CHAPTER 1: NATURE, PURPOSE AND SCOPE OF AUDIT

LEARNING OUTCOME

A1a: **Identify** and **describe** the objective and general principles of external audit engagements
A1b: **Explain** the nature and development of audit and other assurance engagements
A1c: **Discuss** the concepts of accountability, stewardship and agency
A1d: **Define** and provide the objectives of an assurance engagement
A1e: **Explain** the five elements of an assurance engagement
A1f: **Describe** the types of assurance engagement
A1g: **Explain** the level of assurance provided by an external audit and other review engagements and the concept of true and fair presentation.

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1.1 Overview of Assurance

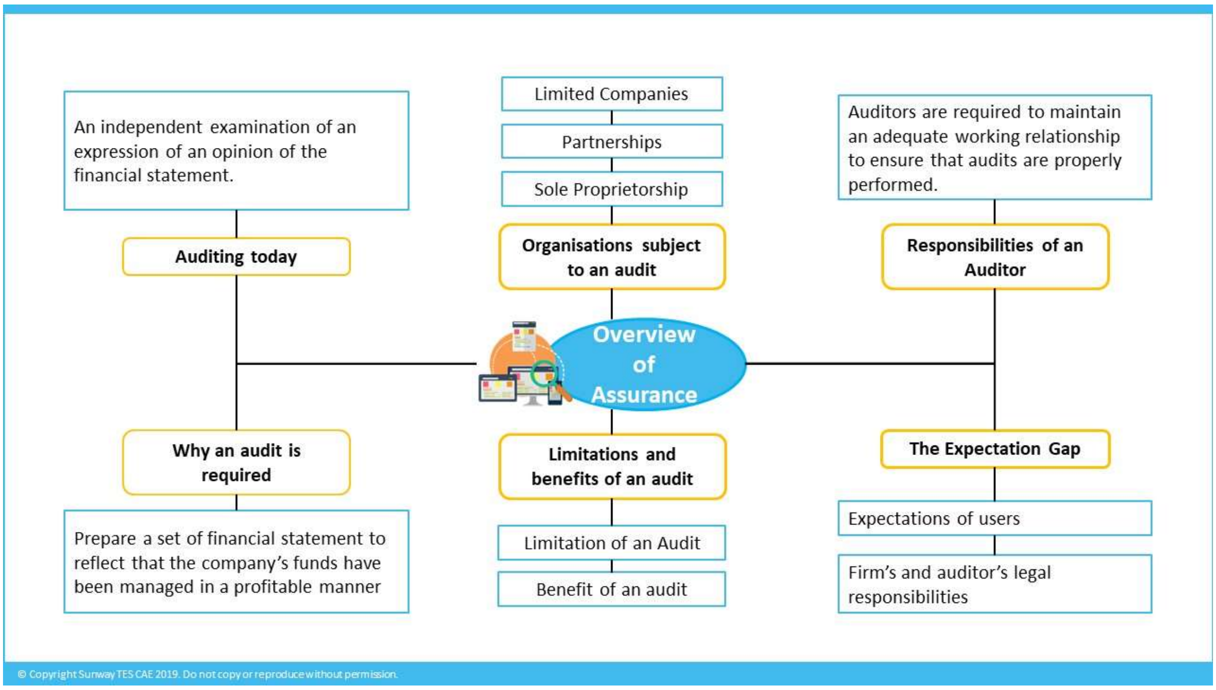
Learning Outcome (ACCA Study Guide Area A)

A1a: Describe the objective and general principals of external audits.

A1c: Discuss the concepts of accountability, stewardship and agency.

ISA 200	**OVERALL OBJECTIVES OF THE INDEPENDENT AUDITOR AND THE CONDUCT OF AN AUDIT IN ACCORDANCE WITH INTERNATIONAL STANDARDS OF AUDITING**
	INTERNATIONAL STANDARD ON REVIEW ENGAGEMENTS 2400 (REVISED)

Diagram 1.1: Overview of Assurance



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1.1.1 Auditing Today

An Audit is the independent examination of, and expression of an opinion on, the financial statements of an entity by a duly appointed auditor in pursuit of that appointment

Audits are performed by **competent, independent** and **objective** persons, known as **Auditors**, who then **issue a report** on the results of the audit. These auditors must **adhere** to generally **accepted standards** set by the professional bodies.

The objective of an audit is to issue an opinion as to whether the financial statements are prepared in accordance with an identified **Financial Reporting Framework** i.e. **the framework adopted in a country determined by its national legislation.**

Per the **International Financial Reporting Standards** (IFRS), a complete set of financial statements comprises of:

- A Statement of Financial Position
- A Statement of Comprehensive Income
- A Statement of Changes in Equity
- A Cash Flow Statement
- A summary **of significant accounting policies and other explanatory notes**

Thus, an audit in accordance with the **ISA** provides a **reasonable assurance**, an **OPINION**, to these users that the financial statements of the company '**fairly'** presents the company financial condition and the results of the operations or that the financial statements taken as a whole are **free from material misstatements.**

1.1.2 Why an Audit is Required

The **owners (the Shareholders)** may appoint **agents (the management/Directors)** to run the company on their behalf, known as "**stewardship**" function. Since the **ownership and the management are separate and distinct**, owners require the agents to prepare a set of financial statement to reflect that the company's funds have been managed in a profitable manner. As the management prepares the financial statements, they would lack credibility, thus the need for an independent audit to ensure that the financial statements are free of bias and manipulation.

The **Auditor is responsible for forming and expressing an opinion** on the financial statements, however, **the responsibility for preparing and presenting the financial statements lies with the management.**

Check Understanding

Topic 1.1.2 Why an audit is required

Learning outcome (ACCA Study Guide Area A)

A1a: Describe the objective and general principals of external audits.

Question 1

Why a statutory audit is required?

1.1.3 Organisations Subject to an Audit

The following organisations are subject to an audit:

i. **Limited Companies** (Mandatory)
   Note: **In UK, entities with a turnover below £10.2 million, are considered as small entities, and thus exempted from statutory audits.**

ii. **Partnerships** (Optional)

iii. **Sole Proprietorship** (Optional)

1.1.4 Limitations and Benefits of an Audit

a. Limitations of an Audit

The limitations of an audit mean that it is only possible to provide a Reasonable Assurance
Limitations of an audit are:

- **Audits incurs fees / costs**
- A whole year's financial statement is tested in a **limited period of time**
- Financial statements include subjective **Accounting Estimates**
- **Internal Controls** may be relied on which have their own inherent limitations
- Most **Audit Evidence are persuasive rather than conclusive**
- Audit is conducted on a **Test Basis**, auditors testing on a sample basis
- **Fraud** may have perpetrated and is concealed **with collusion, forgery, overrides, manipulation** of evidences or **misleading the auditor**
- The work on which the auditor forms an opinion **involves judgement** that is limited by:
  - Nature (needs elaboration in context of limitations)
  - Timing and extent of audit procedures to gather evidence
  - Conclusions drawn based on the evidences gathered

The limitations of an audit mean that it is only ***possible*** **to provide a Reasonable Assurance.**

b. Benefits of an Audit

Despite the limitations of an audit that only provides a Reasonable Assurance, an audit adds credibility to the financial statements. Benefits of an audit are:

- **Access to Capital Markets**
- **Lower cost of capital**
- Evidence that **Adequate Accounting Records have been kept**
- **Control and Operational Improvements** – Auditor highlights the **deficiencies**
- Improves the **Quality and Reliability of information** – investors trust the company and improves its reputation
- Details of **Director's Emolument's and other benefits** have been correctly disclosed
- **Independent scrutiny** and verification is valuable to the company

- Details of **Loan and other transactions** towards the directors are correctly disclosed
- May **reduce the risk of management bias, fraud and error** by acting as a deterrent
- Enhances the **Credibility of the Financial Statements** – for tax authorities, finance providers and stakeholders

Despite the limitations, an audit adds credibility to the financial statements.

1.1.5 Responsibilities of an Auditor

The **shareholders** appoint the auditors at the conclusion of the annual general meeting. Auditors have **no specific duty** to the **directors**, only a **contractual relationship.**

However, auditors are required to maintain an adequate working relationship to ensure that audits are properly performed.

Check Understanding

Topic 1.1.5 Responsibilities of an Auditor
Learning outcome (ACCA Study Guide Area A)
A1c: **Discuss** the concept of stewardship, accountability and agency in the context of an audit

Question 1
What are the responsibility of directors and auditor?

1.1.6 The Expectation Gap

It is the **gap between the expectation of users of assurance reports**, particularly audit reports under the Companies Act, **and the firm's legal responsibilities**

Such expectation gaps include:

Expectations of Users	Firm's and Auditor's Legal Responsibilities
Belief that Auditor is responsible to prepare the financial statements	In reality, it is the management's responsibility
Belief that the Auditor's principal duty is to detect fraud	Auditor's duty is to report that the financial statements are free of material misstatements arising from fraud and error
Perception that Auditors reviews all the entity's transactions	During auditing, it can only be done on a Test basis
Perception that the audit report is 'correct'	Auditors provide reasonable assurance giving a True & Fair view

1.2 Concept of Audit and Assurance Engagement

Learning Outcome (ACCA Study Guide Area A)

A1b: Explain the nature and development of audit and other assurance engagements

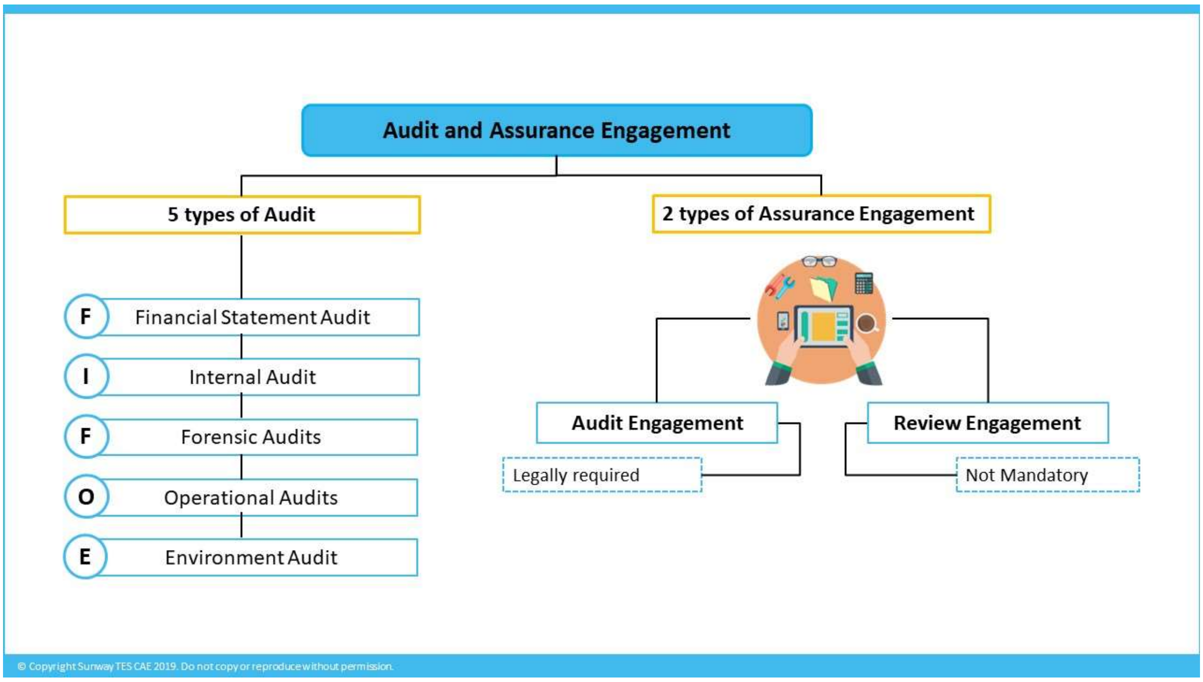
A1d: Define and provide the objectives of an assurance engagement

A1e: Explain the five elements of an assurance engagement

A1f: Describe the types of assurance engagement

A1g: Explain the level of assurance provided by an external audit and other review engagements and the concept of true and fair presentation.

Diagram 1.2: Concept of Audit and Assurance Engagement



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1.2.1 Types of Audit

1) Financial Statement Audits

External auditors review the financial statements prepared by the management, and expresses an opinion on whether the financial statements are prepared, in all material respect, in accordance with an applicable financial reporting framework.

2) Internal Audits

It is an appraisal or monitoring activity provided to the entity. Its functions include examining, evaluating and monitoring the adequacy and effectiveness of internal controls. Internal auditors are employed as part of the organisation's system of internal controls. Their responsibilities are determined by the management and may be wide-ranging.

3) Operational/Performance Audits

It is also known as **"Value for Money" (VFM)** or **"Efficiency Audits".** It involves obtaining and evaluating evidence about **the efficiency, economy and effectiveness** of an entity's operating active ties in relation to specified objectives. it assesses the performance, identifies areas of improvements and develops recommendations.

4) Environmental Audits

An assortment at what extend an organization practise minimize harm to the environment.

5) Forensic Audits

Forensic audits include a wide range of **investigative work** which accountants in practice could be asked to perform. The work would normally involve an investigation into the financial affairs of an entity and is often associated with **investigations into alleged fraudulent activity**.
Forensic accounting refers to the process of investigating a financial matter, including potentially acting as an expert witness if the fraud comes to trial.

1.2.2 Types of Assurance Engagement

The requirements of corporate governance necessitate communication between the directors and the shareholders i.e. directors are required to produce financial statements annually which gives a True and Fair view of the affairs of the company and its income statement for the period as well as communicate matters on director's pay and benefits, going concern, risks etc**.**

An assurance engagement is:

> *"An engagement in which a practitioner expressed 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." (IAASB handbook)*

ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards of Auditing *states that the objectives of auditors are:*

- *Obtain reasonable assurance whether the financial statements as a whole are free from material misstatement, whether due to fraud or error*
- *Express an opinion on whether the financial statements are prepared in all material respects*
- *Report on the financial statements, and communicate as required by* ***international Standards of Auditing (ISA)*** *, in accordance with the auditor's findings*

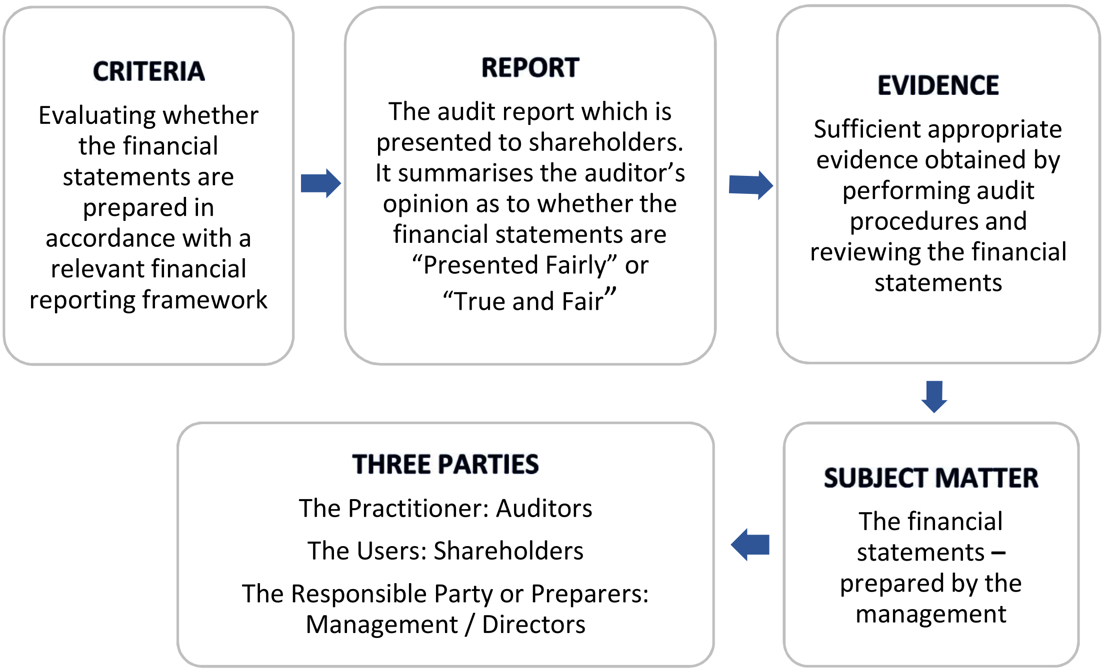
An **external audit** is an example of a **reasonable assurance engagement.**

An audit enhances the degree of confidence of the intended users in the financial statements.

Elements of an assurance engagement **(CREST)**

- **C**riteria – Criteria (standards) to measure / evaluate a subject matter to reach an opinion
- **R**eport – An Assurance Report with the practitioner's opinion issued to the intended users
- **E**vidence – Sufficient Appropriate Evidence gathered to support the opinion

- **S**ubject matter – Data prepared by the responsible party, subject to evaluation
- **T**hree parties' relationship – The Practitioner, Intended Users and the Responsible Party
  - The Practitioner – the reviewer of the subject matter who provides the assurance
  - The Intended User – of the information
  - The Responsible Party – those responsible for preparing the subject matter



Types	Objective	Evidence Gathering Procedure	The Assurance Report
Audit Engagements	These are **Legally required** (Companies Act) Provide: • **Reasonable** • **Positive** • **High Assurance** i.e. the auditor expressing an opinion on whether the financial statements are prepared, in all material respect, in accordance with an identified financial reporting framework. *e.g.* ***Review of financial statements***	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: • Detailed knowledge of the entity • An understanding of the entity's accounting and internal control system • Audit evidence on the financial statements assertions • Obtain corroborative evidence • Determine going concern status	The auditor's **opinion** that the subject matter conforms in all material respect with identified suitable criteria ***"gives true and fair view"*** or ***"presents fairly, in all material respect"***

Types	Objective	Evidence Gathering Procedure	The Assurance Report
Review Engagements	**No legal requirement** for these audits (usually an assignment between the Board of Directors and the Auditors, with an inclusion of a third party like a bank). Assurance engagement risk Levels: • **Moderate** • **Negative** • **Limited Level** ***e.g. Review of cash flow forecast for a bank loan or review of interim financial statements***	Sufficient appropriate evidence is obtained as part of a systematic engagement process that includes: • **An understanding of the client's activities**, including knowledge of the accounting practices of the industry in which the client operates and • **Inquiries of company's personnel and analytical review**	The **Report** that the ***subject matter is plausible*** to identified criteria, is expressed in the negative form i.e. ***nothing has come to our attention that causes us to believe that subject matter*** *(financial statements)* ***are not in accordance with the criteria*** *(financial reporting framework)*

Check Understanding

Topic 1.2.2 Types of Assurance Engagement

Learning outcome (ACCA Study Guide Area A)

A1d: Define and provide the objectives of an assurance engagement.

A1b: Explain the nature and development of audit and other assurance engagements.

Question 1

What is the purpose of audit engagement?

Learning outcome (ACCA Study Guide Area A)

A1e: Explain the 5 elements of an assurance engagement

Question 2

Choose whether the following statement is true or false:

"Assurance engagements can relate only to financial measures and results**"**

a. True
b. False

Learning outcome (ACCA Study Guide Area A)

A1f: Describe the types of assurance engagement

Question 3

What is the difference between audit engagement and review engagement?

Learning outcome (ACCA Study Guide Area A)

A1g: Explain the level of assurance in an audit and a review engagement

Question 4

What assurance is given for audit and review engagement?

1.2.3 Audit Report

THE UNQUALIFIED AUDIT REPORT *(ISA 700, Appendix)*

INDEPENDENT AUDITOR'S REPORT

To the Shareholders of ABC Co (or Other Appropriate Addressee)

REPORTS ON THE AUDIT OF THE FINANCIAL STATEMENTS **

Opinion

We have audited the accompanying financial statements of ABC Company (the Company), which comprise the Statement of Financial Position as at 31 December 2018, and the Statement of Comprehensive Income, Statement of Changes in Equity and Cash Flow Statement for the year then ended, and notes to the financial statements, including a summary of significant accounting policies.

In our opinion, the accompanying financial statement give a true and fair view of (or present fairly, in all material respects), the financial position of ABC Company as at 31 December 2018, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards (IFRS).

Basis for 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 *International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants (IESBA Code)* together with the ethical requirements that are relevant to our audit of the financial statements in [jurisdiction], and we have fulfilled our ethical responsibilities in accordance with these requirements and the IESBA Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key Audit Matters

Key audit matters are those matters that, in our professional judgement were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, an in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with ISA 701]

Responsibilities of Management and Those Charged With Governance for the Financial Statements

Management is responsible for the preparation and fair presentation of financial statements that give a true and fair view in accordance with IFRS and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatements, whether due to fraud or error.

In preparing the financial statements, management is responsible for assessing the Company's ability to continue as going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless management either intends to liquidate the Company or to cease operations, or has no realistic alternative but to do so.

Those charged with governance are responsible for overseeing the Company's financial reporting process.

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements.

[Note: The following paragraph may be located in an Appendix to the auditor's report.]
As part of an audit in accordance with ISAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risk of material misstatements of the financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, international omission, misrepresentations, or the override of internal control.

- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control.

- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management

- Conclude on the appropriateness of management's use of the going concern basis of accounting, and based on audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast a significant doubt on the Company's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Company to cease to continue as going concern.

- Evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

We communicate with those charged with governance regarding, among other matters, the planned scope and timing of audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide those charged with governance with a statement that we have complied with relevant ethical requirements regarding independence, and to communicate with them all relationships and other matters that may reasonably be thought to bear on our independence, and where applicable, related safeguards.

From the matters communicated with those charged with governance, we determine those matters that were of most significance in the audit of the financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstance, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

REPORT ON OTHER LEGAL AND REGULATORY REQUIREMENTS

(The Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities prescribed by local law, regulation, or national auditing standards. The matters addressed by other law, regulation or national auditing standards (referred to as "other reporting responsibilities") shall be addressed within this section unless the other reporting responsibilities address the same topics as those presented under the reporting responsibilities required by the ISAs as part of the Report on the Audit of the Financial Statements section.

The reporting of other reporting responsibilities that address the same topics as those required by the ISAs may be combined (i.e. included in the Report on the Audit of the Financial Statements section under the appropriate subheadings) provided that the wording in the auditor's report clearly differentiates the other reporting responsibilities from the reporting that is required by the ISAs where such a difference exists).

The engagement partner on the audit resulting in this independent auditor's report is [name].

Auditor's signature

[Signature in the name of the audit firm, the personal name of the auditor, or both, as appropriate for the particular jurisdiction]

Auditor's address

Date of the audit report

** The sub-title is unnecessary in circumstances when the second sub-title "*Report on Other Legal and Regulatory Requirements*" is not applicable

THE UNQUALIFIED REVIEW REPORT ***(ISRE 2400 Revised,* Appendix*)***

INDEPENDENT AUDITOR'S REPORT

INDEPENDENT PRACTITIONER'S REVIEW REPORT
[Appropriate Addressee]

Report on the Financial Statements
We have reviewed the accompanying financial statements of ABC Company, which comprise the statement of financial position as at 31 December 2018, and the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory information.

Management's Responsibility for the Financial Statements
Management is responsible for the preparation and fair presentation of these financial statements in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Practitioner's Responsibility
Our responsibility is to express a conclusion on the accompanying financial statements. We conducted our review in accordance with International Standard on Review Engagements (ISRE) 2400 (Revised), Engagements to Review Historical Financial Statements. ISRE 2400 (Revised) requires us to conclude whether anything has come to our attention that causes us to believe that the financial statements, taken as a whole, are not prepared in all material respects in accordance with the applicable financial reporting framework. This Standard also requires us to comply with relevant ethical requirements.

A review of financial statements in accordance with ISRE 2400 (Revised) is a limited assurance engagement. The practitioner performs procedures, primarily consisting of making inquiries of management and others within the
entity, as appropriate, and applying analytical procedures, and evaluates the evidence obtained.

The procedures performed in a review are substantially less than those performed in an audit conducted in accordance with International Standards on Auditing. Accordingly, we do not express an audit opinion on these financial statements

Conclusion
Based on our review, nothing has come to our attention that causes us to believe that these financial statements do not present fairly, in all material respects, (or do not give a true and fair view of) the financial position of ABC Company as at 31 December 2018 and (of) its financial performance and cash flows for the year then ended, in accordance with the International Financial Reporting Standard for Small and Medium-sized Entities.

Report on Other Legal and Regulatory Requirements
[Form and content of this section of the practitioner's report will vary depending on the nature of the practitioner's other reporting responsibilities.]

Auditor's signature

Date of the review report

Auditor's address

True and Fair View (ISA 700)

The accounts of a company are required by the Companies Act to show a **True & Fair** view of the company's financial position as at the statement of financial position date and its income statement for the year ending on that date.

The connotation of the words "**True & Fair**" is that the financial statements are presented reasonably and without bias or distortion. The auditor's opinion pertains to each component of the financial statements taken as a whole. It does not apply to the accuracy or correctness of individual.

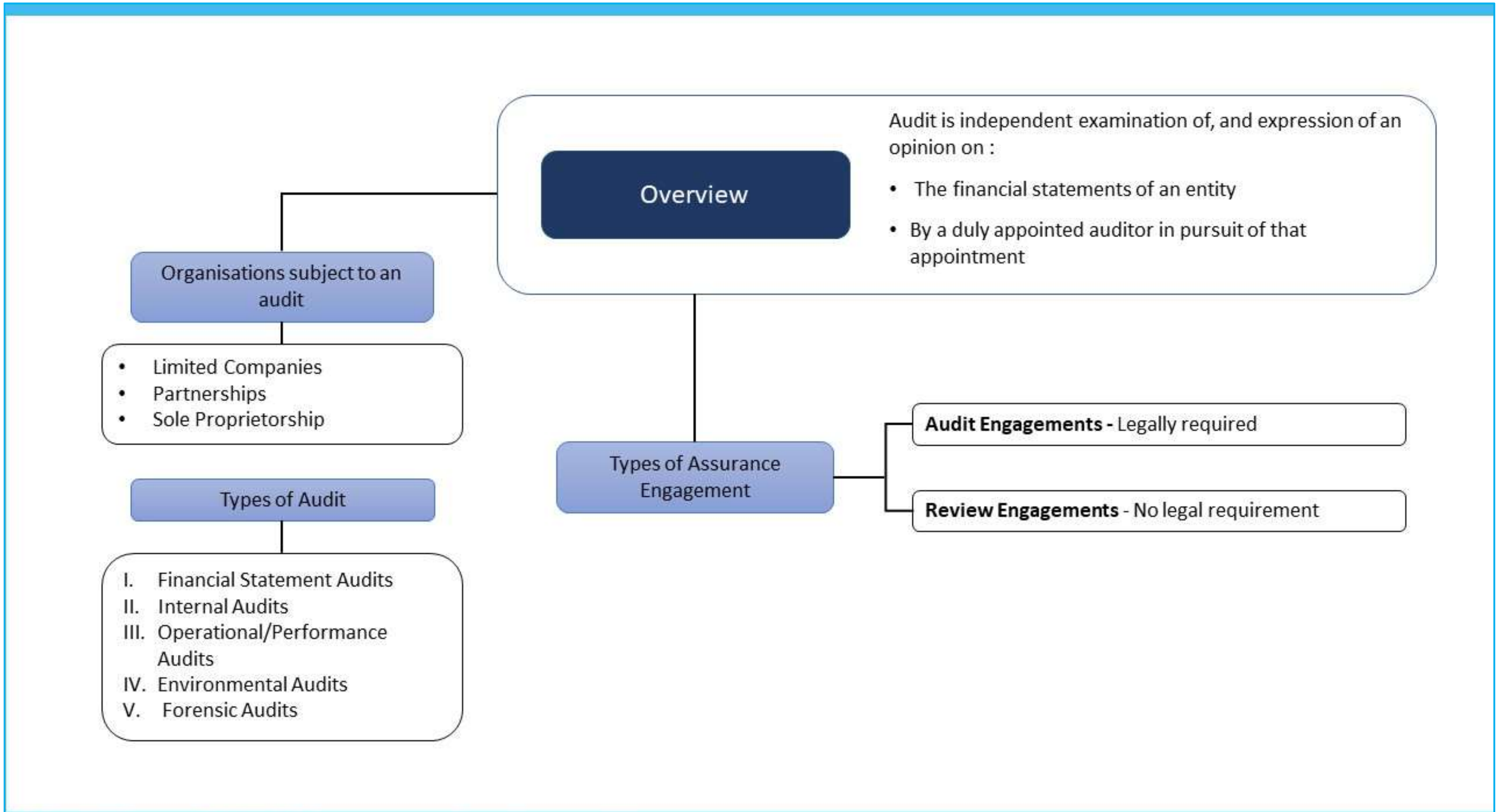
TRUE - Information is factual and conforms to reality, required standards and law; and the financial statements have been correctly extracted from the books and records.	**FAIR** - Information is free from discrimination and bias and in compliance with expected standards and rules, reflecting the commercial substance of the transaction.

ISA 700 FORMING AN OPINION AND REPORTING ON FINANCIAL STATEMENTS (REVISED) The ISA accepts the terms "***give a True & Fair view"*** or "***Present fairly, in all material respects***":

The opinion paragraph of the auditor's report should… In our opinion, the accompanying financial statements give a true and fair view of (or present fairly, in all material respects) in accordance with the financial reporting framework, and, where appropriate, whether the financial statements comply with statutory requirements (ISA 700.25). ***ISA 700*** **notes that the two expressions are equivalent in its views.**

1.3 Chapter 1: Summary

Diagram 1.3: Summary of Nature, Purpose and Scope of Audit



1.4 Chapter 1 Check Understanding: Answer

Topic 1.1.2

(Q) **Why a statutory audit is required?**

(Ans) To ensure that the financial statements are free of bias and manipulation.

Topic 1.1.5

(Q) **What are the responsibility of directors and auditor?**

(Ans) To maintain an adequate working relationship to ensure that audits are properly performed.

Topic 1.2.2 Types of Assurance Engagement

(Q1) **What is the purpose of audit engagement?**

(Ans) It is legally required by Companies Act to provide: Reasonable, Positive, and Highly Assured

(Q2) **Choose whether the following statement is true or false:**

(Ans) b. False

(Q3) **What is the difference between audit engagement and review engagement?**

(Ans) (i) Audit Engagement – Legally required
(ii) Review Engagement - No legal requirement

(Q4) **What assurance is given for audit and review engagement?**

(Ans) (i) Audit Engagements – form of positive assurance that subject matter conforms to criteria.
(ii) Review Engagement – negative form is nothing of concern has been revealed.