EXTERNAL AUDITING

STUDY TEXT

Qualifications and Credit Framework

AQ2016

This Study Text supports study for the following AAT qualifications:

AAT Professional Diploma in Accounting – Level 4

AAT Diploma in Business Skills – Level 4

AAT Professional Diploma in Accounting at SCQF – Level 8

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STUDY TEXT

Chapter

This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2017 IFRS Standards Red Book.

INTRODUCTION

HOW TO USE THESE MATERIALS

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chance of success in your AAT assessments.

They contain a number of features to help you in the study process.

The sections on the Unit Guide, the Assessment and Study Skills should be read before you commence your studies.

They are designed to familiarise you with the nature and content of the assessment and to give you tips on how best to approach your studies.

STUDY TEXT

This study text has been specially prepared for the revised AAT qualification introduced in September 2016.

It is written in a practical and interactive style:

- key terms and concepts are clearly defined
- all topics are illustrated with practical examples with clearly worked solutions based on sample tasks provided by the AAT in the new examining style
- frequent practice activities at the end of the chapters ensure that what you have learnt is regularly reinforced
- ‘pitfalls’ and ‘examination tips’ help you avoid commonly made mistakes and help you focus on what is required to perform well in your examination
- ‘Test your understanding’ activities are included within each chapter to apply your learning and develop your understanding.

ICONS

The chapters include the following icons throughout.

They are designed to assist you in your studies by identifying key definitions and the points at which you can test yourself on the knowledge gained.

Definition

These sections explain important areas of Knowledge which must be understood and reproduced in an assessment.

Example

The illustrative examples can be used to help develop an understanding of topics before attempting the activity exercises.

Test your understanding

These are exercises which give the opportunity to assess your understanding of all the assessment areas.

Quality and accuracy are of the upmost importance to us so if you spot an error in any of our products, please send an email to mykaplanreporting@kaplan.com with full details.

Our Quality Co-ordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Progression

There are two elements of progression that we can measure: first how quickly students move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

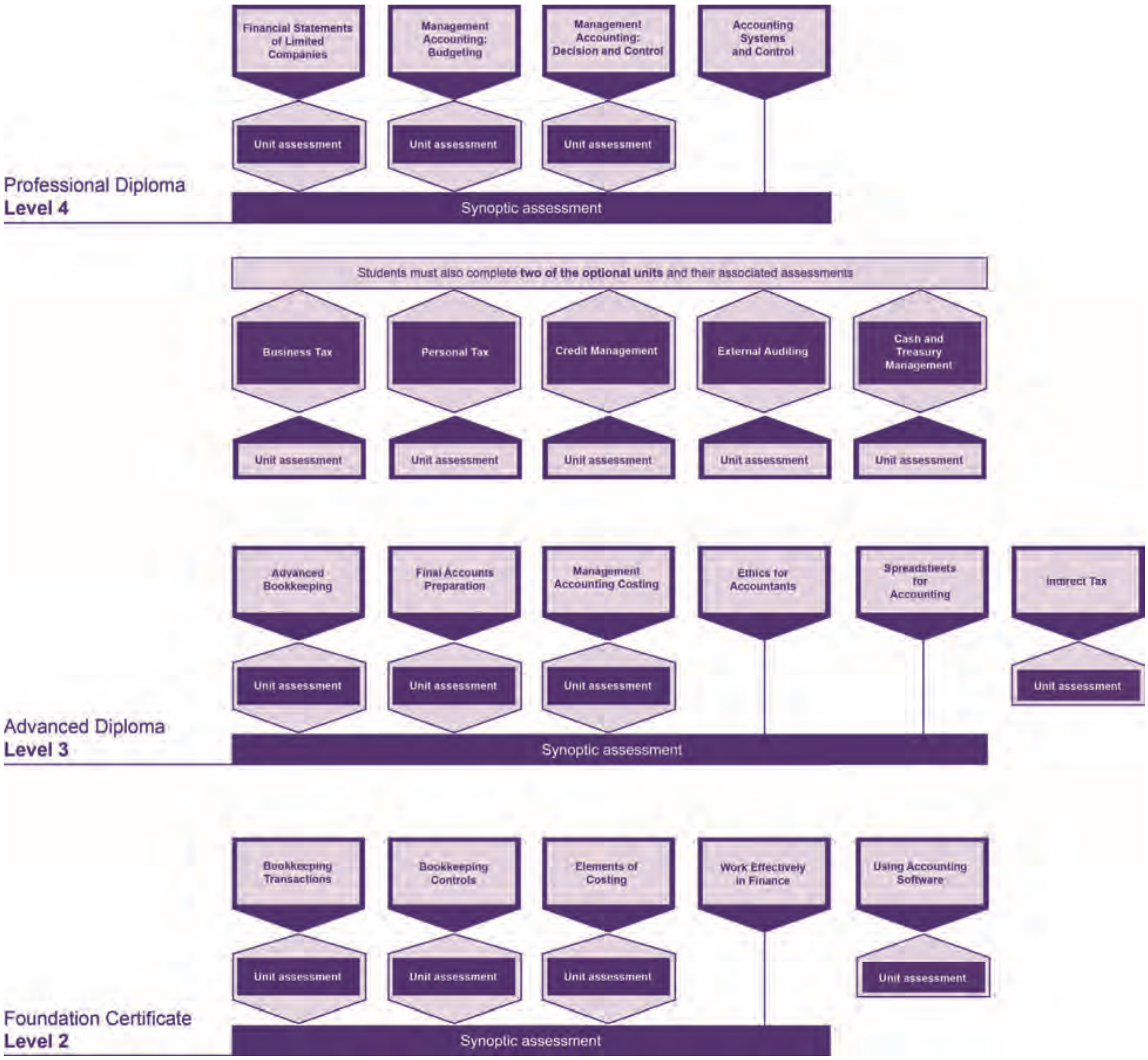
A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example 'I will finish this topic by 30 June', or for overall achievement, such as 'I want to be qualified by the end of next year'.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another.

We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.


Financial Statements of Limited Companies
Management Accounting: Budgeting
Management Accounting: Decision and Control
Accounting Systems and Control
Unit assessment
Unit assessment
Unit assessment
Professional Diploma
Level 4
Synoptic assessment
Students must also complete two of the optional units and their associated assessments
Business Tax
Personal Tax
Credit Management
External Auditing
Cash and Treasury Management
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Advanced Bookkeeping
Final Accounts Preparation
Management Accounting Costing
Ethics for Accountants
Spreadsheets for Accounting
Indirect Tax
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Advanced Diploma
Level 3
Synoptic assessment
Bookkeeping Transactions
Bookkeeping Controls
Elements of Costing
Work Effectively in Finance
Using Accounting Software
Unit assessment
Unit assessment
Unit assessment
Unit assessment
Foundation Certificate
Level 2
Synoptic assessment

UNIT GUIDE

Introduction

The unit is designed to equip students with the knowledge and skills required to undertake an external audit under supervision. This is achieved by assessing whether students:

- understand the essence and objectives of the audit process and the ethical and professional implications of the regulatory requirements and pronouncements of the professional bodies
- understand the nature and importance of internal controls and identify deficiencies in accounting systems
- are able to contribute to the conduct of all stages of an external audit, including planning, gathering sufficient and appropriate evidence, concluding and reporting findings in accordance with International Standards on Auditing.

External auditing is an **optional** unit in the Professional Diploma in Accounting.

Learning objectives

On completion of these units the learner will be able to:

- demonstrate an understanding of the principles of auditing
- demonstrate the importance of professional ethics
- evaluate the audited entity's system of internal control
- evaluate audit procedures for obtaining audit evidence
- evaluate the planning process
- evaluate audit procedures.

Scope of content

To perform this unit effectively you will need to know and understand the following:

		Chapter
1	**Demonstrate an understanding of the principles of auditing**	
1.1	**Demonstrate an appreciation of the concept of assurance** Students need to know: • difference between reasonable and limited assurance • difference between positive and negative expression of assurance • benefits gained from assurance • meaning of true and fair view/presents fairly.	1
1.2	**Discuss the objectives of audits conducted under International Standards on Auditing (ISA)** Students need to know: • the respective responsibilities of management and external auditors in relation to the financial statements • the role of professional scepticism and professional judgement • elements of a report to management on deficiencies in internal control • elements of the auditor's report • contents of adequate accounting records • the role of the International Auditing and Assurance Standards Board (IAASB).	1, 15

Delivering this unit

Unit name	Content links	Suggested order of delivery
Financial Statements of Limited Companies Accounting Systems and Controls	Students require an understanding of: Foundation level units, Bookkeeping Transactions and Bookkeeping Controls Advanced level units, Advanced Bookkeeping and Final Accounts Preparation Professional level unit, Financial Statements of Limited Companies The coverage of internal controls in the External Auditing unit will reinforce the knowledge and skills required in Accounting Systems and Controls.	N/A

THE ASSESSMENT

Test specification for this unit assessment

Assessment type	Marking type	Duration of exam
Computer based unit assessment	Partially computer/ partially human marked	2 hours

The assessment for this unit consists of 23 compulsory, independent, tasks.

The competency level for AAT assessment is 70%.

Learning outcomes		Weighting
1	Demonstrate an understanding of the principles of auditing	5%
2	Demonstrate the importance of professional ethics	12%
3	Evaluate the audited entity's system of internal control	15%
4	Evaluate audit procedures for obtaining audit evidence	15%
5	Evaluate the planning process	33%
6	Evaluate audit procedures	20%
Total		100%

There are three extended writing tasks:

- Task 18: Identify and explain the audit risks of a given scenario.
- Task 19: Set out the audit procedures to be undertaken to audit a specific area of the financial statements.
- Task 22: Prepare extracts, suitable for inclusion in a report to management, which set out the possible consequences and recommendations you would make in respect of a given scenario.

Each of the other assessment criteria may be assessed by any other question type.

STUDY SKILLS

Preparing to study

Devise a study plan

Determine which times of the week you will study.

Split these times into sessions of at least one hour for study of new material. Any shorter periods could be used for revision or practice.

Put the times you plan to study onto a study plan for the weeks from now until the assessment and set yourself targets for each period of study – in your sessions make sure you cover the whole course, activities and the associated questions in the workbook at the back of the manual.

If you are studying more than one unit at a time, try to vary your subjects as this can help to keep you interested and see subjects as part of wider knowledge.

When working through your course, compare your progress with your plan and, if necessary, re-plan your work (perhaps including extra sessions) or, if you are ahead, do some extra revision/practice questions.

Effective studying

Active reading

You are not expected to learn the text by rote, rather, you must understand what you are reading and be able to use it to pass the assessment and develop good practice.

A good technique is to use SQ3Rs – Survey, Question, Read, Recall, Review:

1 **Survey the chapter**

Look at the headings and read the introduction, knowledge, skills and content, so as to get an overview of what the chapter deals with.

2 **Question**

Whilst undertaking the survey ask yourself the questions you hope the chapter will answer for you.

3 Read

Read through the chapter thoroughly working through the activities and, at the end, making sure that you can meet the learning objectives highlighted on the first page.

4 Recall

At the end of each section and at the end of the chapter, try to recall the main ideas of the section/chapter without referring to the text. This is best done after short break of a couple of minutes after the reading stage.

5 Review

Check that your recall notes are correct.

You may also find it helpful to re-read the chapter to try and see the topic(s) it deals with as a whole.

Note taking

Taking notes is a useful way of learning, but do not simply copy out the text.

The notes must:

- be in your own words
- be concise
- cover the key points
- well organised
- be modified as you study further chapters in this text or in related ones.

Trying to summarise a chapter without referring to the text can be a useful way of determining which areas you know and which you don't.

Three ways of taking notes

1 Summarise the key points of a chapter

2 Make linear notes

A list of headings, subdivided with sub-headings listing the key points.

If you use linear notes, you can use different colours to highlight key points and keep topic areas together.

Use plenty of space to make your notes easy to use.

3 Try a diagrammatic form

The most common of which is a mind map.

To make a mind map, put the main heading in the centre of the paper and put a circle around it.

Draw lines radiating from this to the main sub-headings which again have circles around them.

Continue the process from the sub-headings to sub-sub-headings.

Annotating the text

You may find it useful to underline or highlight key points in your study text – but do be selective.

You may also wish to make notes in the margins.

Revision phase

Kaplan has produced material specifically designed for your final examination preparation for this unit.

These include pocket revision notes and an exam kit that includes a bank of revision questions specifically in the style of the new syllabus.

Further guidance on how to approach the final stage of your studies is given in these materials.

Further reading

In addition to this text, you should also read the 'Accounting Technician' magazine every month to keep abreast of any guidance from the examiners.

Principles of auditing

1

Introduction

This chapter demonstrates the features of an audit and introduces the fundamental principles within audit work. This is the basis for the whole External Audit assessment and introduces some important concepts for the rest of the syllabus.

ASSESSMENT CRITERIA

Demonstrate an appreciation of the concept of assurance (1.1)

Discuss the objectives of audits conducted under International Standards on Auditing (ISA) (1.2)

CONTENTS

1 What is an audit?

1.1 The purpose of an external audit

The need for an audit arises from the separation between the management and the ownership of companies – directors are responsible for running the company on behalf of the shareholders. Financial statements are prepared by the directors in order to account for their stewardship to the shareholders, and an examination by an independent person (i.e. the external auditor) gives them credibility.

Once the external auditor has conducted his examination, the auditor expresses an opinion in an auditors' report attached to the financial statements.

1.2 Definition of Assurance and Audit

Definition

Assurance – an assurance engagement is one in which a practitioner 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.

Definition

Audit of financial statements – an audit is a type of assurance engagement and is a process which results in expression of an opinion as to whether the financial statements give a true and fair view of the entity's affairs at the period end, and as to whether they have been properly prepared in accordance with the applicable accounting standards.

The Companies Act 2006 identifies that an external audit is a legal requirement for all UK companies, except those which meet two of the following three criteria: (1) annual turnover not exceeding £10.2m, (2) total assets value not exceeding £5.1m and (3) 50 or fewer employees (this is for companies with an accounting period starting on or after 1 January 2016).

There are a number of benefits of an audit that mean a company might choose to be audited even if it does not legally need to be, such as:

- Adds credibility.
- It is an independent verification.
- There are a number of by-products, such as the fact that an audit can act as a fraud deterrent and the auditor will provide recommendations on internal controls.

During this section, and indeed throughout this book, we shall be referring to International Standards on Auditing (ISAs) which are produced by the International Auditing and Assurance Standards Board (IAASB) and which, after approval by the UK Financial Reporting Council (FRC), must be followed when carrying out audits in the UK and Ireland.

1.3 Expression of opinion – the audit report

ISA 700 (Revised) *Forming an opinion and reporting on financial statements* indicates the required content of an auditor's report. This includes the audit opinion, which is usually expressed in 'true and fair' terms. The idea of 'true and fair' is developed later in this chapter.

An extract from a standard audit report is shown below.

Example

AUDITOR'S REPORT TO THE SHAREHOLDERS OF XYZ CO (EXTRACT)

Opinion

In our opinion the financial statements:

- give a true and fair view of the financial position of XYZ as at 31 December 20X6 and of its financial performance and its cash flows for the year then ended in accordance with the International Financial Reporting Standards; and
- have been properly prepared in accordance with the Companies Act 2006.

Registered Auditors

Date *Address*

1.4 Financial statements

The 'financial statements' comprise:

- statement of financial position
- statement of profit or loss
- statements of cash flows
- statement of changes in equity
- notes to all of the above, including the accounting policies note.

1.5 Misconceptions about the financial statements

There are a number of common misconceptions about the financial statements. The main ones are as follows.

- The statement of financial position is a statement of the value of the business. Wrong – the amounts at which assets and liabilities are stated do not reflect what the business could be sold for.
- The auditors are responsible for preparing the financial statements on which they report. Wrong – the directors are responsible for selecting suitable accounting policies and preparing the financial statements.
- The amounts in financial statements are stated precisely. Wrong – the majority of figures involve some degree of estimation and auditors work with the concept of materiality (see section 2.2).

ISA 700 (Revised) seeks to address these misconceptions in the following ways.

1.6 Directors' and auditors' responsibilities

The auditor's report contains a clear statement of the respective responsibilities of directors and auditors as follows:

The company's directors are responsible for the preparation of financial statements in accordance with applicable law as well as relevant accounting and auditing standards (whether they are UK or international standards).

Readers are made aware that the financial statements have been prepared by the company's management (whose interests may be affected by the resulting figures).The auditor expresses an opinion on those figures.

1.7 Basis of opinion

"We conducted our audit in accordance with International Standards on Auditing (ISAs). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are independent of the Company in accordance with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our other ethical responsibilities in accordance with these requirements. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.''

Auditors aim to provide reasonable assurance. It would be impractical and unduly expensive to provide a guarantee that all errors and irregularities have been uncovered during the audit.

1.8 True and fair view

The use of the word 'view' indicates that a professional judgement has been reached.

The meaning of 'true and fair' has been much debated. It is not defined in the Companies Act or International Standards on Auditing. This is deliberate and any 'definitions' cited in textbooks or elsewhere should be regarded with caution.

A starting point for discussion could be that a true and fair view means that the financial statements are free from material misstatements and faithfully represent the financial performance and position of the entity.

Truth relates to factual accuracy (bearing in mind materiality – see section 2.2) and correctness, whilst fairness relates to the presentation of information and the view conveyed to the reader.

The word 'fair' in particular is difficult because it is subjective – one person's idea of what is fair is probably not another's. The auditor must consider the overall impression created by the financial statements as a whole.

1.9 Accounting standards

The courts will treat compliance with accepted accounting principles as evidence that financial statements are true and fair.

The Companies Act 2006 requires the notes to the financial statements to state:

- whether the financial statements are prepared in accordance with applicable accounting standards, and
- particulars of and reasons for material departures from accounting standards.

Test your understanding 1

1. What are the respective responsibilities of the directors and the external auditors regarding the financial statements of a company?
2. Explain what is meant by a true and fair view.

2 Important principles in audit work

2.1 Introduction

Audit work is a detailed and meticulous process which we shall examine in this text. There are, however, some basic principles which apply to audit work and it will be useful to go through these first.

2.2 Materiality

The auditor does not perform tests aimed at detecting all errors. As part of the planning process, the auditor will determine the maximum amount of error that the auditor is prepared to accept and still be satisfied that the financial statements show a true and fair view. An error over and above this maximum amount is referred to as a material error.

A material error may be:

- qualitative (e.g. transactions relating to directors are considered material by nature regardless of their value), or
- quantitative (e.g. the monetary value of the disclosed figure is incorrect).

The concept of materiality is developed in Chapter 4.

2.3 Selective testing and audit sampling

The auditor will carry out tests to ascertain whether the financial statements are free from material misstatment. These tests must be sufficient to provide evidence of material errors, if such errors exist.

The auditor does not usually test every transaction or item within an account balance, but will limit tests to a selection of items ('selective testing'). However, if the population is small, the auditor may test all of the items.

Where the auditor tests a representative sample of items in order to draw conclusions about an entire set of data, the selective testing is termed 'audit sampling'.

Audit sampling is detailed in Chapter 5.

2.4 Risk

To apply selective testing procedures, the auditor will wish to target the areas of the financial statements which are most prone to material error ('risky').

In some companies there may be many risk areas. This may be due, in part, to the type of industry in which the company operates, e.g. there may be a greater risk of material misstatement occurring in the financial statements of a high technology company than there is in a stable industry.

Also, some areas or account headings may be more prone to material error than others, e.g. inventory is usually subject to more material errors than cash at bank, because its valuation is more subjective.

As part of the planning process, the auditor will analyse risk in order to:

- direct audit tests to those areas most prone to material error
- determine the overall assurance required from a test or combination of tests (and therefore what will constitute 'sufficient' audit evidence).

Audit risk and planning are considered in greater detail in Chapter 4.

2.5 Reasonable assurance

The auditor's opinion on the financial statements is based on the concept of reasonable assurance; his report does not constitute a guarantee that the financial statements are free of misstatement.

As the auditor does not examine every single piece of available audit information and because professional judgement is required when drawing conclusions from the evidence, there is a risk that he will draw an incorrect conclusion: absolute confidence, certainty or assurance is not possible.

There are two levels of assurance you need to be aware of:

	Limited	**Reasonable**
Level	Moderate – conclusion expressed negatively.	High – conclusion expressed positively.
Example of engagement	Report on effectiveness of internal controls. Review of business plan or forecasts.	Statutory audit.
Example of report wording	'Nothing has come to our attention that indicates the internal control systems are not operating effectively.'	'Financial Statements show a true and fair view.'

A conclusion expressed negatively is less certain than a positively expressed opinion. It implies that matters could exist which cause the statement to be unreasonable, but that the practitioner has not uncovered any such matters. A practitioner gives this type of opinion when a limited assurance engagement is being carried out and a lower level of evidence is sought.

Note: Auditors will never give absolute assurance for a number of reasons:

- Audit evidence is persuasive, not conclusive.
- Auditors do not test everything.
- There are areas of judgement in the financial statements.
- There are inherent limitations of internal controls and accounting systems (see Chapter 3).
- Auditors test according to materiality (see later in this session).

2.6 The expectation gap

There is a common misconception that an unmodified audit report provides assurance that no frauds or other irregularities have occurred in the period. Wrong – the auditor is concerned with material misstatements in the financial statements; fraud is one possible cause of such a misstatement, but it is the misstatement which concerns the auditor, rather than the fraud itself. This is considered in more detail in Chapter 15.

This misconception, together with a lack of comprehension of the auditing principles discussed earlier (selective testing, materiality, etc), have been referred to as part of the 'expectation gap'.

The 'expectation gap' has become a jargon phrase used to describe the difference between:

- public perceptions of the responsibilities of auditors
- the legal and professional reality.

3 Auditing standards

3.1 Introduction

The International Auditing and Assurance Standards Board (IAASB) works to improve the uniformity of auditing practices worldwide by issuing pronouncements, particularly ISAs and promoting their acceptance. Their aim is to set standards which facilitate the convergence of national and international auditing standards.

ISAs are to be applied in every audit of historical financial information. Failure to apply ISAs could leave the auditor open to accusations of negligence, which could lead to claims for compensation as well as disciplinary action.

The IAASB's Standards contain basic principles and essential procedures, together with related guidance, in the form of explanatory and other material, including appendices.

From an assessment point of view, it is important to be aware of the broad principles laid down by those standards that are relevant to the syllabus. However, there is no need to memorise the detailed content or formal definitions that they contain.

4 Features of an audit

4.1 Who is the external auditor?

The law defines who can be the statutory auditor and this is considered in Chapter 14. In this context, 'the auditor' can be a person or firm.

Practically, 'the auditor' includes all members of the audit team on a particular assignment.

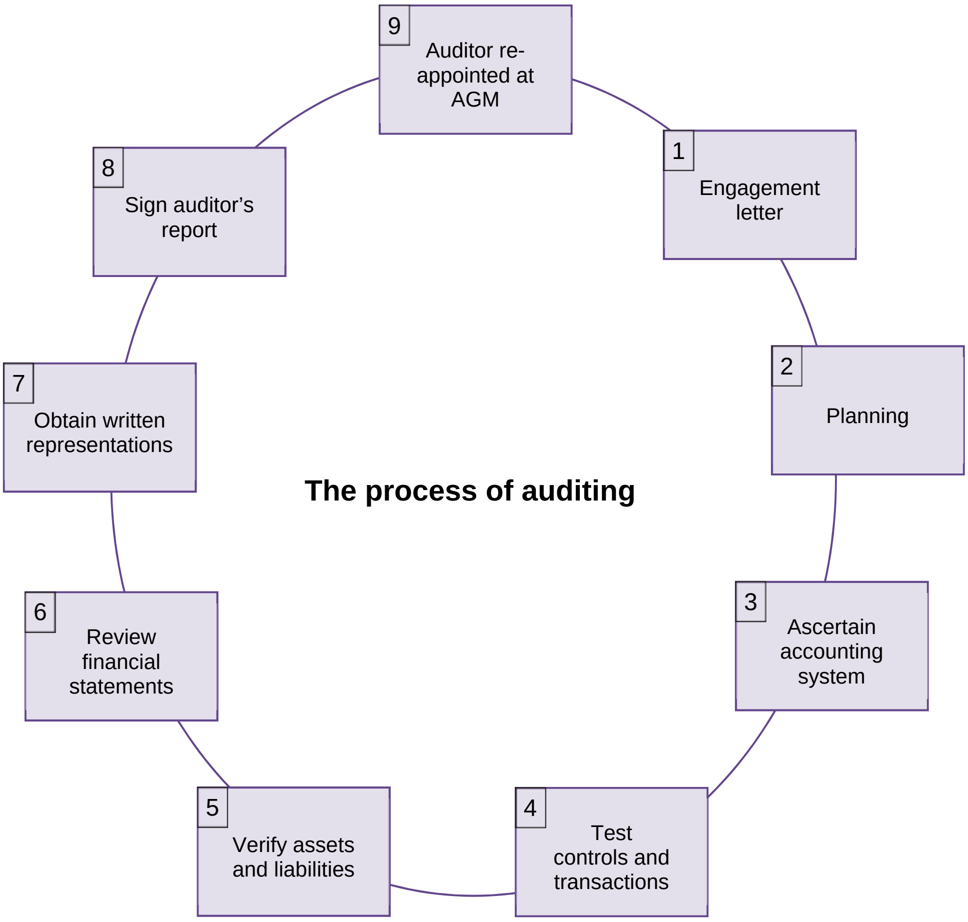
The person who takes overall responsibility for the performance of the assignment and who signs the audit report is known as the reporting partner (or engagement partner). He or she may delegate certain aspects of the audit work to other persons but the overall responsibility for the performance of the audit is the reporting partner's alone.

4.2 Audit team

A typical audit team for a large company audit might be made up as follows:

4.3 The process of auditing

An audit consists of a cycle of activities which can be broken down into a number of distinct phases as shown below. Review the phases illustrated and discussed below to gain an overview. This will all be developed in later chapters.



1 **Engagement letter.** Every auditor should send their client an engagement letter which sets out the auditor's duties and responsibilities. (See Chapter 3)

2 **Planning.** The auditor must plan and control the audit work if the work is to be done to a high standard of skill and care. (See Chapter 3)

3 **Ascertain accounting systems.** An auditor must enquire into and ascertain the client's system of accounting and internal control in order to understand how accounting data is prepared and to gain an impression as to whether systems are reliable, It is the information generated from these systems which is summarised in the financial statements. (See Chapter 4)

4 **Test controls and transactions.** The auditor should test the controls if he/she intends to rely on them and the auditor must test the records in order to obtain evidence that they are a reliable basis for the preparation of accounts. If systems are weak or unreliable, a high level of detailed work is needed. (See Chapter 5)

5 **Verify assets and liabilities.** The auditor must verify the figures appearing in the financial statements. (See Chapters 6 to 11)

6 **Review financial statements.** The auditor reviews the financial statements to see if overall they appear sensible and are consistent with the auditor's knowledge of the entity. (See Chapter 12)

7 **Obtain written representations.** The auditor asks management to confirm formally the truth and fairness of certain aspects of the financial statements, usually subjective areas. (See Chapter 12)

8 **Sign auditor's report.** The auditor signs the auditor's report once the directors have approved the accounts. Audited accounts are laid before the members at the company's Annual General Meeting (AGM). (See Chapter 13)

9 **Re-appointment.** The end of the AGM signifies the end of the auditor's term of office. The members of the company may decide by a majority to re-appoint the auditor if the auditor wishes to continue to act for the company. (See Chapter 14)

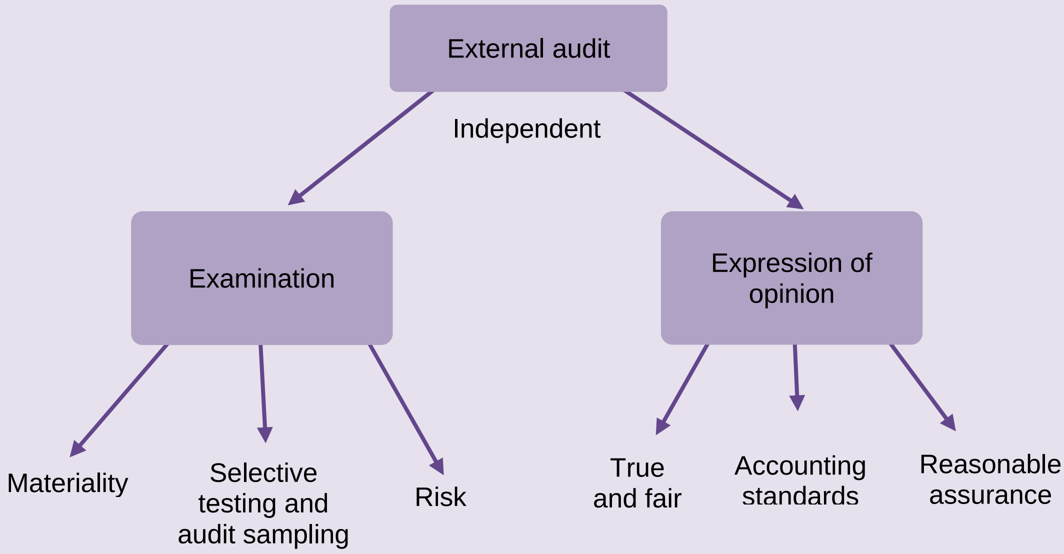
Test your understanding 2

1 What do the financial statements comprise of?

2 Who is responsible for the preparation of the financial statements?

3 Explain what is meant by the term 'qualitative materiality'.

5 Summary



You should now be aware of the basic principles of auditing

Test your understanding answers

Test your understanding 1

1 The directors are responsible for the preparation of the financial statements of a company. The external auditor's responsibility is to report to the shareholders on whether the financial statements show a true and fair view.

2 A true and fair view has no legal or formal definition. However, 'true' indicates that the figures are based upon fact and correctness while 'fair' indicates that the figures in the financial statements are presented so as to give an accurate impression of the position of the company.

Test your understanding 2

1 Statement of financial position.
Statement of profit or loss.
Cash flow statement.
Statement of changes in equity.
Notes to the financial statements.

2 The directors.

3 Qualitative materiality refers to the nature of a transaction or amount and includes many financial and non-financial items that, independent of the amount, may influence the decisions of a user of the financial statements.