shareholders
- understand the advantages and disadvantages of having an audit
- explain the conceptual frameworks of auditing theory
- understand what is meant by the 'Expectation Gap'

## INTRODUCTION

In this chapter we will introduce the basic concepts and theories on which the profession of auditing is based. We will look at some of them in more detail in later chapters, but for now we will concentrate on an overview of the auditing profession, what governs it and why it is needed.

One of the most far-reaching consequences of the Industrial Revolution was the introduction of the limited liability company. The first such was registered at Companies House in 1856 and this, in essence, signalled the final, formal split between ownership and control. Whilst the modern company can be said to have come into being in 1856, the audit profession came somewhat later as it was not until the Companies Act 1900 that an obligation to produce annual accounts was placed on the directors of companies.

Once the corporation had finally developed as a legal entity in its own right, resulting in the mass ownership of shares becoming firmly separated from the management and control of the organization's activities on a day-to-day basis, the stage was set for the role of the auditor as arbitrator and judge.

To understand the position of the auditor more fully it is important to appreciate the distinction between owners and managers and the difference between them in terms of their approach to the company and the rewards of ownership and control.

This is set out in a model which has come to be known as **Agency Theory**.

## AGENCY THEORY

Agency is the name given to the practice by which productive resources owned by one person or group are managed by another person or group of persons. In this case the agents are the directors or managers of the company and the principals are the shareholders or owners of the company.

The problem of owners delegating their interests to an agent or manager had been pondered as early as the eighteenth century by Adam Smith in his book *The Wealth of Nations*:

*The directors of [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partner frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.*

There had been academic writings on Agency Theory in the early 1970s in different social contexts, but the classic paper on Agency Theory, for those academically inclined, was that of Jensen and Meckling in 1976 in a paper called *'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure.'*

In that paper they looked at Agency Theory and the costs of agency and stated:

*We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationship are utility maximizers there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities, of the agent. In addition, in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. However, it is generally impossible for the principal or the agent at zero cost to ensure that the agent will make optimal decisions from the principal's viewpoint.*

This paper helped move academic writing on organizational theory away from the idea of managerial capitalism and the theories that the firm always sought to maximize value to a recognition that shareholders are the principal stakeholders with managers as their agents, and that the principal concern of these agents was empire building with a general disregard for shareholder interest – what Jensen, in 1989, called *'the systematic*



*fleeing of shareholders and bondholders*'. Since then there have been innumerable papers written expanding on the original work and extending it to other fields of human endeavour, but we will leave it to individual students to track these down and study what are, after all, variants on this original theme and speculations as to the causes of the behaviour of agents, none of which is directly relevant to auditing.

So, at its simplest, Agency Theory is the recognition that the inclination of agents is to act rather more in their own interests than those of their employers. What this means to us in practice is that Agency Theory recognizes the tendency of company managers, or directors, to make decisions which are more favourable to their own objectives than to those of their principals, the owners or shareholders, of the business.

Agency Theory is a relatively simple principle to grasp but its ramifications are extensive and it has important implications for how organizations conduct themselves and for their operational culture. It also has importance for auditors, as we shall see.

The differing objectives can be summarized in Figure 1.1.

FIGURE 1.1 Agency Theory

Party	Objective
Principal	<ul style="list-style-type: none"> <li>• Safe investment</li> <li>• Regular dividends</li> <li>• Long-term capital growth</li> <li>• Maintenance of value</li> </ul>
Agent	<ul style="list-style-type: none"> <li>• Salary and benefits</li> <li>• Maximum bonus</li> <li>• Share options</li> <li>• Personal success of successful business measured by share price</li> </ul>

The Institute of Chartered Accountants in England & Wales put it this way:

*In principle the agency model assumes that no agents are trustworthy and if they can make themselves richer at the expense of their principals they will. The poor principal, so the argument goes, has no alternative but to compensate the agent well for their endeavours so that they will not be tempted to go into business for themselves using the principal's assets to do so.*

*The origin of auditing goes back to times scarcely less remote than that of accounting . . . Whenever the advance of civilization brought about the necessity of one man being entrusted to some extent with the property of another the advisability of some kind of check upon the fidelity of the former would become apparent.*

ICAEW (2005)

Clearly this is not universally true, but the extent to which principals don't trust their agents will tend to determine the level of the monitoring mechanisms created for the overview of agents' activities and the extent to which agents' compensation levels are determined to be acceptable.

This is where auditing comes in.

In both the UK and the USA, the growth in share ownership has been a trend towards both institutional ownership of large blocks of shares and widely dispersed ownership by large numbers of individual shareholders, which has been called *ownership without power*. Institutions which hold shares as investments are coming under increasing pressure to adopt some of the rights of ownership, particularly in curbing what has been seen, in some cases, as excessive remuneration voted to directors.

This has reinforced calls for improved transparency in reporting to correct the imbalance in financial reporting – directors have lots of information, shareholders relatively little – which will, in the longer term, enable shareholders to assume more of the responsibilities of ownership and make boards of directors more accountable.

Upon this principle rests the foundation of not only the auditing profession, but ultimately, in the latter part of the twentieth century and the early part of the twenty-first, the establishment of modern corporate governance, which we will look at in Chapter 2.

The role of the auditor becomes increasingly significant when standards of corporate morality are, or are seen to be, declining. Corporate scandals in the USA and Europe in recent years involving misrepresentation of financial information, corruption and theft on a huge scale and the banking crisis of 2007/8 have increased the demand from both investors and regulators for auditors to be more efficient and more demanding of their clients. Auditors, it is suggested, should be more insistent on their client's adherence to ethical principles and improved standards of governance.

We look at this later, but students should be aware from the beginning that the influence of globalization and the increasing power of corporations are placing increasing demands on the auditing profession.

## WHY IS THERE A NEED FOR AN AUDIT?

As mentioned earlier, the problem which emerged when owners began delegating the running of an entity in which they had invested to managers, and thus sacrificed their involvement in the day-to-day control of the organization, is whether or not they could fully trust the financial report prepared by their managers.

As time went on and organizations grew larger, the management became increasingly more powerful with the result that nowadays when managers control huge multinational corporations, they have a direct effect on the ordinary lives of thousands of individuals through their economic decisions. They can relocate or close down factories, change working conditions and terms, decide where to pay tax through transfer pricing agreements – they exercise a huge amount of power (Figure 1.2).

---

FIGURE 1.2 The Modern Corporation – Berle and Means

Adolf Berle and Gardiner Means published their seminal work *The Modern Corporation and Private Property* in 1932. In it they stated that, as corporations grew, the financing requirements made it increasingly difficult for individuals to maintain majority shareholdings so shareholding became divided and fragmented among larger and larger numbers of individuals and other investing bodies.

As shareholding became more diverse and diffuse the one constant in the company was the management and *de facto* power thereby devolved upon them.

As companies grew in size and power a relatively large amount of total corporate wealth became concentrated into relatively few huge corporations. Managers in these corporations were able to disburse company resources in the way that primarily suited them, such as through reinvestment or even enhanced pay, rather than as dividends.

These companies had an impact on society as they were able to open or close factories and branches thus influencing the lives of millions of people without any real form of democratic accountability.

*Berle and Means (1932)*

Even in the modern era, despite the developments and expansion of disclosure in the financial statements and the growth of accounting standards, practical access to detailed financial information by shareholders remains limited. Shareholders, or potential shareholders, may come to believe that they are not getting all the information, or the right information to enable them to make investment decisions. Financial analysts working for major institutional investors may have rather more access to the directors of major corporations than the small investor, but even they have made mistakes and many of them have still lost their employers' money despite their abilities and the access to information granted to them.

## Real World Auditing

### Fraud results in audit changes

The Royal Mail case in 1932 (Rex v Kyslant [1932] 1KB442; [1932] All ER 179) wherein Lord Kyslant was convicted of falsifying a prospectus to induce individuals into buying shares in a failing company in order to prop up its finances fell, as one commentator put it, *'like an atom bomb and changed the face of the world of accounting'*.

The director of the Royal Mail Steam Packet Company, then the largest shipping group in the world when it took over the White Star Line in 1927, Lord Kyslant, had falsified a trading prospectus with the aid of the company accountant to make it look as if the company was profitable and to entice potential investors. Following an independent audit instigated by HM Treasury, Kyslant and John Moreland, the company auditor, were arrested and charged with falsifying both the trading prospectus and company records and accounts.

Although they were acquitted of falsifying records and accounts, Kyslant was found guilty of falsifying the trading prospectus and sentenced to 12 months in prison. The company was then liquidated, and reconstituted as The Royal Mail Lines Ltd with the backing of the British government.

The Royal Mail case was perhaps one of the most significant cases in accounting history and contributed to the transition of the audit process from fraud detection and simply verifying a balance sheet (Statement of Financial Position) in order to demonstrate solvency to the auditing of all the financial statements including a Profit and Loss Account (Income Statement). This was confirmed in the UK in the Companies Act 1948. Consequently, the role of the auditor, as agent for the shareholder, becomes crucial and the costs of the audit are nothing compared with the comfort and reassurance the audit affords the shareholders. The Auditor's Report on the financial statements also becomes crucial to the managers of the business, as a favourable opinion from the independent auditor confirms their actions and reinforces their credibility and reputation as agents for the shareholders.

Owners who appoint managers to look after their property will be concerned to know what has happened to it. In the case of companies, reporting and accounting for their actions is by means of the annual financial statements which the managers must prepare, and it is through these that, ultimately, the owners of the business monitor the activities of their agents. The independent audit is a crucial part of this process to ensure that the financial statements faithfully represent the activities of the managers during the financial period.

In 2019 the Brydon Report *Assess, Assure and Inform: Improving audit quality and effectiveness*, an independent review undertaken by Sir Donald Brydon into the quality and effectiveness of audit came up with the definition of an audit to reflect its role as a public interest function that demonstrates more than compliance with laws and rules. Brydon proposed the following definition:

*The purpose of an audit is to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.*

He suggested that, ideally, this definition would be enshrined in the Companies Act 2006. However, the UK already has a definition in ISA(UK)200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing (UK)*, which we will look at in more detail in Chapter 10. This definition includes the primary objective of an audit as being

*to enhance the degree of confidence of intended users in the financial statements. This is achieved by the expression of an opinion by the auditor on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.*

Brydon's definition is a variance on that in ISA(UK)200 but it should be remembered that the Brydon Report was commissioned following some high-profile corporate failures which reflected badly on the audit profession. The need to retain confidence in the audit process is a key element in retaining investor confidence, so

Brydon was very much determined that public confidence in auditing as a useful function and not merely a rubber stamp should be retained. Brydon suggested that the role of the auditor be extended, for example, by being expected to actively look for fraud rather than react to signs of it should they be discovered during the course of a routine audit – which in reality hardly ever happens (Chapter 20). The case of Patisserie Valerie illustrates the point whereby the chief executive of auditors Grant Thornton tried to explain the auditors' role to a plainly disbelieving committee of MPs.

## Real World Auditing

### The role of the auditor – Patisserie Valerie

In October 2018 KPMG carried out a forensic investigation after Patisserie Valerie collapsed. They found evidence of a massive fraud and deliberate manipulation of the accounts. KPMG discovered thousands of false entries into the company's ledgers, among other deliberate manipulations. This resulted in overstatement of the cash position by £54m, while its liabilities had been understated and the receivables overstated to the tune of £17m. There was also a £23m discrepancy in the way it had valued its assets.

Five people have been arrested by the Serious Fraud Office including the Chief Financial Officer, Chris Marsh. Former auditors Grant Thornton were dismissed. David Dunckley, chief executive of Grant Thornton, told MPs on the Business, Energy and Industrial Strategy (BEIS) Committee that auditors only assess past accounts and are not looking for fraud, saying: 'We're not looking for fraud or the future or giving a statement that the accounts are correct. We're saying they're reasonable, we are looking in the past and we are not set up to look for fraud.' In 2021 Grant Thornton were fined £2.34m for 'serious' lapses in professional judgement, failures to exercise professional scepticism, obtain sufficient appropriate audit evidence and prepare sufficient audit documentation.

This obviously poses questions in the public mind as to the role of the auditor and reinforces the Expectation Gap between what auditors do and what the public think they do. MP Peter Kyle asked the key question: 'What's the point of an audit if it didn't pick that up?' – a question the profession is still looking to answer.

Brydon takes a wider view of the audit process than the merely technical. His view of the purpose of audit, apart from its obvious verification function, is that audit has a public interest function wider than that of one owed to a specific group of stakeholders (the shareholders):

*Such a purpose should reflect and reinforce audit (both the present statutory audit and the audit of any other corporate information) as a public interest function that demonstrates more than just compliance with laws and rules. Audit exists fundamentally to help its users know how confident they can be in the audited information and – by extension – in those who have produced that information.*

However, these views should be considered in the light of academic writings on the subject (see later in this chapter) and learners should consider for themselves the role of audit in the twenty-first century. In other words, are auditors independent arbiters of truth and fairness, or are they simply there to support and build the confidence in a company? Due consideration of this question should be given after further reading!

## Parties to financial statements

Historically, annual reports and accounts of companies were produced by the directors (as managers) to the shareholders (as owners), and other people were not expected to be interested in them. However, today, a much wider range of people are interested in the annual report and accounts of companies and other organizations.

The following people or groups of people are likely to want to see and use financial statements. These are often described as **stakeholders** and comprise actual or potential:

- owners or shareholders
- lenders or debenture holders
- employees

- customers
- suppliers
- people who advise the above – e.g. accountants, stockbrokers, credit rating agencies, financial journalists, trade unions and financial analysts
- competitors and people interested in mergers, amalgamations and takeovers
- the government, including the tax authorities and government bodies concerned with consumer protection and the control and regulation of business
- the public, including those who are interested in consumer protection, environmental protection, political and other pressure groups.

All these individuals or bodies must be sure that the financial statements can be relied upon.

## What's in the financial statements?

Financial statements can take many forms. The best known are the **Statement of Comprehensive Income** (formerly the Profit & Loss Account) and **Statement of Financial Position** (Balance Sheet) of the business. In the specific case of limited companies, financial statements are produced annually and take the form of an Annual Report and Accounts which includes a Statement of Comprehensive Income and Statement of Financial Position and also other statements including the Directors' Report, a cash flow statement and ancillary reports.

The financial statements may:

- contain errors
- not disclose fraud
- be inadvertently misleading
- be deliberately misleading
- fail to disclose relevant information
- fail to conform to regulations.

Further, owners of companies must be protected from unscrupulous management who would use the owner's investment for their own benefit and not that of the owner.

## Real World Auditing

### The greedy director – Leo Kozlowski

Leo Kozlowski is the former CEO of Tyco International plc, a security systems company incorporated in the Republic of Ireland, with operational headquarters in Princeton, New Jersey, United States.

In 2005 he was convicted of crimes related to his receipt of \$81m in unauthorized bonuses, the purchase of art for \$14.725m and the payment by Tyco of a \$20m investment banking fee to Frank Walsh, a former Tyco director. Kozlowski and co-conspirator former CFO Michael Swartz were ordered to pay a total of \$134m in restitution. Kozlowski was further fined \$70m, while Swartz was fined \$35m. Both were convicted on 22 counts of grand larceny, falsifying business records, securities fraud and conspiracy.

Separately, Tyco sued Kozlowski and prevailed, with the court finding that the \$500m in compensation and benefits he received during his time of disloyalty, between 1997 and 2002, were forfeit back to the company under New York's 'faithless servant' doctrine. This holds that an employee who acts unfaithfully towards his or her employer must forfeit to his or her employer all compensation received during the period of disloyalty.

Kozlowski admitted his culpability for the crimes at his parole hearing. *'It was greed, pure and simple'*, the 67-year-old former executive told a New York State parole panel at a video conference hearing. *'I feel horrible . . . I can't say how sorry I am and how deeply I regret my actions.'*

Potential investors must guard against investing in abuse of limited liability where companies are deliberately set up for speculative or high-risk ventures. In this case the initial investors have very little to lose, and the managers perhaps nothing at all apart from their employment. If later investors are not aware of company activity they could be induced to invest in a project which carries a much greater level of risk than the rewards they might achieve would warrant.

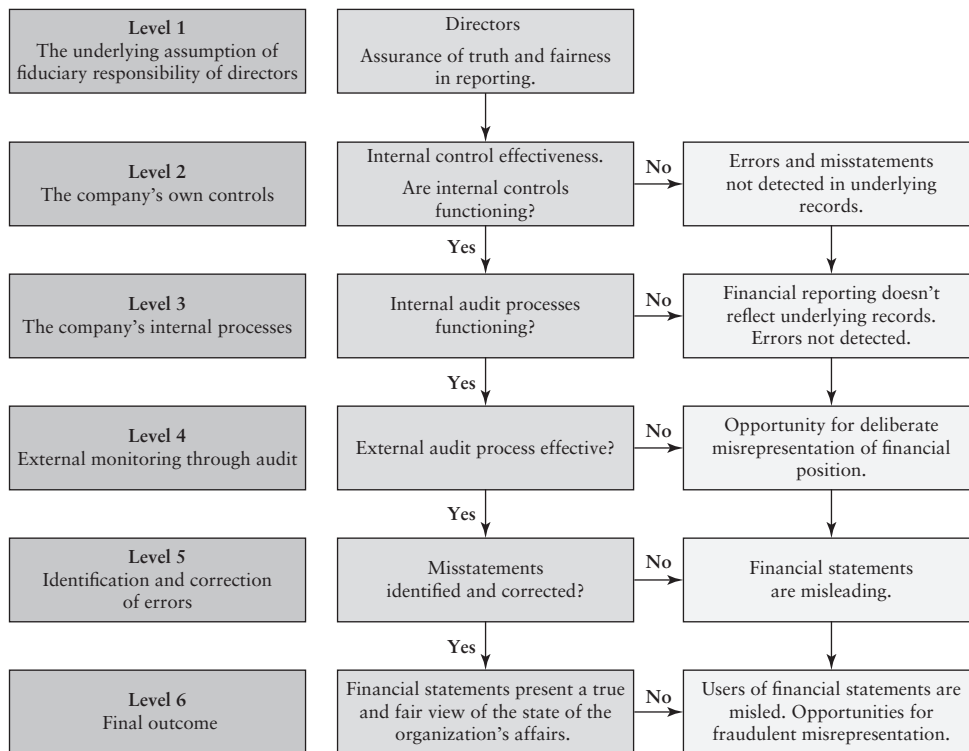
The solution to this problem of credibility in reports and accounts lies in appointing independent professionals to investigate the report and feedback on their findings. An audit helps to reduce these so-called agency costs as it helps to protect investors from the actions of predatory managers.

## THE AUDIT PROCESS

The audit process is described in Figure 1.3. If the process continues down the YES route the financial statements will ultimately represent a true and fair view of the company's financial position.

If, at any point, the processes fail – indicated by a NO response – errors and misstatements will creep in and result in the financial statements becoming incorrect.

FIGURE 1.3 The financial audit process



## INTERNATIONAL PRESSURES AND GLOBALIZATION

Companies or groups can be very large with multinational activities and comprising many subsidiaries and related activities. The preparation of the accounts of such entities is a very complex operation perhaps involving the bringing together and summarizing of accounts of subsidiaries with differing conventions, legal systems and accounting and control systems. The examination of such accounts by independent experts trained

in the assessment of financial information is of benefit to those who control and operate such organizations as well as to owners and outsiders.

The existence of a strong auditing profession is important to global markets because reliable financial reporting promotes confidence and stability in the market. Markets need the confidence and the assurance a strong audit function can bring in order to enable participants in the market, including the entities themselves, investors and potential investors, to make informed decisions.

This involves reducing risk to potential investors by providing them with ‘sound’ information.

Corporate failures, particularly those involving fraud by senior management, reduce confidence and create instability. They also tend to encourage increased regulation which may restrict market operations or encourage further deception.

The concepts of agency highlighted above require an auditing profession which is able to enforce standards of accountability on company managers through the mechanism of the Auditor’s Report (Chapter 26).

We look at this in more detail in Chapter 28 where we look at the audit of group accounts. Students should, however, be aware that the developments in technology which have made possible increasing global trading and the expansion of capital markets have resulted in regulators requiring an improved standard of information, in terms of accuracy and timeliness, in order to protect investors. This applies particularly to banks.

It is being recognized that greater accountability and control are needed over corporate executives running companies which may have revenues considerably greater than some countries; consequently, particularly in the West, increased corporate governance requirements have led to increased accountability and disclosure (Chapter 2).

As we will see in Chapter 2, there is a conflict between the USA’s rules-based approach to control audit firms, based on the Sarbanes–Oxley legislation, and the UK and other countries which have adopted a non-legal audit framework based on self-regulation. This has caused problems where the US jurisdiction and compliance requirements clash with non-statutory approaches to audit regulation.

The regulatory demands for lots of additional information in the financial statements and the rise of global companies has driven the requirement for auditors to increasingly use technology and develop new approaches to the audit of large, multinational businesses. We look at this in more detail in Chapter 10.

There are problems faced by auditors and accountants in producing consolidated financial information for groups of companies in common ownership in compliance with an appropriate accounting framework where financial information from international subsidiary companies may be prepared under a range of differing standards of quality and disclosure (Chapter 28). This has always been difficult, but increased global trading means that audit firms have experienced an increase in the range and significance of group subsidiary companies trading in low-cost economies where standards of corporate governance are low and which produce information that has not been prepared under recognized accounting or auditing standards.

The International Federation of Accountants (IFAC) has gone a long way towards developing standards in both accounting and auditing which are being adopted across the world. This harmonization of approach is gradually reducing information asymmetry between regions.

The growth of internet-based online trading has challenged conventional audit approaches. Companies may trade globally and, apart from huge technical problems in auditing computer-based entities (Chapter 17), it may be difficult to establish which legal jurisdiction applies to such businesses and which set of standards and rules applies to them.

Audit firms are being increasingly required to carry out assurance type assignments (Chapter 30). These require a lower standard of evidence than an audit. There are moves among international regulators to separate the audit function from other types of audit work in order to reduce the inherent conflict of interest this creates in audit firms – i.e. that of acting both as auditor and advisor.

As the size of multinational companies increases, and their sphere of operations expands around the globe, the audit profession has seen the development of auditing mega-firms who, they claim, are the only firms which have the resources to audit modern corporate behemoths. The audit profession is thus dominated by the ‘Big 4’ (PricewaterhouseCoopers, KPMG, Ernst & Young and Deloitte). Smaller firms, with a lower level of global reach, and those which have developed international networks, claim that this reduces competition in the audit market for the biggest clients. Conversely the ‘Big 4’ claim that they compete ferociously between themselves so market competition is limited but undiminished.

We look at all of these points in more detail in the relevant chapters.