

Course: Financial Audit

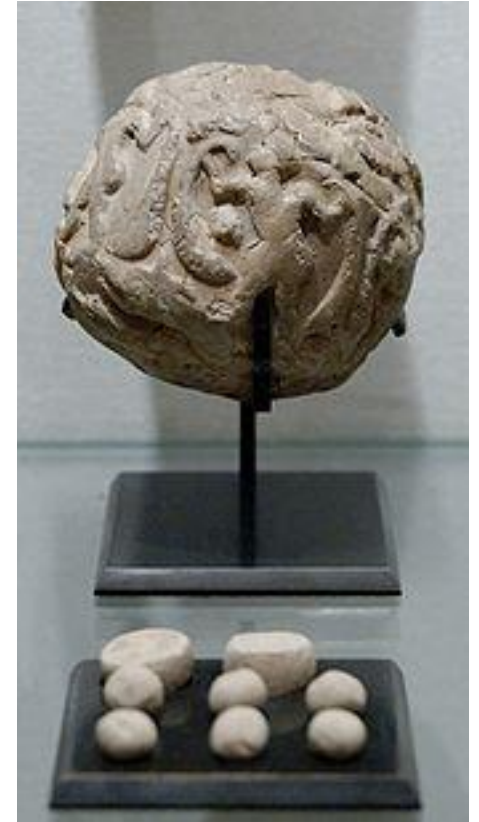
Lecture 1: Introduction to Audit

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Introduction

Historical Roots of Auditing

- Records from Mesopotamia, around 3000 BC, show early forms of auditing practices.
- The word 'auditor' itself comes from Latin, where it originally referred to someone who "listens" or "hears."
- In Roman times, auditors would hear statements from taxpayers, such as farmers, regarding their income and corresponding tax liabilities.



https://en.wikipedia.org/wiki/History_of_accounting#/media/File:Accountancy_clay_envelope_Louvre_Sb1932.jpg

Auditing in Early Chinese & Egyptian Societies

- In China, during the Zhao dynasty (1046–221 BC), a well-structured government accounting process existed, complete with budget reviews and thorough audits across all departments.
- Meanwhile, in Egypt, accountants, known as scribes, were highly respected for their meticulous work.
- Ancient Egyptian auditors worked under severe conditions, especially those managing royal storehouses.
- Two separate auditors were tasked with counting goods—one for incoming items and the other after storage.

Bookkeeping in Ancient Cultures

- Ancient civilizations like Mesopotamia, Greece, and Rome did not prioritize accounting for the purpose of wealth assessment. Instead, their bookkeeping was limited to tracking individual transactions to aid in the memory of traders.
- Their systems were primarily designed to record exchanges rather than optimize wealth generation.
- In contrast to today's business-driven economies, where entrepreneurship and strategic decision-making are key to generating profits, wealth in ancient societies was seen differently.

The Evolution Toward Profit-Oriented Trading

- The transition to a profit-maximizing mindset emerged toward the end of the Middle Ages, marked by the growth of large merchant firms in cities like Venice, Florence, and Pisa.
- These companies centralized operations, moving away from individual trade towards more organized business practices.

Modern Auditing's Foundation

- The modern concept of auditing began with the rise of corporations during the Industrial Revolution. In 1853, Edinburgh saw the establishment of the Society of Accountants, which was one of the first professional accounting bodies.
- Over the following decades, various other institutes were formed, eventually merging in 1880 into the Institute of Chartered Accountants in England and Wales.



https://en.wikipedia.org/wiki/Institute_of_Chartered_Accountants_in_England_and_Wales#/media/File:ICAEW_logo.svg

Growth of Profession & Technical Growth

- As companies became larger and more complex, and as ownership became separated from management, the need for auditing grew significantly.
- As industries across the globe advanced in technology, communication systems, and transportation networks, businesses began to exploit growing international markets. This expansion caused owner-managed companies to outgrow their initial financial resources.

Growth of Profession & Technical Growth

- In many cases, the combined savings of the business owners and the internal profits of their companies were no longer sufficient to fuel further growth.
- To keep pace with these demands, businesses turned to the broader public for financial support, leading to the rise of complex financial markets and credit institutions.
- These entities now play a critical role in meeting the funding needs of both national and international corporations.

Growth of Profession & Technical Growth

- The movement of capital into corporations, and the entire system of financial resource allocation through securities markets, has increasingly relied on the financial reports prepared by corporate management.
- A significant feature of these large corporations is the clear distinction between ownership and management

Diverging Interests

- The goals of corporate management can often differ from those of investors and creditors.
- For example, while management may prioritize higher salaries and benefits, investors are typically focused on maximizing profits and ensuring steady dividends.
- The growing complexity of businesses, combined with the separation between capital provision and company management, has driven the expansion of the auditing profession.

Economic Conditions Driving Audit Reports

- Alongside the growth in global trade and industry, advances in technology, communications, and transport systems enabled businesses to explore new market opportunities on a global scale.
- To meet the increasing demand for investment, companies turned to public savings and institutional investors.
- The process of capital flow from investors to corporations, as well as the broader allocation of financial resources within securities markets, hinges largely on the financial reports issued by company management.

Auditor's Role & Companies

- Investors and creditors depend on the accurate reporting of a company's financial health.
- Auditors help to build this trust by providing an independent, expert opinion, known as an audit opinion, on the accuracy and fairness of these financial statements.
- Auditing plays a crucial role in enhancing the credibility of a company's financial reports.
- Through the audit process, not only are the financial statements given more credibility, but the auditor's review also increases the reliability of other information provided by management, even when it hasn't been directly audited.

Auditor's Role & Companies

- Investors, as well as the public, now expect more than just financial performance data from companies. They want transparency on a range of issues, including:
 - Is the company financially stable?
 - Are there signs of fraud or misconduct?
 - Is management making well-informed decisions?
 - Are internal controls adequate to ensure operational integrity?
 - What are the environmental impacts of the company's operations?
 - How vulnerable is the company to catastrophic errors?, etc.

Auditor's Role & Companies

- Auditors are tasked with ensuring that companies meet high standards not only in their financial reporting but also in their overall management practices, including the systems they have in place for risk management and internal controls.
- Conducting an audit demands significant expertise. Auditors must possess a deep understanding of financial accounting, equivalent to that of their most skilled clients.
- Their role is to gather, interpret, and assess this evidence to form an opinion on whether the financial statements are accurate.

Auditor's Role & Companies

- In addition to their traditional skills, auditors now need to be knowledgeable about their client's technological environment.
- As the auditing landscape continues to evolve, auditors will need to develop new skills, such as critically assessing data and maintaining a questioning mindset.
- In the coming years, companies will continue to produce annual reports, including financial statements, notes, and auditors' reports.
- The scope of auditing will broaden to include non-financial information such as emails, phone records, and other forms of digital communication.

International Standards

- Financial accounting standards and audit standards are fundamentally distinct.
- Typically, auditors assess financial statements against national standards, such as Financial Accounting Standards (FAS) in the US or European Union (EU) standards. In the future, many countries will adopt International Financial Reporting Standards (IFRS), previously known as International Accounting Standards (IAS), which are set by the International Accounting Standards Board (IASB).

International Standards

- The International Accounting Standards Committee (IASC) Foundation was created as a not-for-profit organization.
- The IASC Foundation oversees the International Accounting Standards Board (IASB), which took over the responsibility for setting international accounting standards from the International Accounting Standards Committee.
- The standards established by the IASB are known as International Financial Reporting Standards (IFRS), and the European Union has agreed to adopt most of these standards.

International Standards

- Since its formation in 1970, the EU has played an active role in shaping accounting standards for its Member States.
- Among the various EU Directives that impact international accounting, the Eighth Company Law Directive is particularly relevant to auditing.
- This Directive sets the minimum standards for the training and experience required for accounting professionals across the EU, ensuring consistency in the quality of auditors within the community.

International Standards

- As global accounting standards gained recognition and authority, the need for an aligned set of international auditing standards became apparent.
- A consistent global approach to auditing enables these corporations to ensure the same level of scrutiny and reliability regardless of geographical boundaries.
- With the establishment of international auditing standards, investors worldwide can have greater trust in financial statements prepared abroad.
- International auditing standards have also been a valuable tool for developing nations, aiding them in adopting structured, codified national auditing standards.

International Standards

- The International Auditing and Assurance Standards Board (IAASB), supported by the International Federation of Accountants (IFAC), works to harmonize auditing practices globally.
- The IAASB issues several standards to guide auditors globally. These standards include:
 - International Standards on Auditing (ISAs)
 - International Standards on Assurance Engagements (ISAEs)
 - International Standards on Quality Control (ISQCs)
 - International Standards on Related Services (ISRSs)
 - International Standards on Review Engagements (ISREs)

International Standards

- Public Interest Oversight Board (PIOB) monitors IFAC's public interest activities, including the work of the IAASB, ensuring that these efforts are transparent and responsive to public concerns.
- IAASB Consultative Advisory Group (CAG) offers valuable insights on auditing standards and practices, ensuring that the IAASB's work reflects public interest and considers technical and practical issues relevant to the global community.
- The IAASB's International Standards on Auditing (ISAs) are intended for voluntary adoption rather than imposing mandatory rules .

International Standards

- The International Standards on Auditing (ISAs) are developed under the guidance of the International Federation of Accountants (IFAC) through its IAASB.
- IFAC is structured into various groups responsible for its governance and standard-setting activities.
- The standard-setting work of IFAC is carried out by the IAASB, the Ethics Committee, the Education Committee, and the Public Sector Committee, which focuses on governmental financial reporting.

International Standards

- Auditors primarily focus on International Standards on Auditing (ISAs) because they govern the most common types of audits, including financial statement reviews and audits for specific purposes.
- These standards act as tools for harmonization, ensuring that auditing practices remain consistent internationally.
- The scope of international auditing encompasses more than just ISAs, extending to quality assurance, materiality considerations, audit execution, and coordination of global audit teams and reports.

Audit Defined

- Auditing follows a methodical procedure, adhering to a carefully crafted audit plan. This process involves auditors thoroughly examining financial records using standardized techniques, with the aim of scrutinizing all significant evidence.
- Audits are conducted with impartiality and independence, free from bias or preconceived judgments.
- The auditor's role includes reviewing the accuracy and completeness of information derived from financial records.

Audit Defined

- Audits focus on verifying claims made by management regarding financial events and conditions.
- These claims, or assertions, are embedded in financial statements, such as the existence of assets or the company's ownership over them.
- Auditors assess the alignment of these management assertions with established financial reporting standards.

Audit Defined

- The ultimate purpose of an audit is to provide a professional opinion on the subject matter, often communicated in a formal report.
- While auditors may review non-financial data, their primary focus tends to be financial statements.
- Auditors must adhere to ethical standards, particularly in maintaining their independence.

Audit Defined

- The main goals of financial statement audits are twofold: to ensure that financial statements are free from significant inaccuracies, and to provide a report based on the findings, communicating whether the statements meet the necessary financial reporting standards.
- The aim of an audit is to boost user confidence in financial reports by having an independent auditor provide an expert opinion on their accuracy and compliance with applicable accounting standards, such as IFRS or GAAP.
- Management is responsible for preparing financial statements, with governance bodies overseeing this process

Audit Defined

- Auditors must remain vigilant throughout the audit process, identifying areas where material misstatements may occur, whether due to fraud or error.
- Certain inherent constraints affect an auditor's ability to detect all material misstatements. These include reliance on sampling, the limitations of internal control systems, and the fact that audit evidence is often persuasive rather than conclusive.
- Auditors evaluate risks at two levels: first, the overall risk that financial statements may be misstated, and second, the risk specific to particular transactions, account balances, or disclosures.
- While auditors provide opinions on financial reports, the ultimate responsibility for preparing accurate financial statements lies with management.

Audit Types

- Audits generally fall into three categories: financial statement audits, operational audits, and compliance audits.
- Operational Audits: These audits evaluate how effectively an organization achieves its goals and how efficiently it uses resources.
- Compliance Audits: These audits review whether an organization adheres to rules, regulations, or internal policies.
- Government and Compliance Auditors: Compliance audits often involve government entities, such as tax authorities or regulatory bodies, ensuring organizations meet legal or regulatory requirements.

Auditor Types

- Auditors typically specialize by audit type—financial, operational, or compliance.
- There are two main types of auditors: independent external auditors and internal auditors.
- Large companies often employ internal auditors who assess the efficiency of company operations for management. Their focus tends to be on internal control reviews and operational audits, though they may also conduct compliance audits.
- The internal audit department typically reports directly to top leadership, such as the president or board of directors.
- Internal auditors can influence external financial audits in two ways: their work may shape the audit procedures, and external auditors might directly use the internal auditors' assistance, provided the external auditor evaluates the internal auditor's competence and impartiality.

Auditor Types

- The authority for audit functions stems from national laws in most countries, though in places like the USA and Canada, state or provincial laws can influence who qualifies as an auditor.
- In the U.S., for example, Certified Public Accountants (CPAs) are licensed by individual states.
- Auditors must fulfill academic and licensing requirements. These often include minimum age, citizenship, a university degree, and passing a professional exam.

Audit Objectives

- An audit begins with the financial statements prepared by the client, which include claims, known as "assertions," made by management.
- While management prepares the financial statements, it is the auditor's job to verify that the statements present a true and fair view, essentially validating management's assertions.
- Once the auditor identifies relevant accounts and transactions, along with associated assertions and audit objectives, they will determine the specific procedures needed to test those objectives.
- The exactness of the audit process may vary depending on the size and complexity of the organization.
- When designing an audit program for a specific account, the auditor starts with general objectives based on management's financial statement assertions.

Audit Objectives

- The purpose of audit procedures is to gather sufficient evidence to verify management's assertions about the company's financial transactions and related accounts.
- One typical management assertion might be that financial statements are prepared according to international accounting standards.

Audit Objectives

Management provides both explicit and implied assertions embedded within the financial statements. These can be classified into the following categories:

1. Assertions about Classes of Transactions and Events during the Audit Period:
 - a. Occurrence
 - b. Completeness
 - c. Accuracy
 - d. Cut-off
 - e. Classification

Audit Objectives

2. Assertions about Account Balances at the End of the Period:
 - a. Existence
 - b. Rights and Obligations
 - c. Completeness
 - d. Valuation and Allocation

Audit Objectives

3. Assertions about Presentation and Disclosure
 - a. Occurrence and Rights & Obligations
 - b. Completeness
 - c. Classification and Understandability
 - d. Accuracy and Valuation

Audit Process Model

- Auditors today are tasked with evaluating not only the accuracy of financial statements but also the adequacy of internal controls, compliance with company policies, laws, regulations, and adherence to best practices.
- The audit process can be likened to the empirical scientific cycle, a systematic approach to experimentation. In this approach, a research question is first posed, followed by a plan for testing the hypothesis.
- After conducting the experiment and analyzing the results, a conclusion is reached. Similarly, the auditor begins by outlining an audit question, formulates an audit plan, tests the financial assertions, and finally renders a professional opinion based on the evidence collected.

Audit Process Model

- Despite involving numerous judgments, such as the audit approach and risk assessment, which introduce elements of subjective decision-making, the audit process adheres to a systematic methodology.
- It begins with the client's request for an audit and continues through audit planning and evidence gathering, culminating in the auditor's professional opinion.
- The final opinion may confirm that the financial statements are unmodified (unqualified), modified, or result in a disclaimer.

Audit Process Model

- Just as a scientist formulates a hypothesis and gathers empirical evidence to support or refute it, an auditor formulates an audit plan and tests management's assertions in the financial statements.
- At the heart of the audit lies risk assessment. Every step taken in the audit process is a response to identified risks.
- Business risks arise from events, actions, or conditions that can negatively affect a company's strategic execution, such as changing customer demands or new regulations.

Audit Process Model

The audit process, aligned with the empirical scientific cycle, consists of four distinct phases:

- Client acceptance (pre-planning)
- Audit planning and approach design
- Evidence testing
- Completion of the audit and report issuance

Client Acceptance

- Audit firms handle audits for both returning clients and new clients.
- For established clients, the acceptance process is straightforward as the firm already possesses substantial knowledge about the client's operations.
- Firms adhere to strict procedures when reconsidering engagements with high-risk clients.
- When potential clients approach an audit firm for a bid on their financial audit, the firm must conduct a thorough investigation into the client's business background, financial position, and industry. Moreover, the audit firm must make itself attractive to the prospective client.

Audit Planning

- Effective and timely audits hinge on proper planning. Audit plans must be tailored to the client's business environment and be based on an understanding of the client's operations, control environment, accounting system, and results of analytical procedures.
- A key element of planning is assessing the risks involved and determining materiality levels.

Audit Report

- The audit report must deliver a clear and definitive written expression regarding the auditor's opinion on the financial information examined.
- If the auditor issues a qualified, adverse, or disclaimer of opinion, the report must thoroughly explain the reasons behind such opinions in an informative and clear manner, providing transparency into the nature of any concerns.

Big Four Firms

- The four largest accountancy firms, commonly referred to as the "Big Four," hold significant influence over international auditing practices due to their global operations and membership in the majority of the world's professional accounting bodies.
- The Big Four firms include:
 - Deloitte
 - Ernst & Young (EY)
 - KPMG
 - PricewaterhouseCoopers (PwC)

Structures

- Within a large international auditing firm, the work is carried out by a hierarchy of professionals.
- At the top are the partners, followed by managers, supervisors, seniors or in-charge auditors, and finally staff accountants.

Structures

- Staff Accountants
- Senior Auditors and/or Supervisors
- Managers
- Partners and/or Directors

Conclusion

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Closing

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Reference (reading material):

- Principles of Auditing: an Introduction to International Standards on Auditing, 3rd Edition, Hayes, Wallage, and Gortemaker, Pearson Education Limited, 2014