

To:

Mr Adrian

From:

Nigel Kerr

20 June 1991

I have re-arranged our call on Sir Dermot de T. for 0830
on Tuesday 25 June.

2. I will fax to you tomorrow afternoon (Friday) a draft note summarising the current responsibilities of the various parties involved in corporate governance. You might like to retain the attached copy of my source texts [- The ICAEW's ^{on auditors} booklet 'What is an audit?' (currently out of print - most recent, slightly out of date edition attached) and sections 235 & 237 of the Companies Act 1985.

NJK
20/6

PART I

(2) Every copy of the directors' report which is laid before the company in general meeting, or which is otherwise circulated, published or issued, shall state the name of the person who signed it on behalf of the board.

(3) The copy of the directors' report which is delivered to the registrar shall be signed on behalf of the board by a director or the secretary of the company.

(4) If a copy of the directors' report—

(a) is laid before the company, or otherwise circulated, published or issued, without the report having been signed as required by this section or without the required statement of the signatory's name being included, or

(b) is delivered to the registrar without being signed as required by this section,

the company and every officer of it who is in default is guilty of an offence and liable to a fine."

1985 c. 6.

(2) Schedule 7 to the Companies Act 1985 (matters to be included in directors' report) is amended in accordance with ~~Schedule 5 to this Act.~~

Auditors' report.

9. The following sections are inserted in Part VII of the Companies Act 1985—

"Auditors' report

Auditors' report.

235.—(1) A company's auditors shall make a report to the company's members on all annual accounts of the company of which copies are to be laid before the company in general meeting during their tenure of office.

(2) The auditors' report shall state whether in the auditors' opinion the annual accounts have been properly prepared in accordance with this Act, and in particular whether a true and fair view is given—

(a) in the case of an individual balance sheet, of the state of affairs of the

- company as at the end of the financial year,
- (b) in the case of an individual profit and loss account, of the profit or loss of the company for the financial year,
- (c) in the case of group accounts, of the state of affairs as at the end of the financial year, and the profit or loss for the financial year, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

(3) The auditors shall consider whether the information given in the directors' report for the financial year for which the annual accounts are prepared is consistent with those accounts; and if they are of opinion that it is not they shall state that fact in their report.

Signature of auditors' report.

236.—(1) The auditors' report shall state the names of the auditors and be signed by them.

(2) Every copy of the auditors' report which is laid before the company in general meeting, or which is otherwise circulated, published or issued, shall state the names of the auditors.

(3) The copy of the auditors' report which is delivered to the registrar shall state the names of the auditors and be signed by them.

(4) If a copy of the auditors' report—

- (a) is laid before the company, or otherwise circulated, published or issued, without the required statement of the auditors' names, or
- (b) is delivered to the registrar without the required statement of the auditors' names or without being signed as required by this section,

the company and every officer of it who is in default is guilty of an offence and liable to a fine.

PART I

Duties of
auditors.

(5) References in this section to signature by the auditors are, where the office of auditor is held by a body corporate or partnership, to signature in the name of the body corporate or partnership by a person authorised to sign on its behalf.

237.—(1) A company's auditors shall, in preparing their report, carry out such investigations as will enable them to form an opinion as to—

- (a) whether proper accounting records have been kept by the company and proper returns adequate for their audit have been received from branches not visited by them, and
- (b) whether the company's individual accounts are in agreement with the accounting records and returns.

(2) If the auditors are of opinion that proper accounting records have not been kept, or that proper returns adequate for their audit have not been received from branches not visited by them, or if the company's individual accounts are not in agreement with the accounting records and returns, the auditors shall state that fact in their report.

(3) If the auditors fail to obtain all the information and explanations which, to the best of their knowledge and belief, are necessary for the purposes of their audit, they shall state that fact in their report.

(4) If the requirements of Schedule 6 (disclosure of information: emoluments and other benefits of directors and others) are not complied with in the annual accounts, the auditors shall include in their report, so far as they are reasonably able to do so, a statement giving the required particulars."

Publication of
accounts and
reports.
1985 c. 6.

10. The following sections are inserted in Part VII of the Companies Act 1985—

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What is an audit?

Introduction

1. Everyone who uses financial statements is affected by an auditor's work, yet the scope and limitations of an audit are not well known outside the profession. This booklet attempts to throw some light on what, for laymen, has tended to be an obscure or misunderstood subject. The booklet is not intended to be a technical or legal guide. It has been prepared to help all those who use financial statements to understand what an audit is and what an auditor's report means. Where specific audits are concerned or where points of law arise, reference should be made to the particular circumstances, to the Companies Act or other relevant regulations and to the pronouncements of the professional accountancy bodies.

Why have an audit?

2. Every company registered in the UK, from the largest to the smallest and whether publicly quoted or private, has to have an annual audit under the Companies Acts. Except in a few industries such as banking and insurance, the legal audit requirements are exactly the same whatever the size of the company or the nature of its business. Other organisations, including nationalised industries, building societies, local authorities, and trade unions, are also subject to an audit requirement under the legislation governing their activities. This booklet deals only with companies. Although the basic principles of auditing are the same whatever type of organisation is being examined, the scope of the audit required for other bodies by the relevant statutes may be different.
3. Even without a statutory requirement, companies would still pay for an independent examination of their accounts because an audit confers a number of important practical advantages.
4. From management's point of view, the auditor provides a second expert opinion on difficult matters of accounting judgement. In addition, an audit helps to ensure that the accounting system introduced by management to record transactions and safeguard company assets is working properly. If there are significant weaknesses, the auditor will point them out to management and perhaps suggest how the system could be improved. If there are material errors in the accounts, the auditor will draw management's attention to them for corrective action and investigate the reason for their occurrence. The auditor will draw management's attention to staff fraud or incompetence where these are discovered in the course of the audit. Besides, the knowledge that an audit will be carried out helps to deter employees from risking a fraud in the first place.
5. Those who deal with companies, either directly or indirectly, also benefit from the auditor's work. It's one thing to trust your money to a firm whose accounts have been audited by an independent professional, it's quite another to invest in or do business with a company on the strength of accounts prepared only by the people who will use your money. An independent audit lends credibility to the company's financial statements and helps to protect all those who have an

interest in the company's operations - shareholders, employees, banks, trade creditors, the tax authorities, and potential investors. From the creditors' point of view, an audit helps to balance the responsibilities of a company with the rights and privileges conferred by limited liability.

6. For all these reasons, the audit is an important part of the regulatory system under which companies operate in the Western World. In most industrialised countries, an annual audit is either a statutory requirement or is a safeguard used voluntarily by the majority of significant enterprises.

Which financial statements are subject to audit?

7. As a minimum, financial statements will include the statutory accounts (that is profit and loss accounts and balance sheet) and, except in the case of the smallest companies, a statement of source and application of funds. Auditing standards require the auditor to identify in his report the financial statements which he has audited.
8. A company's annual report may include other financial information, such as five year summaries, which is not covered by the auditor's report and is the responsibility solely of the directors. The directors' report itself, which frequently contains highlights of the company's financial results, is not subject to audit under present UK law, but the auditors must report if the information it contains is not consistent with the accounts.

Who is responsible for the accounts?

9. It is the directors, not the auditors, who are responsible for ensuring that a company keeps proper accounting records and that its year-end accounts give a true and fair view of the company's state of affairs and profit or loss. The auditor's responsibility is to report to the shareholders on whether or not these obligations have been fulfilled.
10. It is important to get this distinction clear. The audit provides a second line of defence against the misuse of shareholders' assets, against error or fraud and against misleading financial statements, but the primary responsibility lies with the directors who have a general duty to ensure that the business is properly managed and that the assets are properly safeguarded.
11. In respect of the accounting records, the directors are required by law to ensure that proper records are kept of all receipts and payments, and assets and liabilities. These records have to be maintained in such a way as to explain the company's transactions and to disclose with reasonable accuracy the financial position of the company at any time. At the end of each financial year, the directors have to draw up accounts of the company that give a true and fair view of the profit or loss and the state of affairs of the company and comply with the disclosure requirements of the Companies Acts. Directors who fail to meet these statutory obligations may be fined or even, in extreme cases, sent to prison.
12. In the past, some directors, particularly those serving on a part-time basis, have assumed that lack of relevant knowledge or experience would relieve them of

legal responsibility in such areas as financial control. However, reports of Department or Trade Inspectors have strongly criticised directors who are ill-informed about company transactions and the controls over company assets. In future, it seems likely that the courts will take a stronger line in interpreting the legal duties of directors, including non-executive directors.

What is meant by a 'true and fair view'?

13. Accounts are made up, on the one hand, of an accumulation of precise monetary transactions - an item costing X pounds is sold for Y pounds and so on - and, on the other hand, of subjective judgements about such matters as the value of stock, the likelihood of debts being collected or the useful life of capital assets.
14. Absolute precision in financial statements is impossible because the exact outcome of these matters cannot be predetermined. United Kingdom law recognises these difficulties by requiring accounts to show a 'true and fair view' rather than by setting an unrealistic requirement for precision alone.
15. The flexibility is both a strength and weakness. It is a strength because it allows the auditor to look at the broad picture and not to get bogged down in details. It is a weakness because it means that accounts can rely significantly on subjective judgements which may or may not turn out to be correct.
16. In making accounting judgements, the degree of subjectivity is liable to be highest in those closest to the company. Moreover, there may be a temptation on the part of those charged with the stewardship of the company to present a better view of the company's affairs than is warranted by the facts. On the other hand, as the only people with a complete picture of the company's operations, the directors should be in a better position than anyone else to make judgements about, for example, the value of assets, the useful life of machinery or the outcome of long-term contracts.
17. In arriving at a true and fair view, a distinction has to be made between what is important and what is insignificant in relation to the whole. The concept of materiality recognises that a small error or uncertainty may be ignored without distorting the true and fair view given by the accounts. In any particular case, what is material is a matter of judgement.
18. The fact that the books balance and that their arithmetic is correct does not necessarily mean that the accounts are a fair reflection of the company's financial position. It is just as important to be sure that proper accounting principles have been applied and that any estimates have been made on a sound basis. Although statements of standard accounting practice cover the most common types of business activity, SSAPs do not eliminate the need for professional judgement in ensuring the correct accounting treatment. When the nature of a transaction is difficult to categorise, the question of judgement becomes even more important.
19. In a time of inflation, accounting and reporting are further complicated because the monetary units used in financial statement are themselves unstable.

20. When all these factors are put together, it is easy to see why producing a set of true and fair accounts, even for a small enterprise, is a difficult task. In a large public company with diverse and complex operations in numerous different locations, the problems of presenting a true and fair view can be immense. Because of the difficulties inherent in arriving at a true and fair view, it is not surprising that the law should require a second opinion on the accounts by an outside expert.

Who carries out an audit?

21. The Companies Acts stipulate that only an auditor registered with one of the following supervisory bodies recognised by the Department of Trade and Industry can sign a statutory audit report

The Institute of Chartered Accountants in England and Wales

The Chartered Association of Certified Accountants

The Institute of Chartered Accountants of Scotland

The Institute of Chartered Accountants in Ireland

The Association of Authorised Public Accountants

Practising Certificates

22. The number of persons entitled to sign a statutory audit report is much smaller than the total number of qualified accountants belonging to the bodies listed above. The professional bodies require their members to apply for a practising certificate before they can take responsibility for audits. Such certificates are held by about [30,000] chartered accountants and by about [4,000] certified accountants who are sole practitioners or partners offering services to the public in such areas as auditing, taxation and accounting. In most cases, accountants in public practice employ other qualified or student accountants to work on statutory audits under their supervision, although the employees do not have to have practising certificates themselves. In order to be granted a practising certificate, an accountant must show that he has had sufficient practical experience and that he maintains proper professional standards.

Training

23. In order to qualify as a chartered or certified accountant, a student has to spend several years working with a qualified accountant and has to pass a series of rigorous professional examinations. Training is done both through classroom instruction and through closely supervised practical work on audit, accounting and other assignments. The professional syllabus includes such subjects as company and commercial law, management accounting, statistics, the use and control of computers, taxation, economics and, of course, accounting and auditing. Guidelines on continuing professional education are laid down by the professional bodies to ensure that qualified accountants keep their knowledge up-to-date.

Audit teams

24. Depending of the size and complexity of the engagement, an audit may be carried out by a single qualified person or by a team of professionals acting under the direction of the audit partner. A typical public company audit is run on a day-to-day basis by an audit manager who reports to the partner in charge. Detailed testing is undertaken by a group of qualified and/or student accountants, working under the direction of the audit manager.

How independent are auditors?

25. It is fundamental to the concept of auditing that the auditor should be independent of the persons responsible for producing the accounts and of the enterprise itself. The Companies Acts do not allow an officer or servant of the company, nor an employee or partner of an officer or servant, to be an auditor of that company. Anyone who is disqualified from being the auditor of a particular company is automatically debarred from auditing any of that company's associates or subsidiaries.
26. Further constraints are placed on auditors by the ethical code agreed by the Consultative Committee of Accountancy Bodies. The auditing profession's independence rules may be summarised as follows:
- A member in public practice should be, and be seen to be, free in each professional assignment he undertakes of any interest which might detract from objectivity.
 - A practice should endeavour to ensure that the recurring fees paid by one client or group of connected clients do not exceed 15% of the gross fees of the practice.
 - A practice should not charge fees on a percentage or similar basis.
 - A practice should ensure that its objective approach to any assignment is not endangered as a consequence of any personal relationship, such as might arise from a mutual business interest with a client, from a close friendship with a client, or when the same partner or senior staff member works for a number of years on the same audit.
 - A practice should ensure that it does not have as an audit client a company which a partner in the practice, the spouse or minor child of such a partner, is the beneficial holder of shares, nor should it employ on the audit any member of staff who is a beneficial holder of such shares.
 - A practice should not have a public company as an audit client if any partner or partner's spouse is a trustee in a trust which holds more than 10% of the company's shares. Even if the holding is less than 10%, the trustee partner should not take part in the audit and the extent of the shareholding should be disclosed in the company's annual report.
 - Where a practice audits a private company, shares in which are held by a trust of which a partner or partner's spouse is a trustee, the shareholding

should be disclosed in the annual report.

- An auditor should not make loans to nor accept loans from an audit client, nor should goods or services be accepted on unduly favourable terms.
- An auditor should not help to prepare the accounting records of a public company save in exceptional circumstances.

Who appoints an auditor?

27. The auditor is appointed and his remuneration is fixed by the shareholders at the annual general meeting, usually following recommendations made by the directors. The auditor's appointment runs only from one AGM to the next, so he usually has to be re-appointed annually, although the shareholders of a private company, if they are unanimous, can dispense with this obligation.
28. Where a change of auditor is proposed, special notice has to be given to the shareholders, to the existing auditor and to the proposed new auditor. The existing auditor has the right to present a written statement to the shareholders and to attend the AGM which appoints a new auditor.
29. The professional ethics of the auditing profession add a further measure of protection for shareholders by requiring the new auditor to consult with the outgoing auditor to see if there is any reason why the audit appointment should not be accepted.
30. In some companies, recommendations on the appointment and remuneration of the auditors are among the tasks performed by a sub-committee of the board known as the audit committee.

What are an auditor's duties?

31. The law has little to say about the statutory duties of an auditor. According to the Companies Acts, the auditor shall make a report to the shareholders on the accounts examined by him and the report has to state whether or not the accounts give a true and fair view of the company's affairs at the balance sheet date and of its profit or loss for the financial year. In addition, it shall be the duty of the auditor in preparing his report to carry such investigations as will enable him to form an opinion as to whether proper accounting records have been kept by the company and whether the company's balance sheet and profit and loss account are in agreement with the accounting records and returns.
32. The auditor's report has to be attached to the annual accounts and read out to shareholders at the AGM. If, in his opinion, proper accounting records have not been kept, or the accounts are not in agreement with the underlying records, or he has failed to obtain all the information and explanations necessary for the audit, the auditor has to say so in his report to the shareholders. In carrying out his duties, the auditor has to show the reasonable care and skill normally expected of a professional auditor.

33. How an audit should be conducted and what an auditor needs to do to demonstrate reasonable care and skill are not spelled out in the law. Clearly, however, compliance with the professional standards laid down by the accountancy bodies would be an important factor in any assessment by the courts of whether an auditor's duties had been properly performed.
34. Nothing can alter the statutory obligations of the auditor to carry out the minimum duties described above. While the directors cannot restrict the scope of the statutory audit, they can ask the auditors to carry out extra work. In order to be clear about the scope of a particular audit, an engagement letter is agreed with the client before the audit begins. A typical engagement letter would remind the company of the legal requirements covering an audit and point out that the auditor is not responsible for the accounting system nor for writing up the books nor for preparing accounts, and that an audit is not a guarantee that frauds or mistakes will be discovered. The engagement letter would normally summarise the types of work to be done by the auditor to form his opinion. Any other services required by the directors, such as the preparation of draft accounts or tax computations, would be described separately to distinguish them from the statutory audit.

What are an auditor's powers?

35. In carrying out his statutory duties, the auditor has a right to access at all times to the books and records and vouchers of the company. He can require from an officer of the company such information and explanations as he thinks necessary. What this means in practice is that the auditor is entitled to see any documents relating to the company's activities, including board minutes, title deeds, contracts and management accounts, and that he can insist on answers to his questions from any director or employee of the company. The auditor is not required to explain his reasons for asking particular questions.
36. An officer of the company who knowingly or recklessly gives an auditor misleading, false or deceptive information may be fined or even sent to prison.
37. In practice it is the auditor's report which provides him with his power. An adverse audit report or a disclaimer of opinion can be very damaging for the reputation of a company. To avoid getting a qualified report, a company will usually make whatever changes to its accounting policies or financial statements as are deemed necessary by the auditor.
38. The auditor has no legal right either to call or to attend board meetings - even the meeting at which the audited accounts are approved - nor does he have the right to bring problems, such as a disagreement with the finance director or a weakness in internal controls, to the attention of the full board except through his audit report. In practice, however, the auditor will usually notify the other directors, or at least the chairman of the board, when there is a major unresolved disagreement with the finance director or when other important matters arise during the audit.
39. Where the auditor is profoundly dissatisfied with the company's accounts because, for example, there is suspected management fraud or a total lack of internal control or a fundamental disagreement with the board of directors, the

auditor normally has to wait until the publication of the accounts before he can report to the shareholders. In extreme circumstances, he may decide to resign in order to alert shareholders more quickly to the existence of some serious problems in the company's financial affairs. A resigning auditor can require the directors to call an extraordinary general meeting to discuss the circumstances of his resignation. Any auditor who ceases to hold office, for whatever reason must either state that there are no circumstances surrounding his departure which should be brought to the attention of shareholders or creditors, or set out the circumstances.

40. At the AGM, the audit opinion is read out to the members, but the auditor has no power to make any additional statements to the shareholders unless he is resigning. Similarly, shareholders have no legal right to require explanations directly from the auditor. Questions about the accounts have to be made to the board of directors.

What are auditing standards?

41. Auditing standards prescribe the basic principles and practices which members of the accountancy bodies are expected to follow in the conduct of audits. Failure to observe auditing standards may result in disciplinary action being taken against a member by his professional body.
42. The standards do not have direct statutory authority. However, they are backed by the law in the sense that compliance with published professional standards may be an important consideration in a case where the adequacy of an auditor's work is being considered by the courts.
43. There are two standards, covering operations and reporting, which apply no matter what the size or constitution of the organisation being audited. The operational standard applies to all audits and the reporting standard applies whenever an auditor expresses an opinion on financial statements intended to give a true and fair view. The standards themselves are brief but are supported by detailed guidelines which indicate how the standard may be applied in practice. The operational standard states:
- The auditor should adequately plan, control and record his work.
 - The auditor should ascertain the enterprise's system of recording and processing transactions and assess its adequacy as a basis for the preparation of financial statements.
 - The auditor should obtain relevant and reliable audit evidence sufficient to enable him to draw reasonable conclusions therefrom.
 - If the auditor wishes to place reliance on any internal controls, he should ascertain and evaluate those controls and perform compliance tests on their operations.
 - The auditor should carry out such a review of the financial statements as is sufficient, in conjunction with the conclusions drawn from the other audit evidence obtained, to give him a reasonable basis for his opinion on

the financial statements.

44. Auditing standards also include the requirement that the auditor should determine whether all relevant statements of standard accounting practice have been complied with by the company in presenting a true and fair view of its financial position and results.

How is an audit conducted?

45. An audit has five basic stages:
- (1) planning;
 - (2) reviewing systems of accounting and internal control;
 - (3) obtaining audit evidence;
 - (4) reviewing financial statements;
 - (5) reporting findings.

Planning

46. Although the auditor reports only on the financial accounts, those accounts have to be fair reflection of the company's total activities. Before the audit can begin, the auditor needs to understand the nature of the company's business, its organisation and the industrial context in which it operates. He will review the results of the previous year's audit and examine interim management accounts for the current year. He will consider the effect upon the company of any changes in legislation or the business climate. If new operating methods have been introduced or a new accounting system installed, the auditor will assess their likely impact. Having done all this, the auditor can then appreciate the scale and complexity of the assignment and can anticipate the events and transactions which may need particular attention.
47. The planning stage includes allocating people with the right experience and skill to the audit team and then briefing them properly. Decisions have to be made about which company locations should be visited and the timing of such visits. The audit plan will also take into account the extent to which analyses and summaries of financial data can be prepared by the company's own employees, and the relevance of any work carried out by the internal auditors. Finally, the audit programme has to be fitted into an appropriate timescale.

Reviewing systems

48. The second stage in the audit is to review the company's system for recording and controlling the financial data on which the accounts are based. What constitutes an adequate accounting system will depend on the size and nature of the enterprise. In a small business dealing primarily with cash sales and with only a few suppliers, the accounting system may only need to consist of an analysed cash book and a list of unpaid invoices. In a large company with diverse manufacturing operations in different locations, a much more complex accounting system will be needed to control and assemble the data needed to prepare financial statements. Whatever form the company's records take - handwritten books, microfilm, computer files - the auditor will examine the system to assess its adequacy.

49. The auditor's examination will often include a review of the internal controls set up by management to safeguard company assets and to ensure the completeness and accuracy of the records. If he obtains reasonable assurance that the internal controls are effective, he may be able to limit the extent of his testing and improve the efficiency of the audit.
50. Examples of internal controls include the use of properly trained and supervised employees; the segregation of duties among different employees; controls which prevent invoices being paid unless the goods or services have actually been received by the company and which ensure an invoice is raised and issued for all goods dispatched to customers; and regular reconciliation of figures between, say, cash book and back statements or between stock levels, sales and purchases.
51. Some companies have an internal audit department to strengthen control over company assets and the proper recording of transactions. While the internal auditors have no legal status in relation to the statutory audit, it is common for the external auditor to rely upon their work in certain areas. The reliance in no way relieves the statutory auditors from responsibility for their opinion on the accounts.
52. Internal control is management's responsibility and the controls described in a company depend on its particular circumstances. If a control costs more than the potential loss it seeks to prevent, there's not much point in having it. Nor can an elaborate system of control be expected in a small firm where lack of staff means that each person has to perform several different tasks and directors exercise a closer control over day-to-day activities.
53. The statutory auditor finds out how the company's accounting and internal control system works partly by asking questions of company management and staff and partly by direct observation. He may trace sample paperwork through the system to see how a particular transaction has been dealt with from start to finish. He will document the system in his working papers, often using diagrams called flowcharts to illustrate a complicated system.
54. Following these preliminary investigations, the auditor will assess the degree of reliance which can apparently be placed upon the company's accounting system. If the system appears to be sound and is subject to controls that should ensure that proper processing of transactions, he will carry out tests to see whether the controls have been complied with in practice throughout the year. If the system appears to be weak, more extensive audit testing may be necessary.
55. Although an auditor's appointment may continue for many years, each year's accounts and audit reports must stand alone. However, during the course of an audit, the auditor will collect certain information of a permanent nature (for example flowcharts and notes) which can be used year after year. The auditor will therefore need to re-confirm these every year and hence his understanding and assessment of the company's accounting systems and internal controls.
56. Following the review of systems the audit then moves into stage three, which is the gathering of sufficient evidence to enable the auditor to form an opinion on the accounts presented to shareholders.

Obtaining audit evidence

57. As far as the year's operations are concerned, the auditor needs evidence that all transactions which actually took place have been properly recorded and properly measured. With regard to the balance sheet, the auditor has to gather evidence that all the company's major assets and liabilities exist, are recorded and are shown in the accounts at a reasonable valuation.
58. Audit evidence can be acquired in many ways, including the following:
- inspection of company records and documents (eg, sales ledger, payroll records, invoices, bank statements, purchase orders, leases, title deeds, share certificates, board minutes);
 - physical observation of company operations (eg, recording sales controlling cash receipts, paying of wages) or tangible assets (eg, capital equipment, stock, buildings);
 - requests for information from the company's customers, suppliers or other third parties (eg, bank certificates, debtors' confirmation letters, solicitors' letters);
 - requests for oral or written statements from company employees (eg, statements by management, directors' letter of representation);
 - computations to check the arithmetical accuracy of the accounting records;
 - analytical review of accounting ratios, industry comparisons, trends or other statistics relating to the company's operations.
59. To substantiate his opinion on a particular section of the accounts, the auditor will try to obtain evidence from several different sources. For example, to verify the authenticity and collectability of the balance sheet figure for 'debtors', he would test the accounting records for sales and receipts and might also write to the company's customers for independent confirmation of outstanding debts. In addition, he might check the extent to which cash has been received after the year end in settlement of the debtors' balances shown in the books.
60. To underline management's responsibility for the accounts, the auditor may request a letter of representation from the directors to confirm, for example, that they are not aware of any undisclosed liabilities or capital commitments, that the accounting records are complete and comply with the law, and that assets are valued realistically.

Reviewing financial statements

61. Having accumulated audit evidence about individual items or groups of items, the auditor will examine the year-end accounts covering the enterprise as a whole. The auditor's review is carried out to determine whether the financial statements seem reasonable in the light of his audit findings, his knowledge of

the company and comparative figures for previous years; whether appropriate and consistent accounting policies have been applied; whether full and proper disclosure has been made of all matters necessary to present a true and fair view; and whether the financial statements comply with the legal requirements relevant to the company.

Reporting findings

62. The fifth and final stage in an audit is to give an opinion on the year-end accounts prepared by management. This is done in a brief report attached to the published financial statements. (Audit reports are discussed in paragraphs 79 to 88).

How much does an auditor check?

63. How much checking is done by an auditor will depend to some extent on his evaluation of the company's system of accounting and internal control. Under normal circumstances, it would be far too expensive and time consuming for the auditor to check everything. On the other hand, he must gather enough evidence to provide a reasonable basis for an opinion on the accounts.
64. What this means in practice is that, with regard to the bulk of ordinary transactions, the auditor applies test checks whose extent depends on the estimated reliability of the system and the number of actual errors found. In selecting item to be checked, the auditor will concentrate on material and unusual items and potential weak spots in the system.
65. The auditor may use statistical sampling techniques to determine the extent of testing required, to ensure the random distribution of items chosen for testing and to evaluate test results. Computer assisted audit techniques may also be used. For example, the auditor may test the company's computer system with the help of specially designed audit programs or he may run test data through the system using the company's own programs.
66. Once he satisfied that the basic system of recording transactions and balances is reliable, the auditor concentrates his attention on any unusual or significant transactions, especially those for which the accounting treatment relies heavily on questions of judgement. Although he will test check additions and calculations and ensure that the books are in balance at the year end, the auditor's main concern is that the accounts properly reflect the substance of transactions. It is more important to be sure that the basis of valuation is reasonable than to check the calculation of, for example, every item in a company's inventory. Mistakes are of interest to the auditor only in so far as they affect the true and fair view given by the accounts.

What can an audit be expected to reveal?

67. Where the auditor has given an unqualified opinion in his report, it may be assumed that the company has kept proper accounting records, that the accounts are in agreement with those records, that they comply with the Companies Acts, and that appropriate accounting principles have been applied properly and consistently. An audit does not guarantee the absolute truth and fairness of the

company's financial statements, but it provides reasonable assurance that the accounts may be relied upon.

Materiality

68. Although financial statements contain approximations, they must reflect a reasonable degree of accuracy. The audit can normally be expected to uncover any material errors but does not imply that there are no errors of any kind in the accounts or underlying records. In an auditing sense, a matter becomes material when non-disclosure, misstatement or omission would be likely to distort the overall view shown by the accounts. Materiality is a relative concept. For example, a £100,000 misstatement of sales for a company with a £200,000 net income is material, while that same misstatement for a company with £500,000 net income may be immaterial. In addition, qualitative characteristics influence materiality. For example, an error in the financial statements might be small as a percentage of a critical component. This small error, however, may be considered material because it could cause an entity to breach a loan agreement, which could result in a misclassification of current and noncurrent debt. An auditor considers both quantitative and qualitative aspects of errors found during the audit, and considers each case separately in the light of his judgement of its impact on a true and fair view.

Efficiency

69. Another misconception would be to regard the audit as a review of management efficiency. The audit opinion is a reflection of efficiency only in the sense that a company, whose accounting records are reported to be inadequate or uncontrolled, might be assumed to have bad management. The statutory audit is not a management audit, although of course the financial statements may provide some indication of the quality of the company's stewardship.

What is the auditor's responsibility in relation to fraud?

70. The auditor's responsibility for detecting error or fraud affecting the financial statements is widely misunderstood. Although the auditor may have some responsibility in certain circumstances, the responsibility for preventing and detecting error and fraud is primarily management's.
71. Fraud is the use of deception to obtain an unjust or illegal advantage. Errors are unintentional mistakes, such as
- arithmetical or clerical mistakes (omitting an entry, making a wrong calculation).
 - inadvertent misapplication of accounting principles.
 - the oversight or misinterpretation of facts.

When any of these are done intentionally, they amount to fraud.

72. Fraud also could involve the recording of non-existent transactions. Generally, fraud involves a loss of assets and thus requires either direct or indirect access to

assets. Such a loss should be discovered when the assets are compared with the accounting records, unless these records were adjusted to conceal the shortage. To conceal the fraud requires access to the accounting records as well as the assets; this is why good internal control necessitates the division of duties between access to assets and access to related accounting records. In the case of an error, no attempt is made to conceal it and it should be brought to light in due course by the operation of the system. Thus, management discharges its responsibility for the prevention and detection of error and fraud primarily through the installation and monitoring of an effective internal control system.

73. A special type of fraud - distortion - does not involve a loss of assets but rather a deliberate misrepresentation of the financial position or operating results. It requires access only to accounting records and, as it will generally involve senior management, internal controls may not be an effective safeguard. For example, to make his financial results for the year appear better than they really are and improve his bonus, a branch manager might overstate his sales. This could be discovered by someone at head office carrying out analytical review procedures as part of the system of internal control.

The auditor's responsibility

74. An auditor's objective is to obtain reasonable assurance that there is no material misstatement in the financial statements. Such misstatement could only be due to error or fraud. The auditor can only be reasonably sure, and not certain, since ordinary audit techniques may be inefficient where there is collusion between management or employees (which counteracts the separation of duties required by effective internal control) or forgery. Even if a company were willing to incur the exorbitant cost involved, an audit would frequently be ineffective against a well-devised scheme involving management in collusion or forgery.
75. The auditor will generally be expected to discover a significant error which affects the financial statements, although the accepted use of testing, as opposed to a 100% check, may sometimes work against discovery of such errors. The trade-off is one of cost. If audit testing were not acceptable, all material errors and some additional frauds might be expected to be discovered by the auditor. The cost of a 100% check, however, would make the entire exercise uneconomical and, even then, transactions which should have been recorded but were not, would not necessarily be discovered.
76. Thus in the spectrum ranging from insignificant error to material collusive fraud, the degree of the auditor's responsibility in each case will depend on the circumstances. It is generally not possible to be more specific than this. In the final analysis it may be left to the courts to decide whether an auditor has fulfilled his responsibility. In such cases, the court will consider whether the auditor complied with the standards of his profession which require that an auditor who encounters suspicious circumstances must not ignore them, but must probe them to the bottom.

Reporting fraud

77. The auditor normally reports frauds brought to light by the audit to senior

management. He may also recommend improvements in working practices in order to assist in the prevention of further occurrences. Provided the financial statements give a true and fair view, the auditor does not need to qualify his opinion merely because a fraud has occurred.

78. Although the auditor is generally bound to protect confidential information about his client obtained in the course of his duties, in exceptional circumstances he can disclose matters to a proper authority in the public interest. This could apply to a fraud

- that was likely to result in a material gain or loss for any person, or is likely to affect a large number of people
- if non-disclosure was likely to allow the fraud to be repeated with impunity
- that was particularly grave.

What does an auditor's report mean?

Unqualified report

79. The most common type of auditor's report contains an unqualified opinion. An auditor issues an unqualified opinion when no significant limitations affect the performance of the audit and when there are no significant disagreements with management about matters affecting the financial statements, such as the determination of accounting policies or the method of their application. An unqualified opinion implicitly indicates that changes in accounting principles or in the method of their application and the effects of such changes have been properly determined and disclosed in the financial statements. This report consists of paragraphs containing standard words and phrases having a specific meaning. One paragraph identifies the financial statements audited and indicates the auditing standard or practices followed in conducting the audit. In another paragraph, the auditor communicates his opinion. The independent auditor expresses an informed and expert opinion on the financial statements.

80. An example of an auditor's report containing an unqualified opinion is as follows

Auditor's Report to the members of XYZ Limited

We have audited the financial statements on pages...to... in accordance with Auditing Standards.

In our opinion, the financial statements give a true and fair view of the state of the company's affairs at 31 December.... and of its profit and source and application of funds for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Smith Jones & Co
[Chartered Accountants]

[Registered Auditors]
5 Moorgate Place, London EC2

Date

The following discussion explains the specific meaning of the language used in the auditor's unqualified report.

81. The title *Auditor's Report* helps the reader identify the auditor's report and distinguishes the report from those that might be issued by others, such as management or the board of directors.
82. *We have audited the financial statements on pages....to.... in accordance with Auditing Standards.*
- "*We have audited.*" This phrase identifies the type of service performed and, therefore, the level of assurance the independent auditor is providing and the corresponding responsibility assumed. This is the highest level of assurance that auditors can provide.
 - "*the financial statements on pages... to...*" The auditor's report covers the financial statements identified in the report including the related notes in those financial statements. The auditor identifies the financial statements covered by his opinion by making reference to the pages on which such information is included. The auditor has not audited additional information that may also be presented with the financial statements.
 - "*in accordance with Auditing Standards*". This provides the user with assurance that the audit has been carried out in accordance with established standards or practices. These standards establish criteria for the auditor's professional qualifications, the nature and extent of judgements exercised in the audit, and the preparation of the auditor's report. These standards apply equally in any financial statement audit, regardless of the type or size of the company.
83. *In our opinion, the financial statements give a true and fair view of the state of the company's affairs at 31 December 19.. and of its profit and source and application of funds for the year ended and have been properly prepared in accordance with the Companies Act 1985.*

The auditor's conclusions, as a result of the audit, are described by the following phrases in the opinion paragraph.

- "*In our opinion*". This phrase implies that the auditor is reasonably sure of his conclusions. The auditor gives a high level of assurance; however, he does not express a guarantee. Like a physician or an attorney, an auditor's opinion is based on professional judgement, not absolute certainty.
- "*give a true and fair view*" Financial statements are based upon a framework of concepts determined by legislation, accounting standards and established practice. This framework of concepts has as its goal the truth and fairness of the financial statements, and it is in these terms that the auditor expresses his opinion.

The auditor is also required to give an opinion on whether the financial statements conform with the law.

85. Smith Jones & Co
[Chartered Accountants]
[Registered Auditors]
Moorgate Place EC2

Date

The auditor's report is signed in the name of the auditor's firm or the personal name of the auditors, or both, as appropriate in the circumstances. In addition, the auditor's report may disclose the specific location of the auditor's firm that performed the audit. The date of the auditor's report is important because this represents the date that the auditor concluded all significant procedures. If the auditor becomes aware of material transactions and events occurring between the date of his report and the date he issues the report, he considers their effect on the financial statements and on his report. The auditor must indicate that he is a Registered Auditor.

Qualified report

85. Qualified audit reports fall into two principal groups, depending on whether they arise from uncertainty or disagreement. The strength of the qualification used in each of these groups will in turn depend on whether the matter is regarded as fundamental to an understanding of the accounts.
86. The first group of qualifications, arising from uncertainties, may be used where there is material unresolved litigation or where there is uncertainty about the outcome of a major long-term contract or the ability of a company to continue as a going concern. In most cases, the audit report will use the words 'Subject to this uncertainty' and continue with a normal opinion. But in rare cases, if the uncertainty is so fundamental as to make the accounts as a whole meaningless, the report may take the form of a disclaimer in which the auditor states that he is unable to give any opinion on the accounts.
87. The second group of qualifications, arising from disagreement, will be used where the auditor considers that something has been incorrectly dealt with in the accounts. This may be due to a disagreement about the accounting policies used, about specific facts or the extent of disclosure of information. Usually the report will use such words as 'Except for the failure to...', followed by a normal opinion. Many 'Except for' opinions relate to a failure to apply a particular accounting standard. In rare circumstances, the auditor may decide that the disagreement is so fundamental as to make the accounts totally misleading. He will then give an 'adverse' opinion, stating unequivocally that the accounts do not show a true and fair view. Clearly, it would be most unwise to rely upon financial statements which the auditor qualifies in this way.
88. It is important to recognise that in many instances uncertainty qualifications (subject to...or disclaimer) arise from circumstances outside the control of management and do not necessarily imply criticism of the accounts or of management. On the other hand, disagreement qualifications (Except...or

adverse) do imply criticism because they arise from circumstances which are within the control of management.

Is an unqualified auditor's report a clean bill of health?

89. Some financial statement users consider an auditor's unqualified opinion to be a clean bill of health. For example, some users believe that an audit endorses an entity's policy decisions, its use of resources, or the adequacy of its internal control system. This is not the objective of a financial statement audit. The auditor's opinion on the financial statements does not pertain to these matters.
90. An audit enhances users' confidence that financial statements do not contain material error and fraud because the auditor is an independent and objective expert who is also knowledgeable of the entity's business and financial reporting requirements.

Going concern

91. Some financial statement users believe that an audit provides positive assurance that a business is a safe investment and will not fail. It is true that in the preparation of financial statements, a company's ability to continue as a going concern is assumed. Experience indicates that, in the absence of significant information to the contrary, continuing operation is highly probable for most companies; therefore, the assumption that a company is a going concern is not discussed in every set of financial statements. If there is doubt about an entity's ability to continue as a going concern in the next year, then management should disclose, in the notes to the financial statements -
 - pertinent conditions that raise doubt the company's ability to continue as a going concern in the next year.
 - the possible effects of such conditions, such as the possibility that the company may be unable to continue in operation and therefore be unable to realise all of its assets and pay all of its liabilities in the normal course of business.
92. In the course of planning and performing an audit, the auditor is alert to the possibility that the going concern assumption may not be an appropriate assumption for management's preparation of financial statements. When normal audit procedures raise questions about the appropriateness of the going concern assumptions, the auditor will obtain information about management's plans for the future. If, after considering management's plans and the reasonableness of those plans, the independent auditor concludes that he has serious doubts about the entity's ability to continue as a going concern the auditor considers the adequacy of financial statement disclosure about this uncertainty and may include an additional explanatory paragraph in the auditor's report discussing the uncertainty.
93. The auditor has a responsibility to consider the ability of the entity to continue as a going concern for one year from the balance sheet date (or six months from the signing of the audit report if later) based on its current condition. However, the auditor is not responsible for predicting future conditions or events, nor is

he able to do so. For example, the auditor is not expected to predict a significant drop in commodity prices or other changes in the market for a client's products or services. The absence of a reference, in the report, to the auditor's doubt about the entity's ability to continue in operation should not be viewed as providing assurance that future events will not affect the entity's ability to continue as a going concern.

Who gets an auditor's report?

94. The statutory auditor's report is addressed to the shareholders, since it is they who appoint him to carry out the audit on their behalf. The report is attached to the annual accounts filed with the registrar of companies. Any member of the public may inspect those audited accounts by applying to Companies house.
95. It is common practice for an auditor to submit to the directors a separate report on internal controls. This more detailed report, often referred to as the 'management letter', is not a statutory requirement and is not available to shareholders or the public.

How should audited financial statements be used?

96. The auditor's report and financial statements presented by management are useful only to those who make the effort to understand them. Knowledgeable use of the auditor's report requires a general understanding of both the audit process and the meaning of the auditor's report. Effective use of audited financial statements also requires a basic understanding of accounting standards, the related concepts of financial measurement and disclosure, and the inherent limitations of financial statements caused by the use of accounting estimates, judgements, and various alternative accounting principles and methods.

Accounting policies

97. Accounting policies encompass the principles, conventions, rules and procedures adopted by management in preparing and presenting financial statements. There are many different accounting policies in use even in relation to the same subject; judgement is required in determining and applying those that are best suited, in the circumstances, to present properly a company's financial position and results of operations. For example, there are many acceptable methods for valuing inventory or depreciating fixed assets. Management is responsible for determining the accounting policies that are appropriate for the circumstances when preparing financial statements. Once management has determined the initial accounting policy, it must have reasonable justification to change it.
98. The accounting policies determined by management affect the information relevant to the user's decision. An evaluation of the financial statements requires that the user read the notes to the financial statements to ascertain the significant accounting policies used to prepare the statements.

Financial measurement

99. Financial measurement involves measuring the monetary amounts of the effects of events and transactions. Such measurement is not always as easy as

determining the amount of a payment. Many financial statement amounts involve significant accounting estimates. For example, what portion of credit sales will be uncollectible? How long will depreciable assets remain in use? What product warranty claims will have to be paid?

100. Some transactions, such as the purchase of stock, can be objectively identified, measured, and recorded when they occur. While the initial recording of a transaction is often straightforward, evaluating the subsequent effects of these transactions on the financial position, results of operations, or changes in financial position may require more judgement. For example, management must estimate the amount of unsold stock that is obsolete or determine whether its market value is significantly impaired. These applications of accounting principles require significant assumptions, estimates, and professional judgements that are inherently imprecise.

Financial stability of the company

101. The evaluation of a company's financial stability - its financial position, operating results, and changes in financial position - is the user's responsibility. Financial statements provide information helpful in making that evaluation. It is the reader's responsibility to interpret these statements according to his interests and concerns.

Business risk and quality of management

102. Management will take risks with varying degrees of economic potential and uncertainty of results. An audit does not evaluate the wisdom of management's decisions nor indicate the safety or future profitability of investing in the company. Financial statement users are responsible for deciding whether management has made appropriate decisions. The user must evaluate the quality of past performance and decide whether management has adequate knowledge and experience to guide the company successfully.

Risk of financial involvement with a company

103. Specific decisions about doing business with a company, such as investing or extending credit, are the responsibility of those contemplating such matters. An audit only adds credibility to management's financial statements that users may consider in evaluating those risks for themselves.

The independent audit

104. An audit allows creditors, bankers, investors, and others to use financial statements with confidence. While the audit does not guarantee the accuracy of financial statements, it provides users with a reasonable assurance that a company's financial statements give a true and fair view of its financial position, results of operations, and changes in financial position in conformity with accounting standards. An audit enhances users' confidence that financial statements do not contain material error and fraud because the auditor is an independent, objective professional who is knowledgeable of the entity's business and financial reporting requirements.

105. The auditor's report provides information about the scope of the independent auditor's work and any material concerns that he had about the fairness of presentation of the financial statements in conformity with accounting standards.