European Federation of Accountants

OCTOBER 2007

Selected Issues Relating to Financial Statement Audits – Abridged Version

Introduction

Under national laws implementing the European Union (EU) Fourth and Seventh Directives, relevant entities are required to prepare financial statements which comply with the requirements of the Directives and, in the case of the consolidated financial statements of listed entities, with International Financial Reporting Standards (IFRSs) as adopted by the European Union ('IFRS'). For all entities that are larger than the EU small company limits and which are not dormant, the Directives require an opinion by an independent auditor as to whether the financial statements comply with those requirements and give a true and fair view.

The recent Statutory Audit Directive requires that the European Commission (EC) moves towards the adoption of International Standards on Auditing (ISAs). Following discussions with the European Commission Services, FEE has decided that it would be helpful to prepare a paper explaining some key issues relating to the ISAs:

- The meaning of the phrase "inherent limitations of an audit";
- Whether the application of professional judgement is one of these inherent limitations? Or is it a strength of the audit process?
- Does the application of professional judgement prevent effective regulation of audits?

The full paper on 'Selected Issues Relating to Financial Statement Audits' is available from http://www.fee.be/publications/default.asp?library_ref=4. This high-level abridged version sets out to highlight the key points in the full paper for the benefit of the non-technical reader. Readers may wish to refer to the full paper to follow the complete technical arguments including detailed references to supporting technical literature. This abridged version considers only financial statements prepared in accordance with financial reporting frameworks aimed at giving a true and fair view, including IFRS and European member state national frameworks, and the opinion of the auditors as to whether the financial statements give a true and fair view in accordance with such frameworks.

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Inherent limitations of an audit

Some users of financial statements have questioned why auditors cannot express an absolute conclusion (i.e. certify a statement of fact), rather than an opinion that the financial statements give a true and fair view. Auditors have traditionally expressed an opinion, based on 'reasonable assurance' because the audit process is subject to inherent limitations that prevent absolute assurance.

Indeed, the very nature of financial statements themselves mean that management does not assert that the financial statements are absolutely correct either. There are two reasons for this: firstly, accounts involve judgements and estimates made by management in areas where absolute information is not available (for example, the future selling price of an office occupied by the entity, and hence whether it may be impaired, will not be known until it is sold). Secondly, there are many possible ways in which an entity could choose to report its accounts; the choice of an accounting framework and then the options and policy choices available within that framework means that no set of financial statements can be a mathematical collection of undisputable facts. Therefore, many of the areas described as 'inherent limitations of an audit' are in fact 'inherent limitations of financial reporting'.

Sources of inherent limitation

Some of the sources of limitations inherent to an audit are outside the control or influence of the auditor and are therefore inherent to the audit process. These are matters that prevent an auditor from achieving absolute assurance, even given unlimited time and resources, and include:

- The applicable financial reporting requirements;
- The circumstances of the company;
- The available audit evidence;
- The powers of the auditor to obtain evidence;
- The limitations of internal control systems; and
- Other environmental factors.

As outlined above, some of these limitations are in fact limitations of the financial reporting process; these would be present even if no audits were required. For example, both the Fourth Directive and IFRS require that, except for certain specialised assets, inventory is held at the lower of cost and net realisable value. Unless the auditor delays signing his opinion until all of the year-end inventory is sold and there is no prospect of it being returned, the auditor cannot have perfect knowledge of the price at which it will be sold. Given that all statutory financial reporting regimes impose deadlines for filing financial information (and the statutory audits thereon), this is an inherent limitation of the financial reporting process and, consequently, of the audit.

Other limitations inherent to an audit are those over which the auditor has some influence or control which are, broadly speaking, constraints on the conduct of the audit. They may include economic limitations ("how much audit do we as a society want to pay for?") or constraints on timing ("shareholders want the financial statements soon after the year end so that the information is useful to them"). For example, where an auditor chooses to test a population by statistical methods, he needs to determine an appropriate sample size. The larger the sample size, the greater the level of confidence in the conclusions drawn from the results of testing. However, as any statistician will explain, the marginal increase in confidence achieved by testing more items decreases with each additional item tested. In common with all regulatory processes, at some point the cost outweighs the benefit – and by the time the additional testing is completed, more time will have elapsed since the year end and the greater the chance that the snapshot view of the company at that date will have been overtaken by events and is therefore of less use to the shareholders.

Value-added of an audit

It is possible that, in considering the inherent limitations of an audit, the reader may believe that these limit the value of an audit. Whilst they may affect the perceived value of an audit the actual value of audit results from a complex range of factors, some of which are impossible to quantify. For example, one key benefit is that, knowing that their organisation is to be audited, individuals responsible for preparing and presenting the financial statements may be deterred from both fraud and error, including taking steps to implement systems which generate

reliable raw data. In this regard, the use of professional judgement is a benefit as it means that the audit is not entirely predictable. This prevents the planning of a fraud in such a way as the perpetrators can be sure that the auditors will not choose to look at the relevant transactions. It also means that those responsible for financial systems wish to produce the right answer for each and every transaction and balance as again they cannot be sure where the auditors' testing will probe each year.

Academic studies have also shown that the existence of audited financial statements results in a lower cost of capital for entities; even for those smaller entities where an audit is optional as a matter of law, access to capital from banks for smaller entities is often dependent on audited financial statements.

Limitations outside the control or influence of the auditor

The applicable financial reporting requirements, the circumstances of the company, and available audit evidence

The financial reporting requirements (i.e. the set of principles and rules used by companies in preparing their financial statements) are established by accounting standard setters and by law; whether this is the International Accounting Standards Board (IASB) and the comitology process set out in EU law (for IFRSs as adopted for use in the EU) or member state governments or standard setters (for accounts prepared in accordance with the Directives). Except in the rare circumstances when it is appropriate to use a true and fair override, or include additional disclosure in order to achieve a true and fair view, the requirements of the framework are beyond the control of the preparer and auditor.

Both IFRS and EU member state frameworks require extensive judgement for its proper application. This may be because, for example, it requires a future event to be estimated (as in a provision for the costs of an unsettled dispute), or it requires an asset or liability to be valued at the balance sheet date although there may be no transaction by reference to which that value may be definitively established. Judgement is also required for its interpretation: for example, have the conditions for recognition of a liability been met, or into which category of assets does a particular item fall?

Furthermore, the circumstances of the company to which the financial reporting requirements are applied differ in complexity or clarity which is not always directly linked to the size of the company. For example, in a food retailer, the analysis of revenue recognition is often very simple – goods are checked out through the till and when they are, they have generally been sold. By contrast, in the automotive industry, stocks are often held on consignment subject to "sale or return" and judgement is required in the analysis of the legal and economic risks and rewards of ownership of a car in the dealer's showroom to decide if it has been sold to the dealer yet and the manufacturer should record the revenue or whether it remains the manufacturer's property.

The answers to such questions determine what is included in the financial statements, how, and at what amount. About each such judgement, views may differ between different users of the financial statements. Accordingly, when auditors form opinions as to whether the financial statements comply with a financial reporting framework their job is to decide whether there is a range of acceptable interpretations or judgements that may be made, or only one, and whether the preparer's interpretation or judgement is one of those acceptable. The fact that different interpretations are possible is one of the strengths of a principles-based set of standards which means that the standards do not seek to anticipate and answer every question with a detailed rule. To do so would entail creating a set of rules which would be unduly large and inflexible when new circumstances arise.

As indicated in the introduction to this paper, even simple concepts such as the value of inventory can have inherent limitations arising from the fact that, without perfect hindsight, no-one could absolutely confirm the valuation. And this is not a new issue, nor a criticism of the financial reporting frameworks used in Europe – valuation of inventory in this way has been a requirement of member state accounting requirements since long before this principle was embedded into the first version of the Fourth Directive.

Due to the nature of financial reporting requirements, circumstances of the company and the audit evidence available in relation to these,

auditors are not able to obtain a high uniform level of assurance just below absolute assurance for every financial statement item. This means that the degree of comfort (reasonable assurance) that auditors obtain from the evidence for different financial statement items varies. For example, the evidence supporting (and hence the assurance obtained for) the valuation of a complex financial instrument at fair market value for which there is no active market would be less than that for a simple financial instrument for which there are deep active markets.

The powers of the auditor to obtain evidence

The powers of the auditor to obtain evidence may be established in law or regulations, or by agreement with the entity's management as a condition of accepting the engagement. Even in those jurisdictions that do grant some authority to auditors' enquiries, any powers are likely to fall well short of police powers of seizure of documents or powers to compel third parties to respond to auditors' questions. The auditor can therefore only rely on the production of information by the company and its management to the extent they are obliged to do so by law, and by third parties where the auditor considers that evidence from such parties is necessary. Where the company's management has a legal duty to provide information to the auditor, the effectiveness of this will depend on management's complying with that duty and on the auditor's correctly identifying evidence that is likely to be available and asking for it. Even where the law compels management to provide relevant audit information, the auditor is still dependent on management deciding whether a particular fact is relevant to the audit of the financial statements.

These are important constraints to be borne in mind when considering the emphasis often given to the failure of an auditor to identify management fraud. Although the auditor will be sceptical about the information being presented, and where the evidence appears inconsistent or raises further questions they will apply additional procedures, ultimately there are clear barriers to obtaining information that management does not wish to supply. This is particularly true if the auditor has no reason to believe that the information exists or where collusion between management and, in some cases third parties, actively seeks to conceal evidence. However, if auditors do not believe they have the information they need, or that information is being actively concealed, they will qualify their report or issue a disclaimer of opinion.

The limitations of internal control systems

In many cases, it is necessary for the auditor to rely on an entity's internal control for some of the evidence about the financial statements. Sometimes this is on the grounds that to do so is more efficient; in other cases it is where the alternative of testing substantively the details of transactions and balances may not result in enough evidence, no matter how much such testing is done. An entity may obtain supplies from all manner of third parties, including ones with whom relations are occasional or unique. Unless the entity's systems are sufficient to capture all such relationships, there may be no way in which the auditor can be confident that the financial consequences are properly reflected in the financial statements. The auditor may have to rely on internal control for this purpose, having obtained evidence about its effectiveness in this respect.

It is well established that effective internal control is designed to give the entity's management reasonable assurance about the matters controlled. It follows that the auditor can obtain no more from such a system, even if effective. This is acknowledged as an inherent limitation of an audit even in the USA, where a separate auditor's opinion is given on the effectiveness of internal control. An assessment of internal control therefore forms a key part of the auditors' assessment of the risk of misstatement and drives their judgement as to the mix of evidence they seek to obtain from tests of internal control and tests of transactions and balances themselves.

Other environmental factors

An audit is a service, required or requested as the case may be. It must therefore be provided within a timescale and a cost that are useful to those requiring it. The timeliness and cost of financial information are recognised by IASB and European national accounting standard setters as legitimate factors to be weighed in considering the relevance and reliability of financial statements. In the case of statutory audit,

timescales for the delivery of audited financial statements to shareholders and regulatory authorities are usually specified in legislation; in practice, the rules of listing authorities and the demands of the market often require financial statements to be made available long before statutory limits have expired. These factors clearly restrict the time that an auditor may devote to an audit, and the time at which the audit must be conducted, and therefore the nature and amount of audit evidence an auditor can obtain.

Limitations over which the auditor may have some control or influence

The limitations over which the auditor may have some control or influence are essentially constraints of resource, or cost and benefit or timing (to some extent): they are economic constraints, flowing from the other environmental factors referred to above.

Thus the auditor has to determine the effort to be put into the conduct of the audit itself. However the auditor must also deliver an audit opinion that meets the reasonable expectations of society, which include that it be delivered at a reasonable cost and within a reasonable time. This leads to the following accepted audit practices, as also allowed for in ISAs (and other auditing standards):

- The acceptance of documents as genuine, unless there are indications to the contrary;
- The use of audit testing, including sampling under which inferences are made about populations on the basis of tests of samples;
- The direction of audit effort to areas expected to be most likely to contain errors or fraud, with correspondingly less effort directed at other areas; and
- Reliance on internal control, bearing in mind that no system of internal control can be 100% reliable, to reduce the need to examine everything using substantive procedures.

Furthermore, European national financial reporting requirements and IFRS recognise the concept of materiality – that is, there are certain matters that do or do not concern users, and there are variations in reported amounts that do not concern them. In general, materiality is defined by reference to the decision making needs of users as a class, and it is well understood that the concept of the true and fair view allows for the fact that variations within the bounds of what is material are acceptable, as they do not affect the decisions of users in general. Accordingly, an auditor is not required to detect immaterial misstatements. Therefore, to conduct an efficient audit, the auditor is concerned with detecting misstatements in the financial statements that are material, and is not required to plan the audit to detect immaterial misstatements.

The relationship between the inherent limitations of an audit, ISAs and professional judgement

As indicated above, the auditor is required to express an opinion on whether the financial statements give a true and fair view in accordance with the applicable financial reporting framework. In principle, subject to necessary departures to achieve that true and fair view, the financial statements will give such a view when they comply in all material respects with that framework and hence are free from material misstatement. Given that the auditor's aim is to form an opinion as to whether this is the case, he needs evidence that is both appropriate (i.e. relevant and reliable) and sufficient.

Because of the inherent limitations of an audit, the auditor can never obtain, or be sure of obtaining, so much relevant and reliable evidence as to be certain that the financial statements are free of material misstatement. Instead, the auditor seeks to reduce the risk that the financial statements, after audit, will contain a material misstatement (the 'audit risk') to an acceptably low level. At that point the auditor has obtained sufficient appropriate audit evidence, and has obtained reasonable assurance.

Within this explanation there are a number of related factors:

- Materiality;
- Sufficient appropriate audit evidence;
- Audit risk at an acceptably low level; and
- Reasonable assurance.

These concepts are inter-related. Whilst items may be qualitatively

material, in purely quantitative terms the greater the level of materiality, the larger the misstatement that an auditor could tolerate before qualifying his opinion and hence the smaller the amount of evidence he would need in order to obtain reasonable assurance that the financial statements give a true and fair view.

Deciding what is material is one of the key planning judgements of the auditor. Using professional judgement, knowledge of financial reporting requirements and the entity and knowledge of the users of the financial statements, the auditor determines both:

- What is quantitatively material – which may differ for different balances and transactions. For example, auditors and users of financial statements would normally expect cash at bank to be well controlled and also capable of firm measurement and therefore the level of expected error would be low, whereas for a provision for future pension obligations which depends on future mortality of the workforce, interest rates and investment performance over many years, there is a greater degree of uncertainty and hence estimation and in this case the auditor's task is to consider whether the estimate is within an acceptable range rather than being a specific amount; and
- What is qualitatively material. For example, auditors may determine that, whilst directors' pay is often very small compared to total revenue, it is a matter of great interest to users of the financial statements and where very low levels of misstatement would be acceptable.

Having determined what is material for the purposes of planning the audit, the auditor is required by ISAs to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level. At that point, reasonable assurance is obtained. It should be noted that, due to the cost-benefit and timing constraints over which the auditor exercises influence, sufficient appropriate audit evidence is always less than all of the evidence the auditor could have obtained, and therefore reasonable assurance is always less than the assurance that the auditor could have obtained in the absence of such constraints.

These three concepts – sufficient, appropriate audit evidence; an acceptably low level of audit risk; and reasonable assurance – are inextricably linked in that each defines the other two. The relevance of professional judgement is implicit in the term 'reasonable assurance'. Those words indicate that the level of assurance is not a certainty; nor, as noted above, is it all the evidence which could be obtained as (a) no stakeholders are willing to bear an unreasonable cost for an audit and (b) auditors do not seek evidence which would provide evidence about matters which could cause a misstatement that is at most immaterial. For the reasons explained above, they also indicate that the fundamental test is one of 'reasonableness'. This being a matter of professional judgement, it is ultimately determined – subject perhaps to the courts overruling professional opinion, in extreme cases – by a test of what informed professional opinion would regard as being reasonable in the circumstances.

For these reasons, FEE believes that references to the term "high" in relation to definitions of "reasonable assurance" need to clarify that "high" does not mean that auditors obtain a uniform high level of assurance just below absolute assurance, because this would exacerbate the expectations gap – that is, lead to unreasonable expectations by users of auditors' reports. Rather, when achieving reasonable assurance, auditors obtain a high level of assurance relative to that obtainable.

Does the application of professional judgement prevent effective regulation of audits?

Professional judgement is not unchallengeable. It may be subject to a range of views of what is acceptable, but there are undoubtedly judgements that a sufficient number of informed professionals including auditors, preparers and users of financial statements, consider unacceptable. To generate a reasonable amount of consistency of judgement amongst auditors, professional bodies require auditors to meet academic requirements, follow a course of professional study tested by examination, to serve a period of practical training within a professional firm and, importantly, to continue with professional development throughout their working lives. ISAs reinforce the importance and consistency of professional judgement by requiring: auditors to be satisfied about the competence and experience of their engagement teams; the work of less experienced members of the team to be supervised and reviewed; important judgements to be taken by appropriately senior members of the team; and consultation on important matters of judgement. In part, these are

specific applications of the separate standard on quality control for professional firms of accountants, International Standard on Quality Control 1.

It will be seen, then, that ISAs do not determine these important matters of judgement, and in particular what constitutes reasonable assurance in any particular case. What ISAs do is to put constraints on the exercise of professional judgement by setting the parameters within which professional judgement is exercised – meaning that there are many things an auditor must do before they exercise their judgement as to what more is required. These constraints may vary from the very general (for example, the requirement to obtain sufficient appropriate audit evidence) to the specific (for example, the requirement to obtain written representations from management to confirm certain specified matters).

The auditor's professional judgement is in fact a positive influence in addressing the inherent limitations of an audit. This is reflected in debate about the relative merits of principles and rules. It is generally accepted that principles are important, and that principles-based standards are necessary. There have been many examples of corporate failure where rule-based accounting standards have been blamed for permitting a legalistic application which does not reflect the underlying substance of a transaction. Similarly, whilst applying purely rule-based auditing standards might make regulation and enforcement easier, it would not allow for situations where a professional might decide, given the nature of what is audited, that he needs to look for further evidence.

This does not mean that there should be no debate about the level of detail in which auditors should be required by standards to do specific things. In general, the more that level of detail is specified, the less scope the auditor has to exercise professional judgement and the more the auditor's freedom of action is circumscribed. This could have serious consequences for both the efficiency of auditing (for example, having a set formula to determine sample sizes for testing) and effectiveness (not allowing the auditor to choose to do more work in an area where they feel they need to challenge further). It would also run a serious risk of reducing the audit to a compliance exercise, in which the auditor is more concerned to ensure that rules-based standards are followed, than that the objective of the audit is achieved – and if reduced ultimately to following a fixed set of rules would run the risk that preparers of financial statements could plan frauds in a way that they knew that the rules could never detect. The standards, which in future will specify high-level objectives, seek to achieve an appropriate balance and, as indicated above, are developed only after comments from auditors, preparers, regulators, governments and investors. What they can never do, even if they were dangerously over-specified, is to remove entirely the need to exercise professional judgement in their application.

Regulation of auditor's professional judgement

The regulation of areas of professional judgement is not unique to auditing. Many laws require individuals to make "reasonable" efforts to achieve an outcome. For example, what precautions might be appropriate for a government to take to prevent road accidents is a matter of judgement. No-one would argue that an absolute standard is desirable or even achievable (short of banning the motor car!). Yet courts under both common and civil law jurisdictions are able to enforce such laws.

There are various key considerations in the enforceability of standards that involve professional judgement:

- Documentation of the factors and evidence considered in exercising significant professional judgement for significant matters is vital. First, the act of recording such judgements provides a test of their appropriateness: nothing provides a better test of reasoning than writing it out. Secondly, it provides transparency of those judgements to those who have reason to review them, whether this is the auditor's firm's quality control processes, external monitoring agencies or other bodies. Their review in turn requires professional judgement for a proper assessment of the quality and appropriateness of the judgements. By recording the factors considered and the rationale for the conclusion, professional judgement is not a "black box" labelled "trust me, I'm an auditor" but rather a reasoned statement which others in the financial reporting supply chain can understand and where considered necessary, challenge. The matters to be recorded are set out in ISAs and in particular ISA 230 (Revised) on Audit Documentation.
- Standards do not permit the unfettered application of professional

judgement. The fact that ISAs are developed under due process, including in particular an open consultation process, is intended to ensure, amongst other things, that the standards reflect as a minimum the accepted views of informed professional opinion as well as reflecting the findings of audit regulators and other interested stakeholders. Indeed, the International Auditing and Assurance Standards Board applies thorough consultative processes with observers from key regulatory bodies and comments from a Consultative Advisory Group which includes regulators and investors.

- The application of professional judgement by an auditor is the subject of both internal and external quality control processes. In areas of difficult judgement, such as where there is a disagreement between the auditor and management about the application of an accounting standard, the auditor may consult with experts to confirm their judgement. Auditors will also document the application of their professional judgement and support the factors considered by them with evidence in the knowledge that they will be the subject of both internal and external quality control procedures. These quality control procedures will call on an auditor to explain not just what his judgement was but how he or she came to that judgement. The application of these quality control procedures are also required to be documented by ISAs and are therefore capable of being challenged subsequently by a regulator with necessary knowledge, training and experience in accounting and audit.
- Because audits are designed to address risks of material misstatements in the financial statements, the structure of audits and their process is largely driven by the items that are, or should be, in the financial statements. Consequently, auditing standards cannot be used as a simple "checklist" by audit regulators to determine whether in the particular circumstances audits were properly done. Rather, enforcement of audits would need to be directed towards the audit process relevant to the audited entity in light of the full requirements of auditing standards.

Conclusion

The assurance obtainable by auditors to support their opinions is subject to inherent limitations that prevent certainty and, because shareholders will not wait indefinitely for the audit report, nor pay an exorbitant amount for it, that limit the level of assurance that would be achievable with unlimited time and resources. Auditors are required by ISAs to obtain reasonable assurance as the basis for their opinions. Such assurance cannot be specified in any quantitative sense by standards, but is a matter of professional judgement. While the inherent limitations of an audit provide limits to that assurance, ISAs set out requirements designed to support the auditor's professional judgement, conduct and recording of the audit. These requirements promote sound, consistent judgements the basis for which are recorded in audit documentation. The purpose of such documentation is to contribute to high quality audits, and in particular the extent of compliance with standards and the validity of judgements in a way that is demonstrable to others, including regulatory authorities.

Professional judgement is one of the strengths of the audit process as it allows the auditor to tailor their approach to the entity being audited. It is not a "black box" incapable of challenge by regulators. Rather, it is governed by reference to what informed professional opinion would regard as being reasonable in the circumstances which can be challenged, and cannot be advanced to support positions that other professionals would regard as unreasonable. Accordingly, audit quality can be measured against ISAs and hence effectively regulated by individuals with the required knowledge, training and experience in accounting and auditing.