Chapter 1
Introduction to Audit

Full chapter infographic: LO 1 to LO 7

1 Origin and advantages of audit

Shareholders
- Owners of the company
- Provide the capital

→ **Directors / management**
- Run the company
- Separation of ownership and management

→ **Conflict**
- F/S show "best view", not "true and fair view"
- Incentives: bonuses
- Pressures: fear of removal

→ **Auditor**
- Independent expert verifies F/S
- Credibility restored

(a) Stewardship
- Directors manage assets on behalf of the owners, responsibly

(b) Agency
- Directors = agents, shareholders = principals
- Act in principals' best interest

(c) Accountability
- Directors prepare annual F/S and present them to shareholders for decisions

Statutory assurance
- Required by law
- Pakistan: annual audit under Companies Act 2017

Non-statutory assurance
- Voluntary, for benefits
- Sole proprietors, partnerships, clubs, societies, NPOs, small companies

Independence
- Independent of directors and management
- Report is objective and unbiased

True and fair view
- F/S present fairly financial position and performance
- Free from material misstatement, comply with framework

Materiality
- Omission or misstatement could affect users' decisions
- Rs.100 petty cash error = immaterial; Rs.200,000 bad receivables = material

5 advantages of audit

1 Credibility
- F/S more reliable

2 Internal controls
- Weaknesses found, improvements recommended

3 Compliance
- Statutory and non-statutory duties

4 Decisions
- Buying or selling businesses

5 Financing
- Banks require audited F/S

2 Parties involved in an audit

Management (and TCWG)
- Prepare and present F/S under AFRF (policies, estimates)
- Design, implement and operate internal controls
- Give auditor all information, additional information and unrestricted access to people

Auditor
- Obtain reasonable assurance F/S are free from material misstatement (error or fraud)
- Report on the F/S (opinion)
- Communicate findings as required by ISAs

Users / shareholders
- Must remove their expectation gap
- Expectation gap = public expects more than the auditor's statutory role

5 common misunderstandings (expectation gap)
- Auditor prepares F/S
- Auditor checks 100% of transactions
- Auditor provides absolute assurance
- Auditor is responsible to prevent and detect fraud
- Auditor gives opinion on internal controls

3 Who is a good auditor?

1 Independence
- Free from bias or influence
- Free from: financial interests, family and personal relationships, employment with client

2 Professional judgment
- Apply knowledge, experience and training to reach conclusions
- Planning: risk assessment, materiality
- Performance: nature, timing, extent; sufficiency of evidence
- Reporting: conclusions

3 Professional skepticism
- Questioning mind; alert to error or fraud; critical assessment of evidence
- Apply even if management was honest before
- Investigate if evidence contradicts, reliability is doubtful, or fraud is indicated

Why skepticism matters
- Auditor does not overlook unusual circumstances
- Does not over-generalise
- Does not use inappropriate assumptions

4 Process of preparing financial statements

Stage 1: Transactions
- Selling goods, buying raw material, paying salaries

→ **Stage 2: Internal control**
- Rules and checks recording transactions in journal, ledger, trial balance
- Strong control = fewer errors and frauds

→ **Stage 3: Prepare F/S**
- Select AFRF (IFRS, US GAAP, law)
- Balance Sheet, Income Statement, Cash Flow, Changes in Equity, Notes

5 Process / phases of audit

Risk assessment procedures
- Understand entity and its internal control
- Assess risk of material misstatement
- Inquiry, observation, inspection, analytical procedures

→ **Tests of controls**
- Confirm operating effectiveness of internal control (prevent, detect, correct)

→ **Substantive procedures**
- Detect material misstatements at assertion level
- Analytical procedures and tests of details

6 Evidence and procedures

SUFFICIENT = quantity
- Risk of misstatement: higher = more evidence
- Materiality and complexity
- Auditor's knowledge and experience
- Quality of evidence
- Strength of internal controls: stronger = less substantive evidence

APPROPRIATE = quality: relevance
- Logical connection with the assertion tested
- Occurrence (overstatement): records to documents
- Completeness (understatement): documents to records
- Inspecting assets proves Existence, not Rights and Obligations

APPROPRIATE = quality: reliability
- Original over copies
- Documentary over oral
- External over internal
- Effective controls
- Direct over indirect

7 audit procedures

1 Inquiry
- Of a person; alone is not enough

2 Observation
- Of a procedure; limited to time observed

3 Inspection
- Of an item: records, documents, tangible asset

4 External confirmation
- Written, directly from third party

5 Recalculation
- Maths accuracy of records

6 Reperformance
- Redo the entity's control or procedure

7 Analytical procedures
- Comparisons and plausible relationships

7 IFEA and IAASB

IFEA
- Non-profit; supports high-quality standards in ethics, auditing and assurance

→ **IAASB**
- Develops ISAs, promotes adoption, improves quality, strengthens public confidence

→ **IESBA**
- Ethics standards board for accountants

Standards issued by IAASB

ISAs
- Audits of historical F/S

ISREs
- Reviews of historical F/S

ISAEs
- Assurance other than audit or review

ISRSs
- Compilation, agreed-upon procedures

ISQMs
- Quality management for all services

IAPSs
- Practice statements; guidance only

New ISA: 1
- Subject selected for study

→ **2**
- Research, then exposure draft

→ **3**
- IAASB approves and circulates for comment

→ **4**
- Comments reviewed

→ **5**
- Final draft, ISA published

ISA contents
- Introduction, objectives and definitions
- Requirements (must follow)
- Application and explanatory material

Authority
- Follow ALL requirements of ALL ISAs for reasonable assurance
- IAPSs guide only; not same authority