

# Chapter

# 5

## Stages of the Audit Process

### Learning Objectives

Upon completion of this chapter you should be able to explain:

- LO 1 Explain the audit process.
- LO 2 Accept a new client or confirming the continuance of a current client.
- LO 3 Plan an audit.
- LO 4 Gather audit evidence.
- LO 5 Complete the audit.
- LO 6 Issue a report on the audit engagement.

### Relevant Accounting and Auditing Pronouncements

FRAME, International Framework for Assurance Engagements

ISQC 1, Quality Control for Firms That Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements

ISA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing

ISA 210, Agreeing the Terms of Audit Engagements

ISA 220, Quality Control for an Audit of Financial Statements

ISA 300, Planning an Audit of Financial Statements

ISA 315, Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment

ISA 320, Materiality in Planning and Performing an Audit

ISA 330, The Auditor's Responses to Assessed Risks

ISA 450, Evaluation of Misstatements Identified During the Audit

ISA 500, Audit Evidence

ISA 700, Forming an Opinion and Reporting on Financial Statements

This chapter provides an overview of the financial statement **auditing** process. It acts both as an introduction, as well as a summary for Chapters 6 to 20. Because of this, this chapter differs from the rest of the chapters in this book, in length, detail and the number of questions. The flow of the audit process followed in this book is not specifically documented in an International Standard on Auditing but comes from a combination of International Standards on Auditing, as well as audit methodology as implemented by different audit firms. The audit process is depicted in a circle since it is a continuous process. As soon as the auditor gets to the reporting stage, he or she is already busy considering whether to continue with the client for the next period. It is also important to note that, although the process is explained step by step, some steps can take place together with other steps, or information obtained during later steps may require the auditor to go back in the process and rethink steps already completed.

## LO 1 The Audit Process

This chapter starts with an explanation of how the auditor goes about the process of auditing financial statements, and presents the major phases that the auditor performs during a financial statement audit.

### Overview of the Financial Statement Auditing Process

Consider the auditor's task from a logical perspective. The end product of a financial statement auditor's work is an audit report indicating an opinion whether or not the client's financial statements are free of material misstatement. After accepting a client what should an auditor do to obtain the necessary (and appropriate and sufficient) evidence to form and support that opinion? The auditor must first obtain a thorough understanding of the entity and its environment, including the entity's internal control. The auditor must understand the risks the client faces, how it is dealing with those risks, and what remaining risks are most likely to result in a material misstatement in the financial statements. Armed with this understanding, the auditor develops an audit strategy and an audit plan that will produce evidence helpful in forming and supporting an opinion on the financial statements.

To understand this process you should consider how transactions are captured and finally processed into the financial statements. From your financial accounting courses, you know that accounting systems capture, record, and summarize individual transactions. Entities should design and implement controls to ensure that those transactions are initiated, captured, recorded, and summarized appropriately. These individual transactions are grouped and summarized into various account balances, and finally, financial statements are prepared by organizing meaningful collections of those account balances. We have just identified three stages in the accounting process that take place in the preparation of financial statements: *internal controls* are implemented to ensure appropriate capturing and recording of *individual transactions*, which are then collected into ending *account balances*. This summary might seem like an oversimplification, but it will help you understand the stages of a client's accounting process on which auditors focus to collect evidence.

Keep in mind that the auditor is required to express an opinion on *whether the financial statements are fairly stated*. Therefore, the auditor should design audit procedures to collect *direct* information about the closing account balances that make up the financial statements. For example, an auditor might confirm the closing balance of the cash account by contacting the client's bank, or the auditor might verify the closing balance of the inventory account by physically examining individual inventory items that make up the closing balance. But remember – account balances are made up of *individual transactions* that occurred during the reporting period (or beyond). If the auditor designs procedures to test whether the transactions were actually captured and handled properly, the auditor can obtain indirect information about whether the closing account balances



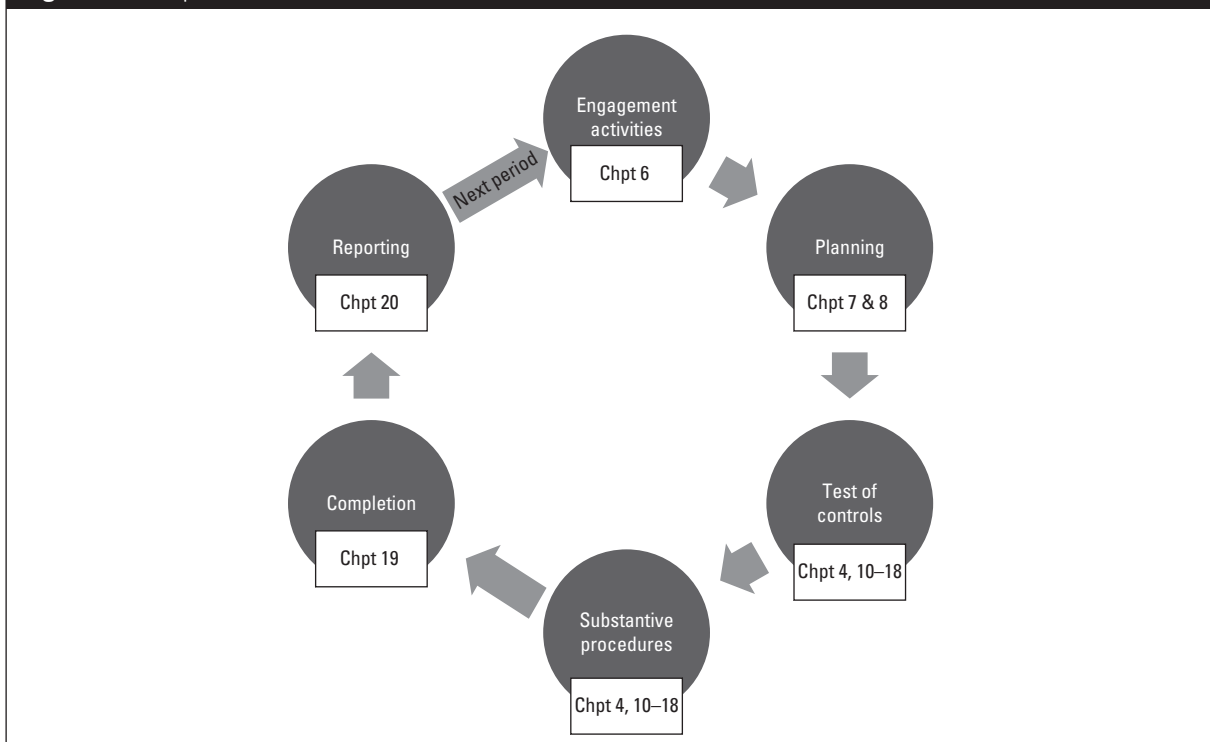
are likely to be fairly stated. This information is clearly one step removed from the closing account balances themselves. But we can even back up one more step. If the auditor designs procedures to test whether the entity's *internal control* over financial transactions is effective, the auditor can obtain additional indirect information regarding whether the account balances are fairly stated. Take a moment to think through the logic in this last step: if controls are effective, then the transactions will probably be captured and summarized properly, which means in turn that the account balances are likely to be free of material misstatement. Thus, information about internal control is even more indirect than information about transactions, but it is useful information nonetheless! In fact, while it is indirect, evidence about internal control is usually a relatively cost-effective form of **audit evidence**.

In summary, the auditor can collect evidence in each of three different stages in a client's accounting system to help determine whether the financial statements are fairly stated: (1) the *internal control* put in place by the client to ensure proper handling of transactions (e.g. evaluate and test the controls); (2) the *transactions* that affect each account balance (e.g. examine a sample of the transactions that occurred during the period); and (3) the ending *account balances* themselves (e.g. inspect a sample of the items that make up a closing account balance at period end). Evidence that relates directly to closing account balances is usually the highest quality, but also the costliest evidence. Thus, an auditor will usually rely on a combination of evidence from all three stages (if the internal control system is reliable) in forming an audit opinion regarding the fairness of the financial statements. Which of these three areas it is best to focus on depends on the circumstances, and this is generally left to the auditor's **professional judgement**. Chapter 3 addresses the types of procedure and types of evidence available to the auditor in more detail.

## Major Phases of the Audit

The audit process can be broken down into a number of audit phases (see Figure 5–1). While the figure suggests that these phases are sequential, they are actually quite iterative and interrelated in nature. Phases often include procedures designed for one purpose that provide evidence for other purposes, and sometimes procedures accomplish purposes in more than one phase. Figure 5–1 also shows the specific chapter(s) where each of these phases is discussed in detail.

**Figure 5–1** Major Phases of an Audit

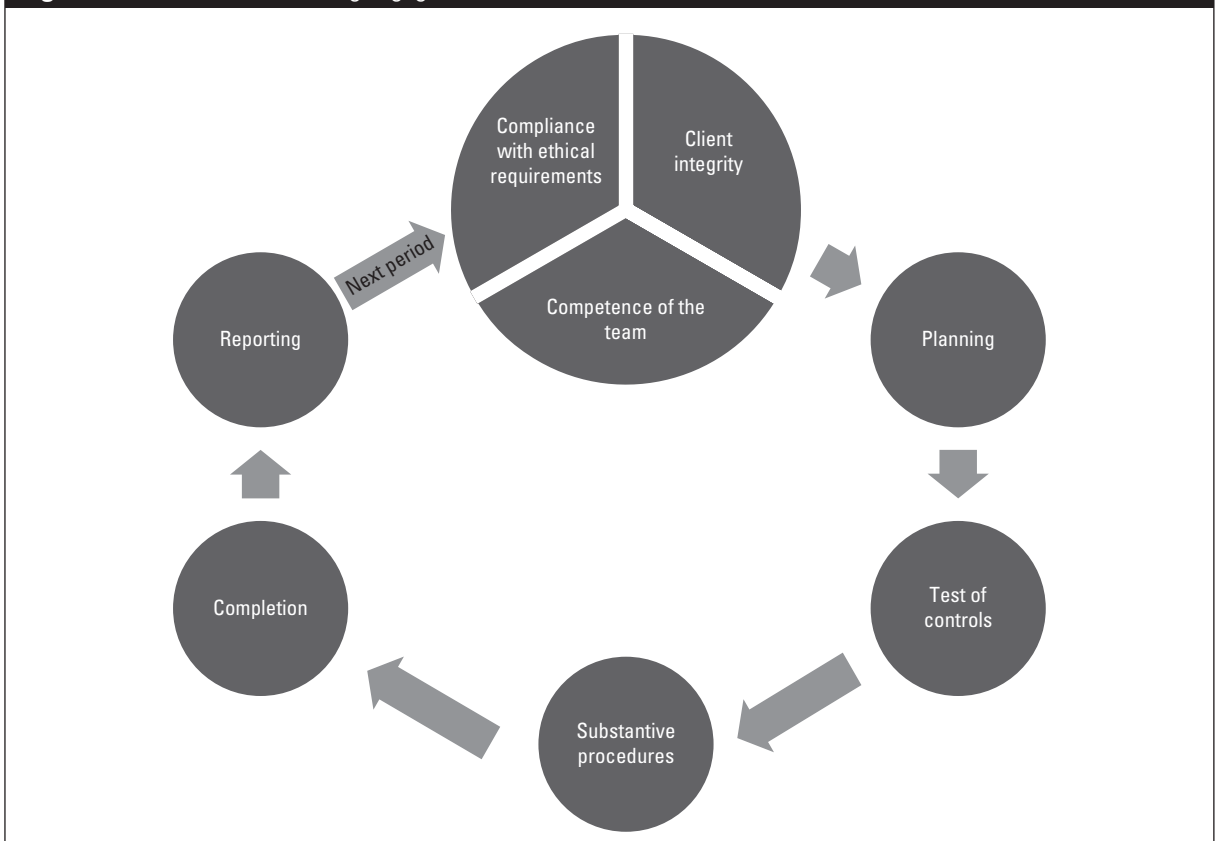


## LO 2

## Accepting a New Client or Confirming the Continuance of a Current Client

To accept, or not to accept, that's the question. Professional standards require that audit firms establish policies and procedures (see Chapter 4 for quality control) for deciding whether to accept new clients and to retain current clients. The purpose of such policies is to minimize the likelihood that an auditor will be associated with clients of which the auditor is not independent; lacks integrity; or accepts an engagement which they do not have the skill or competence to perform. Figure 5–2 illustrates what the auditor should consider when deciding to accept a new client or whether to continue with a current client. If an auditor is not independent of a client it can lead to non-compliance with ethical requirements, as well as bad publicity. If an auditor is associated with a client who lacks integrity or the auditor does not have the skill and competence to perform the audit, the risk increases that material misstatements may exist and not be detected by the auditor. This can lead to lawsuits being brought against the auditor by users of the financial statements. For a prospective new client, auditors would ordinarily confer with the predecessor auditor or knowledgeable third parties, and conduct background checks on top management. The knowledge that the auditor gathers during the acceptance/continuance process is not as in-depth as when later gaining an understanding of the entity and its environment, to assess risk and plan the audit. However, the knowledge obtained during the engagement activities should be sufficient to make an informed decision whether or not to accept a client. To determine if the firm has sufficient skill and competence, the competence of the audit team as a whole is considered and also whether the firm has sufficient staff and resources available to perform the engagement. Before the auditor can make the acceptance/continuance decisions, the auditor and the client need to establish and understand the terms of the services to be performed. This includes

**Figure 5–2** Considerations During Engagement Activities





confirming that the engagement complies with the five elements of an assurance engagement as set out in the Framework, par. 20 namely:

- 1 a three-party relationship;
- 2 appropriate subject matter;
- 3 suitable criteria;
- 4 sufficient appropriate evidence;
- 5 written assurance report.

Once the decision for acceptance/continuance has been taken, the auditor and the client need to confirm the terms of the engagement by signing an engagement letter. Terms included in the engagement letter include the responsibilities of each party, the assistance to be provided by client personnel and internal auditors, the timing of the engagement, and the expected audit fees. Chapter 6 addresses the engagement activities and terms of engagement in more detail.

## Consider Additional Value-Added Services

As part of the engagement activities, the auditor should look for opportunities to recommend additional value-added services. Traditionally, value-added services have included tax planning, transaction support, IT consultancy, and internal reporting processes. With auditors taking a more global view of the entity and its environment, there are new opportunities to provide valuable services for the client. For example, the auditor can provide recommendations based on the assessment of the entity's business risks. With the knowledge gathered through assessing business risks, the auditor can provide important feedback to management and those charged with governance on the strengths and weaknesses of business processes, strategic planning, and emerging trends. Proper consideration of value-added services during the planning process should alert the audit engagement team to proactively identify opportunities to improve client service. Of course, auditors are limited in the types of consulting services they can offer their audit clients (see Chapter 4).

### LO 3

## Planning an Audit

Auditing standards require the audit to be properly planned; this is to ensure that the audit is conducted in an effective and efficient manner. Planning involves all the issues the auditor should consider to develop an overall audit strategy and audit plan for conducting the audit. Therefore, the outcome of the auditor's planning process is a written plan that sets forth the overall audit strategy and the nature, extent, and timing of the audit work. The steps to be performed during the planning phase are set out in Figure 5-3.

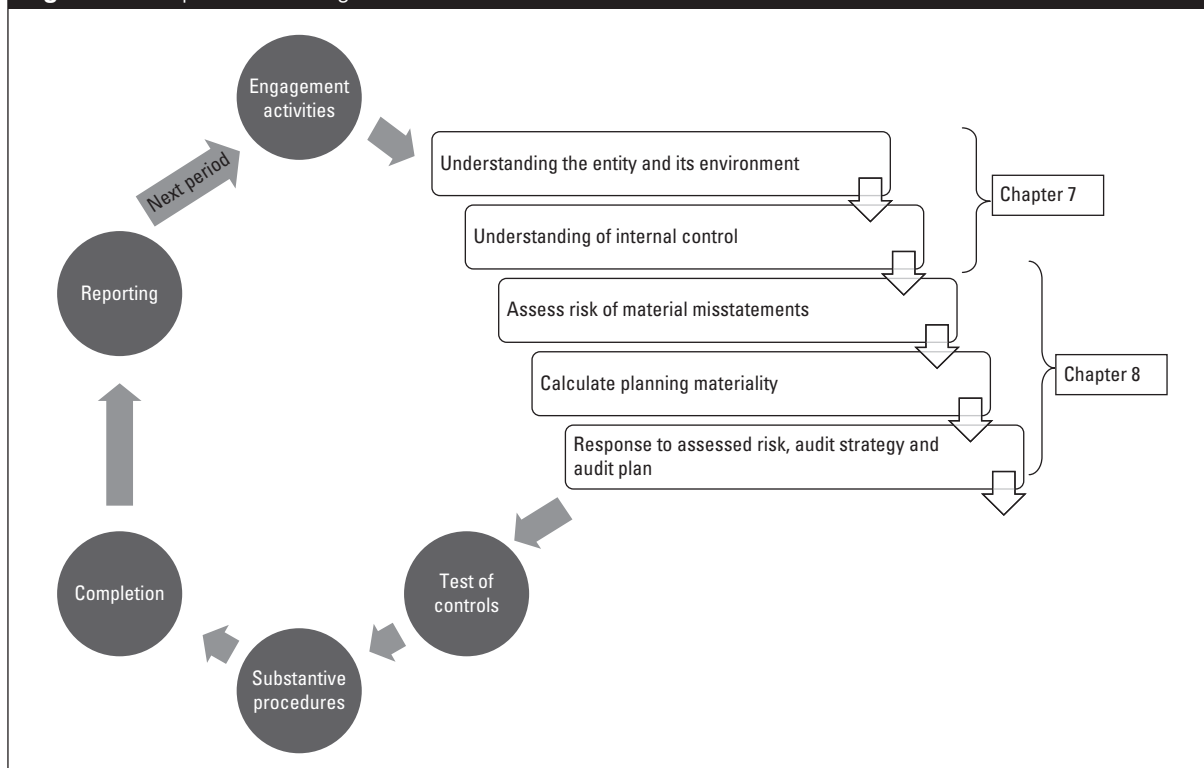
This process begins with obtaining sufficient knowledge of the entity, including its internal control system. With this knowledge the auditor is able to identify **risk of material misstatement** which affects the calculation of planning **materiality**. After performing all these procedures, the auditor is able to develop the overall audit strategy and the detailed audit plan, also referred to as the *audit programme*.

An integral part of planning that is not referred to in any standards, is general administration, e.g. scheduling team members, arranging travelling and lodging for the audit team if so required, and communicating deadlines with the client.

If the audit is not properly planned, the auditor may conduct an inefficient audit or issue an incorrect audit report.

## Understanding the Entity and its Environment

In order to plan the audit properly, the audit team starts by obtaining (for a new engagement) or updating (for a reoccurring engagement) the understanding of the entity and its environment. The auditor should obtain this understanding to enable the auditor to identify business risks that may result in material misstatements. The auditor evaluates the client's response to these business risks and decides whether the responses have been adequately implemented.

**Figure 5–3** Steps of the Planning Phase

The auditor's understanding of the entity and its environment should include information about each of the following categories:

- Industry, regulatory, and other external factors, including the applicable financial reporting framework.
- Nature of the entity.
- Selection and application of accounting policies.
- Objectives, strategies and related business risks.
- Measurement and review of financial performance.
- Entity's internal control (discussed later in this chapter in the next step of planning).

The above list indicates *what* the auditor should obtain knowledge of. Risk-assessment procedures are *how* to obtain knowledge. See ISA 315 par. 6 (and appropriate explanatory paragraphs) for examples of risk-assessment procedures, as well as Chapter 7.

As part of the planning process, the auditor may also conduct preliminary analytical procedures (such as ratio analysis) to identify specific transactions or account balances that should receive special attention due to an increased risk of material misstatement. The auditor compares actual ratios calculated to expected ratios to identify balances with an increased risk. These expectations can only be formed if the auditor has sufficient knowledge of the entity. For example, the expected gross profit margin and number of days in debt can only be determined if the auditor has knowledge of the entity's profit mark-up percentage and the company's credit policy.

## Obtaining an Understanding of Internal Control

In the course of reaching an understanding of the entity, the auditor should also obtain an understanding of its internal control system. This assists the auditor in identifying potential **misstatements** and the factors that could increase the risk of material misstatement. This understanding assists the auditor later on



in the planning phase in designing further audit procedures. ISA 315 discusses internal control in four sections:

- 1 General nature and characteristics of internal control;
- 2 Controls relevant to the audit;
- 3 Nature and extent of the understanding of relevant controls;
- 4 Components of internal control.

Internal control is designed and affected by an entity's board of directors (or other body charged with governance), management, and other personnel to provide **reasonable assurance** regarding the achievement of objectives in the following categories:

- 1 Reliability of financial reporting;
- 2 Effectiveness and efficiency of operations;
- 3 Compliance with applicable laws and regulations.

Chapter 9 provides detailed coverage of internal control in a financial statement audit. Later chapters apply the process of considering internal control in the context of various business processes.

### *Components of Internal Control*

Internal control is divided into the following five components:

- 1 Control environment;
- 2 The entity's risk assessment process;
- 3 Information system, including business processes, relevant to financial reporting, and communication;
- 4 Control activities;
- 5 Monitoring of controls.

The auditor typically assesses the risk of material misstatement by examining both the general control environment and the application controls per business processes or accounting cycles (e.g. purchasing process or revenue process). The auditor then determines the audit procedures that are necessary to reduce the risk of material misstatement to an acceptably low level for the financial statement accounts affected by a particular business process. Individual audit procedures are directed toward specific **assertions** in the account balances that are likely to be misstated. For example, if the auditor is concerned about the possibility of obsolete inventory, the auditor could conduct lower-of-cost-or-value tests to determine if the inventory on hand is properly valued. On most engagements, actually performing the planned audit tests comprises most of the time spent on a financial statement audit.

### **Assess the Risk of Material Misstatement**

On the basis of the information obtained above, the auditor needs to identify and assess risks of material misstatement at both financial statement level and assertion level. When identifying and assessing these risks, the auditor has to consider both inherent and control risks. The assessed level of risk of material misstatement is used to determine the acceptable level of detection risk and to plan the auditing procedures to be performed, which are ultimately developed into the audit strategy and audit plan. Chapter 7 discusses **audit risk** in detail.

### *Consider the Possibility of Misstatement Due to Fraud and/or Non-compliance with Laws and Regulations*

Misstatement can arise either from error, **fraud** and/or non-compliance with laws or regulations. The main distinguishing factor between fraud and error is that fraud is intentional while error is unintentional. There are three main factors contributing to fraud:

- 1 Pressure and incentive;
- 2 Opportunity;
- 3 Rationalization and attitude.

Fraud can be classified into two categories:

- 1 Fraudulent financial reporting;
- 2 Misappropriation of assets.



The term **non-compliance** refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations. In some instances, fraud may be a result of a non-compliance act. Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognize the non-compliance.

## Calculate Planning Materiality

When calculating planning materiality, the auditor needs to apply professional judgement. This judgement is founded on the knowledge already obtained during the planning phase as well as the risks identified from this knowledge. The auditor considers materiality from the perspective of how the misstatements could reasonably be expected to influence the economic decisions of users. The detail on how to calculate materiality, including both planning and performance materiality, is discussed in detail in Chapter 8.

## Develop a Response to Assessed Risk, Overall Audit Strategy and Audit Plan

During this phase the auditor should develop and document the responses to assessed risk, the overall audit strategy and the detailed audit plan. This involves documenting the decisions about the nature, timing, and extent of audit tests. At this stage, the auditor compiles his or her knowledge about the client's business objectives, strategies, and related business and audit risks. The auditor records how the client is managing its risks (i.e. through internal control processes) and then documents the effect of the risks and controls on the planned audit procedures. Auditors ensure they have addressed the risks they identified in their understanding of the risk-assessment process by documenting the linkage from the client's business objectives and strategy to audit plans. The form of documentation varies from firm to firm, but a simple illustration using EarthWear might look as in Exhibit 5–1.

The overall audit strategy and audit plan are documented in a written plan (ISA 300). Exhibit 5–2 presents a partial audit plan for substantive tests of accounts receivable. The types of audit procedures are discussed in the next section.

In determining the audit strategy, the auditor should determine the scope of the engagement, ascertain the reporting objectives to plan the timing of the audit, consider the factors that will determine the focus of the engagement team's efforts (determination of appropriate materiality levels, areas of high risk of material misstatement, etc.). Developing the audit strategy helps the auditor determine what resources are needed to perform the engagement.

Once the audit strategy has been established, the auditor develops an *audit plan*. The audit plan is more detailed than the audit strategy. In the audit plan, the auditor documents a description of (1) the nature, timing, and extent of the planned risk assessment procedures to be used, (2) the nature, timing, and extent of planned further audit procedures at the assertion level for each class of transactions, account balance, and disclosure, and (3) a description of other audit procedures to be performed in order to comply with auditing standards. Basically, the audit plan should consider how to conduct the audit in an effective and efficient manner.

When preparing the audit plan, the auditor should be guided by the results of the risk assessment procedures performed to gain the understanding of the entity. Additional steps that should be performed include:

- Assess business risks and establish materiality.
- Assess the need for experts.
- Consider the possibility of non-compliance with laws and regulations (illegal acts).
- Identify related parties.
- Conduct preliminary analytical procedures.
- Consider additional value-added services.

## Planning Administration

The engagement partner or manager needs to ensure that the audit team is composed of team members who collectively have the appropriate audit and industry knowledge and experience for the engagement. The partner or manager also determines whether the audit will require IT or other types of experts (e.g. actuaries or appraisers). All of the staff above needs to be booked on the audit engagement; otherwise, they might not be available to perform the audit during the times arranged with the client. If the audit team need to travel to the client, e.g.





<b>Exhibit 5-1 Planning Documentation</b>					
<b>Business Objectives and Strategy</b>	<b>Business Risks</b>	<b>Account(s): (Assertions)</b>	<b>Audit Risks</b>	<b>Controls</b>	<b>Effect on Audit Plan</b>
Increase market share through sales at new locations (e.g. during the current year websites were developed for 10 more countries)	Restrictive trade laws may affect sales tactics	Revenue: accuracy and valuation	Overstated due to pricing issues	EwC has installed a special group to track compliance with local and international laws	Observe and test group's policies and procedures (see work-paper R-11)
	Strong consumer protection in several European countries				
	Political uncertainty in less developed countries (LDCs).	Reserve for returns: completeness	Understated due to failure to properly track returns in new locations	EwC has placed more frequent review of returns in new locations	Extend audit work on EwC's return tracking with emphasis on new locations (see work-paper R-15)
<b>Currency risks</b>					
		Gains/ losses from currency hedging: valuation and accuracy	Gains/losses not properly calculated or accrued on hedging activity	EwC has strong controls in the Treasury Department to account for hedging activities	Increase the number of hedging contracts tested with particular emphasis on contracts in unstable currencies (see work-paper S-14)


**Exhibit 5-2** A Partial Audit Plan for Substantive Procedures Testing of Accounts Receivable

**Audit Procedures**
**W/P Ref. Completed by Date**

- 1 Obtain the 31 December 2009, aged accounts receivable trial balance and
  - a Foot the trial balance and agree total to accounts receivable control account.
  - b Randomly select 30 accounts from the aged trial balance; agree the information per the aged trial balance to the original sales invoice and determine if the invoice was included in the appropriate aging category.
- 2 Confirm accounts receivable using a monetary-unit sampling plan. Set the desired confidence level = 90%, tolerable misstatement = R50,000, and expected misstatement = R20,000.
  - a For all responses with exceptions, follow up on the cause of the error.
  - b For all non-responses, examine subsequent cash receipts and or supporting documents.
  - c Summarize the sampling test results.
  - d Summarize the confirmation results.
- 3 Test sales cut-off by identifying the last shipping advice for the year and examining five large sales for three days before and after year-end.
- 4 Test the reasonableness of the allowance for doubtful accounts by the following:
  - a Test the reasonableness using past percentages on bad debts.
  - b For any large account in the aged trial balance greater than 90 days old, test for subsequent cash receipts.
  - c For the following financial ratios, compare the current year to the trend of the prior three years results and internal budgets:
    - Number of days outstanding in receivable.
    - Ageing of receivables.
    - Write-offs as a percentage of sales.
    - Bad debt expense as a percentage of sales.
- 5 Prepare a memo summarizing the tests, results and conclusions.



a client with branches throughout the country, travel and lodging arrangements also need to be made. See Exhibit 5–1 for an example of planning documentation.

### *Assess the Need for Experts*

A major consideration in planning the audit is the need for experts. Auditing standards (ISA 620) define an **auditor's expert** as an individual or organization possessing expertise in a field other than accounting or auditing, whose work in that field is used by the auditor to assist the auditor in obtaining sufficient appropriate audit evidence. An auditor's expert may be either an internal (partner or staff of the auditor's firm) expert or an external (not employed by the auditor's firm) expert. This would include experts in finance, tax, valuation, pension, and information technology (IT). Such experts may assist the auditor with measuring fair values, valuing financial instruments, determination of physical quantities, amounts derived from specialized techniques, or interpretations of regulations or agreements. The use of an IT expert is a significant aspect of most audit engagements. When deciding whether an IT expert is to be used, a primary concern is the extent to which IT is used in processing accounting information. The presence of complex information technology may require the use of an IT expert.

The auditor is still ultimately responsible for work performed by the expert. In relying on the expert, the auditor should evaluate competence and objectivity of the expert, audit the inputs used by the expert (e.g. census data for actuary) and tie out the output (e.g. estimate should be found in the financial statements or disclosures), and review the expert work for reasonableness, including the reasonableness of assumptions.

## LO 4

## Gathering Audit Evidence

After the auditor has planned the audit the auditor needs to gather sufficient appropriate audit evidence on which to base his/her audit opinion. The auditor gathers evidence by performing audit procedures. These audit procedures consists of test of controls and substantive procedures.

### Test of Controls

Test of controls are performed either to test the system, because the auditor wants to place reliance on the controls (combined approach), or when substantive procedures on its own cannot produce sufficient appropriate audit evidence (e.g. performing an inventory count provides evidence on the existence of inventory). The auditor will only test key controls: key controls are controls which contribute to the reliance the auditor can place on figures in the financial statements. The auditor is, therefore, not interested in testing controls which only contribute to efficient operations or providing good service to customers.

When testing controls, the auditor can perform manual tests and/or use computer-assisted audit techniques (CAATs). These CAATs are referred to as 'system' CAATs. Should the auditor decide to rely on the computer environment when testing internal controls, the auditor should test both general and application controls. Detailed discussions on test of controls can be found in Chapters 12 to 18.

### Substantive Procedures

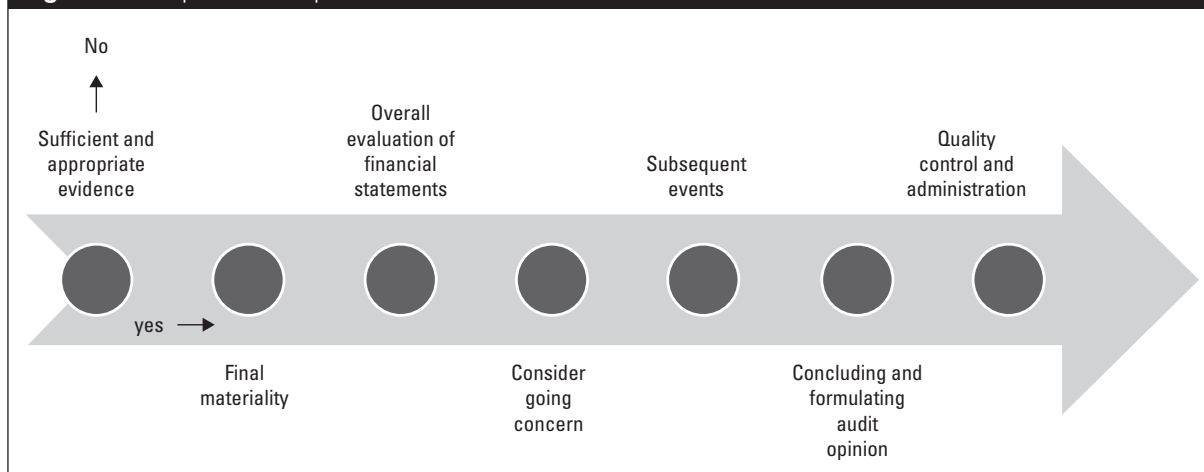
The auditor needs to perform substantive procedures to obtain sufficient and appropriate audit evidence to express an audit opinion. The assertions, either per transaction, balance or disclosure, together with the risks identified during the planning phase guide the auditor in developing substantive procedures.

When performing substantive procedures, the auditor can perform either manual tests and/or use computer-assisted audit techniques (CAATs). These CAATs are referred to as 'data' CAATs. Data CAATs can be used to select samples, stratify information, analyse data, extract reports to identify items that require further investigation and to recalculate totals and calculations. Detailed discussions on substantive procedures can be found in Chapters 12 to 18.

## LO 5

## Completing the Audit

Once the auditor has completed gathering evidence relating to the financial statement assertions the audit enters the completion phase, See figure 5–4 for detail on this. First the sufficiency and appropriateness of the

**Figure 5-4** Steps of the Completion Phase

evidence gathered is evaluated. The preliminary assessments of the risk of material misstatement (as identified during the planning phase) are used to evaluate the sufficiency and appropriateness of the evidence collected (see Fig. 5-4). The auditor shall obtain sufficient appropriate evidence in order to reach and justify a conclusion on the fairness of the financial statements. Should the auditor determine that sufficient appropriate evidence was not obtained, additional substantive procedures need to be performed. Once the auditor is content with the sufficiency and appropriateness of the evidence, the completion phase can continue.

The next stage of this phase is to determine the final materiality figure and to evaluate all misstatements identified. The auditor can either accept the planning materiality figure as the final materiality figure or lower it. However, the auditor should never increase the planning materiality figure during the completion phase. The auditor then aggregates the total identified misstatements and determines if it causes the financial statements to be materially misstated (compare to the final materiality figure).

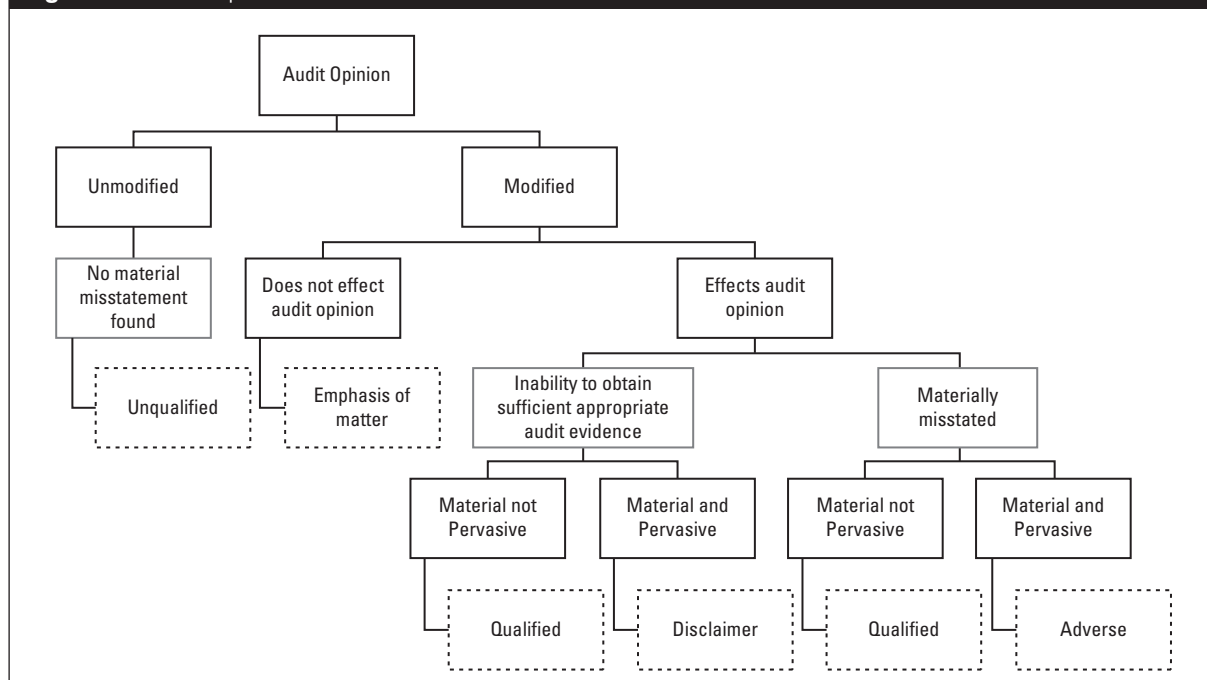
The list of identified misstatements is discussed with the client, and the client is given the opportunity to correct some or all of the identified misstatements should they wish to do so. If the uncorrected misstatements are judged to be material, the auditor issues an opinion that explains that the financial statements are materially misstated. If the uncorrected misstatements do not cause the financial statements to be materially misstated, the auditor may issue a report with an **unqualified opinion**. During the completion phase the auditor also carries out an overall evaluation of the financial statements. This uses analytical procedures as well as the knowledge of the entity obtained throughout the previous phases of the audit. The auditor also needs to assess the appropriateness of preparing the financial statements on a going-concern basis as well as identifying possible subsequent events which have not been correctly disclosed in the financial statements. After performing all these procedures, the auditor needs to make a conclusion and formulate an audit opinion. This phase concludes with performing quality control procedures as required by ISQC1, ISA 220 and the applicable firm's audit methodology (e.g. completing evaluation forms for all team members). Chapter 19 covers each of these issues in detail.

## LO 6

## Reporting

The final phase in the audit process is to evaluate the results of the audit evidence and choose the appropriate audit opinion to issue. The auditor's report is the main product or output of the audit. Just as the report of a building surveyor communicates the surveyor's findings to a prospective buyer, the audit report communicates the auditor's findings to the users of the financial statements.

Figure 5-5 contains the different possible audit opinions. The double-lined blocks provide the different scenarios, while the dotted-line blocks indicate the appropriate audit opinion. The detail of how to decide on an audit opinion and the detail of the audit report are explained in Chapter 20.

**Figure 5-5** Audit Opinions

## Key Terms

**Assertions** Representations by management, explicit or otherwise, that are embodied in the financial statements, as used by the auditor to consider the different types of potential misstatements that may occur.

**Audit evidence** All the information used by the auditor in arriving at the conclusions on which the audit opinion is based, and includes the information contained in the accounting records underlying the financial statements and other information.

**Audit risk** The risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated.

**Auditing** A systematic process of: (1) objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria; and (2) communicating the results to interested users.

**Auditor's expert** An individual or organization possessing expertise in a field other than accounting or auditing.

**Fraud** Intentional misstatements that can be classified as fraudulent financial reporting or

misappropriation of assets.

**Materiality** Misstatements, including omissions, that individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. Judgements about materiality are made in light of surrounding circumstances, and are affected by the size or nature of a misstatement, or a combination of both.

**Misstatement** A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud.

**Non-compliance** This refers to acts of omission or commission by the entity, either intentional or unintentional, which are contrary to the prevailing laws or regulations.

**Professional judgement** The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed

decisions about the courses of action that are appropriate in the circumstances of the audit engagement.

**Reasonable assurance** The concept that an audit done in accordance with auditing standards may fail to detect a material misstatement in a client's financial statements. In an auditing context this term has been defined to mean a high, but not absolute level of assurance.

**Risk of material misstatement** The risk that the financial statements are materially misstated prior to audit. This consists of two components: inherent risk and control risk.

**Unqualified opinion** The opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.



## Review Questions

- 5-1 (LO 1) List the different phases of an audit.
- 5-2 (LO 2-6) Describe the steps the auditor should perform during each phase of the audit, as listed per question 5-1.



## Problem

- 5-3 (LO 1,2) John Josephs, an audit manager for Tip, Acanoe, & Tylerto, was asked to speak at a dinner meeting of the local Small Business Association. The president of the association has suggested that he talk about the various phases of the audit process. John has asked you, his trusted assistant, to prepare an outline for his speech. He suggests that you answer the following:
  - a List and describe the various phases of an audit.
  - b Describe how audit procedures designed for one purpose might provide evidence for other purposes. Give an example.
  - c One of the steps involves understanding an entity's internal control. Why might the members of the association be particularly interested in the work conducted by auditors in this phase of the audit?



## Discussion Case

- 5-4 (LO 1-6) The audit process is depicted as a continuous process.

### Required

*Discuss how evidence obtained in later stages of the audit process can result in the auditor needing to rethink procedures already performed earlier in the audit process.*



## Internet Assignment

- 5-5 (LO 1-6) Use one of the Internet browsers to search for two other explanations (either diagrams or descriptive) of the audit process and critically evaluate it against the process depicted in this chapter.



When you have read this chapter, log on to the Online Learning Centre for *Auditing and Assurance Services* at [www.mcgraw-hill.co.uk/textbooks/crous](http://www.mcgraw-hill.co.uk/textbooks/crous), where you'll find auditing weblinks for each chapter and a glossary in Afrikaans.