CHAPTER 2: THE FINANCIAL AUDIT

Chapter 2: Overview

In this chapter the researcher will investigate the nature and characteristics of the financial audit. This is done in view of the problem statement (cf. Chapter 1, paragraph 2.2) that was developed upon reading the article by Robertson (1994:34-36) and the questions raised by him (cf. Chapter 1, paragraph 2.1). Financial auditing will be discussed from an international perspective and specific reference will be made to the South African situation. The purpose of this chapter is to provide the reader with an overview of the process of auditing as it is applied in the financial environment and to provide an overview of the different types of financial audits. The characteristics of these audits will be investigated in Chapter 6 in terms of their applicability when designing an information audit methodology.

1. Introduction

Audits are conducted in many different forms in organisations today. The purpose of auditing is to discover, check, verify and control some or other aspect in an organisation. It can therefore be said that one of the main characteristics of an audit is that it is diagnostic. In correlation with this, Ellis et al (1993:146) state that an audit is similar to an annual physical examination. It is used to identify and/or highlight functions and/or areas of dysfunction. According to Robertson (1994:34) an audit is also synonymous with the process of compliance.

2. Definitions of key terms

The following are definitions of key terms used within the environment of financial auditing. More specific definitions will also be included in the discussion in the rest of this chapter.

The Webster's seventh new collegiate dictionary (1976:58) defines an *audit* as: "1a: a formal or official examination and verification of an account book; 1b: a methodical examination and review; 2: the final report of an examination of books of account by auditors".

The same source (Webster's, 1976:58) defines the verb to *audit* as follows: "to examine with intent to verify".

Auditing is defined as: "... the independent examination of financial information of any entity, whether profit-oriented or not, and irrespective of its size, or legal form, when such an examination is conducted with a view to expressing an opinion thereon..." (The principles and practice of auditing, 1992:44).

An *auditor* can be defined as a person who is "authorized to examine and verify accounts" (Webster's, 1976:58).

The Webster's seventh new collegiate dictionary (1976:6) defines an *account* as "a record of debit and credit entries chronologically posted to a ledger page to cover transactions involving a particular time or a particular person or concern" (Webster's, 1976:6).

3. Auditing: A historical overview

3.1 The history and origins of auditing

Evidence of accounting can be traced back to the earliest civilisations, where it was originally done orally. The term "auditor" was derived from the Latin *audire*, to hear. At first the auditor was the master who *listened* to his steward recite (from memory) the disposal and possession of the master's goods and chattels over a specific period of time. Within this context the term auditor acquired a secondary meaning, i.e. "one who satisfies himself as to the truth of the accounting of another" (The principles and practice of auditing, 1992:2). In layman's terms the process of auditing is described as the checking of accounts.

With the development of writing, people started keeping written records of the types of transactions referred to above. This process was called "bookkeeping" (The principles and practice of auditing, 1992:2).

Evidence of complex auditing has been found in ancient Egypt and Babylonia, as well as in the early Greek and Roman civilisations. The principles of Greek and Roman accounting and auditing formed the basis for a statute passed in England in 1285, under the reign of Edward I. The statute stated that auditors must be appointed to check the accounts of the "Masters" and if they were found to be in "arrearages upon the account", they were to be arrested (based on the auditor's testimony) and jailed (The principles and practice of auditing, 1992:2).

During the fifteenth century an increase in trade in Italy and Europe resulted in a number of bookkeeping problems and complexities. The Italian, Frater Luca Pacioli offered a solution, when he developed the double-entry system. He wrote a treatise on this subject in 1494. Subsequently, the first society of accountants was founded in Venice, Italy, in 1581 (The principles and practice of auditing, 1992:3).

During the Industrial Revolution a number of joint stock companies were formed. It was expected of the various businesses to account clearly and honestly to its shareholders (owners). Accountants were appointed to act as agents for the shareholders. This in turn resulted in the profession of accounting and auditing as it exists today (The principles and practice of auditing, 1992:4).

The term "chartered accountant" was used for the first time after the first British society of accountants, incorporated by royal charter, was formed in Edinburgh in 1854.

The International Federation of Accountants (IFAC), an international organization for the accountancy profession, was founded in 1977 with the purpose of creating "a stronger, more unified accountancy profession". By 1996 the IFAC consisted of 119 professional accountancy bodies from 86 countries. These include accountants from industry, commerce, the public sector, education as well as those in private practice (IFAC, 1996a). The mission of IFAC "is the development and enhancement of the profession to enable it to provide services of consistently high quality in the public interest" (IFAC, 1996d).

These international developments resulted in various national developments where organisations were formed for accountants. These are not relevant to this dissertation and therefore will not be discussed.

4. The nature and objectives of an audit

4.1 The nature of auditing

Auditing is only one of the activities of a professional accountant. Over the years the term has developed a more generic meaning with the application of the auditing process to other areas of financial and business activities. The researcher has also determined a trend whereby the process of auditing is applied within the information environment (refer to Chapter 3 for a discussion of communication, knowledge and intelligence audits; see Chapters 4 and 5 for a more detailed discussion of the information audit).

Currently the following branches of auditing can be distinguished:

- Independent/external/financial auditing
- Internal auditing
- Governmental auditing
- Operational auditing
- Management auditing
- Comprehensive auditing

In different countries, different national prerequisites apply to who is allowed to perform these different types of audits. For example: in South Africa independent audits may only be performed by auditors registered in terms of the Public Accountants' and Auditor's Act. In order to perform any of the other types of audits listed above, a person does not need a specific statutory qualification and the independence and responsibilities of the auditor also differ from those of an independent auditor (The principles and practice of auditing, 1992:44).

The main focus of this dissertation is on the independent (or external) audit, but the following part of the discussion will briefly focus on the other types of audits listed above.

4.1.1 Independent/external/financial auditing

The financial audit is also referred to as an external or independent audit. A very basic definition for the financial audit states that it is an "audit of financial statements". The main objective of a financial audit is to determine whether the financial statements (including the balance sheet, income statement and cash flow statement) of an organisation provide a fair representation of the operations and financial condition of the organisation (Flesher, 1996:240-241).

4.1.2 Internal auditing

The internal audit has the same objective as the financial audit, but differs from the latter in the sense that it usually evaluates a more specific/limited aspect in an organisation, e.g. "departmental or segment financial reports". The focus is mainly on operational auditing (Flesher, 1996:241). This means that an "internal" auditor must determine whether management controls the company in a responsible manner, by:

- evaluating all internal systems and procedures;
- determining whether internal control policies and procedures are being adhered to;
- ensuring that the assets of the company were protected, and
- performing special investigations, as needed (The principles and practice of auditing, 1992:44).

More specifically an internal audit can include one or more of the following audit assignments:

- the purchasing function
- application systems
- ethics and fraud auditing
- internal auditing and total quality management
- environmental and social responsibility auditing (Flesher, 1996:xii-xiv).

The responsibilities of the internal auditor correspond with the main objectives of an internal audit, i.e.:

- reliability and integrity of information;
- compliance with policies, plans, procedures, laws, and regulations;
- safeguarding of assets;
- economical and efficient use of resources; and/or
- accomplishment of established objectives and goals for operations and programs (Flesher, 1996:657).

No two internal audit assignments are performed exactly the same way, i.e. no "routine" internal audit assignment exists. Every assignment and its objectives are unique.

Examples of more common internal audit assignments include:

- Financial audits
- Operational audits
- Performance audits
- EDP (information systems) audits
- Contract audits
- Compliance audits
- Special investigations (e.g. fraud)
- International audits (Flesher, 1996:240).

o Internal vs. external auditing

The responsibilities of the internal auditor are more comprehensive than the typical responsibilities of the external (financial) auditor. The latter usually performs mainly financial audits, as opposed to the internal auditor who performs different types of audits, including financial audits. Table 2-1 (below) compares the typical responsibilities of the external auditor with those of the internal auditor:

TABLE 2-1: Typical responsibilities of auditors

External auditor	Internal auditor
Responsibility: attest as to fairness of financial statements.	Responsibility: to aid the organisation in the effective discharge of its objectives.
Information mainly for stockholders.	Information mainly for management.
Direction of audit is looking back.	Direction of audit is looking forward.

(Flesher, 1996: 241)

4.1.3 Governmental auditing

The purpose of governmental auditing is to check the financial statements of the various authorities in the public sector that derive their income from direct and indirect taxes. In South Africa the Auditor-General is responsible for checking the revenue and expenditure of the various authorities. Auditing functions are usually delegated to practising chartered accountants. The auditor reports his findings to the local authority and supplies the Auditor-General with a copy of the report. The Auditor-General is responsible for auditing government finances and reports his findings to Parliament (The principles and practice of auditing, 1992:45).

4.1.4 Operational auditing

The operational audit is regarded as a "nonfinancial" audit, when contrasted to the financial audit. Operational auditing involves the auditing function being applied to an operational function, rather than a financial area (The principles and practice of auditing, 1992:45). Flesher (1996:242) defines the operational audit as "... an organized search for efficiency- and effectiveness-related problems ... [within] an entity or one of its subdivisions." The distinctions between operational and financial audits are increasingly regarded as merely academic and the two types of audits are often combined in practice. The Institute of Internal Auditors (IIA) also regards these two fields as interrelated in the field of internal auditing.

Another definition of the operational audit states that the main objective is to evaluate "efficiency and effectiveness of operations and operating procedures." When an operational audit is performed, operating problems are discovered and reported to management, who in turn uses the information to solve problems and to recommend appropriate plans of action. It is therefore clear that the auditor "... is more concerned with the *who, what, when, where, why, and how* of running an efficient and profitable business than just the accounting and financial aspects of business functions" (own italicisation). In summary, it is said that operational auditing focuses on the three E's: efficiency, effectiveness and economy (Flesher, 1996:242-243).

The researcher will include a few remarks on operational audit methodology: The first (preliminary) phase of the operational audit is to have an orientation meeting with the management of the organisation during which the scope and reason for/purpose of the audit is discussed and explained. Table 2-2 (below) provides an overview of the basic steps that make up a typical operational audit methodology:

TABLE 2-2: Overall approach to an operational audit

1. Seek out and identify the organization's objectives.
2. Determine the pertinent facts and conditions.
    a. Conduct a physical tour.
    b. Obtain internal forms and documents.
    c. Interview departmental employees.
    d. Prepare financial analyses.
3. Define problem areas or opportunities for improvement.
4. Present findings to management.

(Flesher, 1996:245).

The term management audit is a synonym for operational audit, with the latter being the predominantly used term (Flesher, 1996:48).

o External vs. operational auditing

The financial audit can also be compared to the operational audit in terms of scope. The financial audit usually reviews the financial statements of an organisation and focuses on internal controls within the organisation. In contrast to this, the operational audit reviews organisational objectives, the operating environment of the organisation, its operating policies, as well as the personnel and physical facilities of the organisation. Both types of audits review the various aspects against standards. When performing an operational audit, evaluation can be done in terms of standards of the organisation (e.g. goals and objectives) or standards of industry. These are not necessarily objective standards but in view of the nature of an operational audit (which is used to identify areas where efficiency and effectiveness can be improved), objective standards are not necessary (Flesher, 1996:243).

4.1.5 Management auditing

The purpose of a management audit is to evaluate how effectively the management systems of a firm operate and to spell out the risk(s) if they are not. Management audits are mandatory in the United States, according to the House Bill 1256 (The principles and practice of auditing, 1992:45).

4.1.6 Comprehensive auditing

The term comprehensive auditing is taken from the Canadian business environment and refers to a management and operational audit being performed in addition to the traditional independent (or external) audit (The principles and practice of auditing, 1992:45).

4.1.7 Other audits

In addition to the different types of audits discussed above, Puttick and Van Esch (The principles and practice of auditing, 1992:45) also mention two developing branches of audits, i.e. the energy audit and the strategic audit. The energy audit is used to evaluate the use and allocation of energy resources and the main aim of the strategic audit is to audit the planning process in a firm – this includes the entire information system.

4.2 The objectives of an audit

4.2.1 Major objectives of an audit

Originally an independent (i.e. financial/external) audit was known as a cash audit, i.e. an audit with the purpose of determining whether or not all receipts and payments had been accounted for by the responsible party. Today an independent audit is far more comprehensive (The principles and practice of auditing, 1992:46). Its main objective is to express an opinion on the fairness of management's presentation of the financial position of a company at a specific time as well as the results of its operations over a specific period. Three key terms are evident in this objective. These are:

- Opinion - the auditor does not certify or guarantee fairness.
- Fairness - relates to the concept of materiality and therefore does not mean 100% correct.
- Presentation - refers to the fact that the financial statements of a company are the responsibility of management (Human, 1996a:1,3).

4.2.2 Secondary objectives and advantages of an audit

From the main objective (discussed above), two further objectives are identified. The auditor does not only give an opinion on the financial statements of a company, but his presence and procedures aim to:

- detect errors and fraud; and
- prevent errors and fraud.

Strictly speaking the detection and prevention of errors and fraud are the responsibility of management. It is however most probable that the auditor will come across errors and/or fraud while verifying the financial statements of a firm. In instances where fraud and/or error are detected, the auditor must use his judgement to decide whether he will extend his investigation and how much further (The principles and practice of auditing, 1992:46-47).

4.2.3 Other advantages

Besides the main objectives and advantages of an audit that have been discussed above, various other advantages result from an independent audit. These include the following:

- Financial statements that have been approved by an auditor are more readily accepted as reliable by interested parties such as banks.
- Inland revenue authorities use audited financial statements for calculating taxation.
- Audited financial statements provide a reliable basis for valuation of a business as well as for the settlement of claims.
- The auditor can use the information obtained during an audit to propose improvements to the accounting system of a firm.
- The auditor can also make suggestions regarding increased proficiency and profits (The principles and practice of auditing, 1992:51-52).

4.3 The scope of an audit

The instructions that an auditor receives from the client determine the scope of a specific audit. The instructions must be confirmed in writing. This written agreement is referred to as *Engagement Letters* according to the *Generally accepted auditing standards, AU 211,* issued by the South African Institute of Chartered Accountants in April 1977 (The principles and practice of auditing, 1992:52). For an example of the scope of an audit, refer to the discussion of the scope of a typical internal auditing assignment, earlier in this chapter (paragraph 4.1).

4.4 Classes of audits

In the literature one finds various classifications of audits. Puttick and Van Esch (The principles and practice of auditing, 1992:53) identify two main classes of audits, namely:

- Complete or standard audit

  This involves checking and testing to the extent that the auditor regards necessary to enable him to decide "whether or not the financial statements [of a firm] fairly represent the state of affairs".

- Restricted or partial audit

  This type of audit involves either:

  - An audit that is not required by law but that is requested by a client and results in auditing some of the records of a firm, e.g. an audit of the cash transactions only.
  - An audit that is requested by a client in addition to a complete or standard audit, e.g. a share transfer audit of a limited company (The principles and practice of auditing, 1992:53).

Once the auditor has decided to perform either of these two types of audits, three other aspects have to be considered, namely where, when and how the audit will be performed. Answers to these questions are in turn influenced by the following three aspects:

- The size of the company.
- The statutory requirements (if any) that govern the audit.
- The wishes of the client (The principles and practice of auditing, 1992:53-54).

Another possible classification is the one by Ellis et al (1993:134). These authors identify two main types of audits commonly used in the commercial environment, namely compliance and advisory audits.

- Compliance audit: The compliance audit can be performed as an independent audit or as part of an operational or financial audit. The purpose of a compliance audit is to determine whether an organisation is meeting certain specified requirements, e.g. internally or externally imposed laws, regulations, standards, policies, plans and procedures. Management can request a compliance audit or it can be performed to satisfy a legal requirement (Flesher, 1996:251).

The steps of a typical compliance audit are listed in table 2-3.

TABLE 2-3: "Methodology" for a "typical" compliance audit

1. Find a system within the organisation that identifies all the policies, procedures, standards, laws, etc. that applies to the organisation.
2. Evaluate the effectiveness of the system through research, to determine all the requirements (internal and external) that apply to the units that are audited.
3. Test for compliance with the identified policies, procedures, etc. and draw conclusions.
4. Report the results of whether compliance has occurred.

(Adapted from Flesher, 1996:251)

Over the past few years, compliance audits have become increasingly important, as organisations are being held accountable at a higher level for their performance. This is because boards of directors, top management, stockholders, taxpayers and governments all request accountability (Flesher, 1996:251).

An example of a compliance audit is a traditional financial audit. The purpose of a compliance audit is to examine the accuracy with which specific procedures are being followed within an organisation as well as to determine whether legal and fiscal standards are being adhered to (Ellis et al, 1993:134).

- Advisory audit: The focus of advisory audits differs from that of compliance audits. The characteristics of the latter include the following: the audit is diagnostic, it is used to evaluate the appropriateness of existing information systems and services and it also informs users in the organisation of its findings, e.g. regarding problems with information systems and services (Ellis et al, 1993:134).

Ellis et al (1993:134) conclude that a compliance audit focuses on financial systems in organisations in contrast with advisory audits. The findings of the latter are often used for strategic planning.

5. The auditing process

As have already been explained, the main objective of an audit is for an auditor to express an opinion on the fairness of management's presentation of the financial statements of a company. This process consists of two major components. These are:

- assessing the reliability of the accounting system of a company; and
- verifying the fairness of the balances accumulated in the accounting records (The principles and practice of auditing, 1992:59).

5.1 Procedures and activities that make up the auditing process

The specific procedures and activities that make up the auditing process can be divided into four main stages, namely:

- Pre-engagement activities
- Planning
- Compliance and substantive procedures
- Evaluating, concluding and reporting (The principles and practice of auditing, 1992:56).

Each of the stages mentioned above and their various sub stages will be discussed below.

5.1.1 Pre-engagement activities

According to Statement AU 015 (see Addendum A, The South African Institute of Chartered Accountants statements on auditing standards) there are three pre-engagement activities. Each of these will be discussed briefly:

- Investigation of a new client or the change(s) in the circumstances of an existing client: The purpose of this investigation is to reduce business risk. See also the discussion under Quality control (paragraph 7.3).
- Determine skills and competence requirements: An auditing firm must perform a situation analysis of the company where the audit must be performed. The purpose of this is to determine whether the auditing firm has personnel with the necessary skills to effectively perform an audit in a specific environment.
- Establish terms of engagement: The instructions that an auditor receives from the client must be confirmed in writing. This written agreement is referred to as *Engagement Letters* (The principles and practice of auditing, 1992:56).

5.1.2 Planning

Absence of planning or ineffective planning result in an ineffective audit. The researcher has determined that proper planning is the key to success of any project. The ultimate objective of planning is to limit the audit risk (Human, 1996b:1).

The following sub stages make up the planning process:

- Obtain knowledge of the entity's business: The auditor must familiarise himself with the functions performed within the company to be audited, as well as the environment within which it operates (The principles and practice of auditing, 1992:57).
- Make a preliminary judgement of materiality: The auditor has to obtain interim financial statements of the company. Based on these he makes a judgement of materiality, the purpose of which is "to plan the audit so that sufficient evidence is gathered to draw such a conclusion" (The principles and practice of auditing, 1992:57).
- Consider inherent risk: Consideration of inherent risk is important to the auditor as it has an influence on the procedures for gathering audit evidence. Inherent risk is defined as "the intrinsic susceptibility of errors occurring" which could have an effect on financial statements, before internal control has been taken into account (The principles and practice of auditing, 1992:57).
- Obtain an understanding of the accounting system and related controls: It is also necessary for the auditor to make a preliminary assessment of control risk. "Control risk is the risk that a material error which could occur will not be prevented or detected timeously by the internal controls." Information obtained in this regard will help the auditor to determine whether or not internal controls exist that could influence the accuracy of the financial statements. In instances where no or insufficient controls exist, the auditor must determine what types of errors could

occur. He must then make provision for the detection of these (The principles and practice of auditing, 1992:57-58).

- Formulate an audit approach: The audit approach constitutes the overall plan designed by the auditor to accomplish his primary objective, i.e. to express an opinion on the financial statements of an entity (The principles and practice of auditing, 1992:58).
- Study internal controls on which reliance is intended: If the auditor intends to rely on specific internal controls in order to achieve his audit objective, he should evaluate these controls. The auditor can do this by:
  - ➢ inquiring into the detailed working of the accounting system and its controls;
  - ➢ recording a description of the system;
  - ➢ confirming that the record is an accurate description of the system; and
  - ➢ making a preliminary evaluation of the internal controls (The principles and practice of auditing, 1992:58).

As a final stage of the planning phase the auditor prepares a written audit programme in which he stipulates the nature, timing and the type of audit procedures that are necessary to conduct the audit (The principles and practice of auditing, 1992:58).

5.1.3 Compliance and substantive procedures

Compliance procedures are used to prove that the controls on which the auditor relied during the audit, operated effectively. If it is found that the controls were functioning ineffectively, substantive procedures must be increased (The principles and practice of auditing, 1992:57-58).

5.1.4 Evaluating, concluding and reporting

During the final stage of the auditing process, the auditor determines whether he has obtained sufficient evidence to support the conclusions he has come to. The conclusions relate to whether the financial information of a company is presented fairly. These conclusions are included in the audit report (The principles and practice of auditing, 1992:59).

5.2 Different approaches to the auditing process

It is important to note at this point of the discussion, that Statement AU 015 (see Addendum A) acknowledges different approaches to the audit process. The Statement does however state that when the approach outlined in the statement, is followed, it should result in an effective audit being performed (The principles and practice of auditing, 1992:58).

Different approaches to the audit process include the following:

- Balance sheet approach
- Systems-based approach
- Transaction flow or cycle approach
- Risk-based approach (The principles and practice of auditing, 1992:59-66).

5.3 Common auditing activities

Activities common to all types of audit assignments include the following:

- Planning, control and supervision
- Fact finding, analysis and documentation
- Recommending
- Reporting (Flesher, 1996:253).

6. The auditing profession and the professional auditor

The most important role player in the auditing profession, is the professional auditor who earns this title, based on his qualifications and responsibilities.

6.1 Qualifications

In South Africa a "public accountant and auditor" is a person who is registered with the Public Accountants' and Auditors' Board (PAAB), after obtaining the professional qualifications as specified by the PAAB:

- a candidate must obtain a *degree, diploma or certificate* (as determined by the Board) from a university in South Africa
- the candidate must serve a *training contract* (for a period, five years or less, as determined by the Board)
- the university qualification and training contract are prerequisites for the *qualifying examination* conducted by the Board (The principles and practice of auditing, 1992:15,17).

When a candidate has obtained the above-mentioned university qualification, when he has served the training contract and has passed the qualifying examination, he gains entry into the auditing profession in South Africa (The principles and practice of auditing, 1992:15).

Besides the qualifications listed above, Puttick and Van Esch (The principles and practice of auditing, 1992:15-16) discuss a number of characteristics a good auditor should have as well as the type of personality suited to this profession. These will not be discussed in this dissertation.

6.2 The auditor's responsibilities

In his professional capacity as an auditor in South Africa, the auditor has a number of professional responsibilities. These are listed below:

6.2.1 Reports his opinion

The auditor must report his opinion of the financial or other statements "of any entity, whether profit-oriented or not, and irrespective of its size, or legal form..." (The principles and practice of auditing, 1992:24, 44). The report is always in written form and the types of statements the auditor investigates, depends on the subject of the audit.

6.2.2 Conducts the audit with due professional care and competence

The above requires the auditor to conduct and audit honestly and with the necessary care and skill regarding the subject matter. If this is not done, the auditor may be held liable for fraud and negligence.

6.2.3 Maintains an independent mental attitude

The auditor is often obliged to rely on information provided to him by others, especially if this information is obtained from an area beyond his expertise. In these instances the auditor must represent information in a way that does not advantage or disadvantage anyone (The principles and practice of auditing, 1992:26-27).

6.2.4 Reports on material irregularities

It is the duty of the auditor to report on material irregularities that exist or has taken place and which can lead or has already lead to financial loss. If the situation is not rectified within 30 days of the auditor having handed in the report, it is his duty to report the situation to the Public Accountants' and Auditors' Board (The principles and practice of auditing, 1992:27).

6.2.5 Detects and reports illegal acts, other irregularities and errors

In April 1990, the South African Institute of Chartered Accountants issued Exposure Draft 80, defining various concepts and guidelines on the auditor's reporting responsibility (The principles and practice of auditing, 1992:28-29).

6.2.6 Registers with the PAAB (Public Accountants' and Auditors' Board)

The Act ensures that firms fulfil the training requirements set out by the PAAB and that the trainee has undergone the necessary tertiary education, as firms must register all training contracts with the PAAB. The Act also controls the number of trainees per firm. The PAAB maintains registers of the successful completion of contracts, cancellations of contracts and transfers of trainees (The principles and practice of auditing, 1992:32-33).

6.2.7 Adheres to code of conduct

It is expected of a professional auditor to conduct himself according to the code of conduct of the PAAB and therefore to conduct him-/herself in a manner befitting a member of the profession. The code lists a number of acts that are regarded as improper conduct (The principles and practice of auditing, 1992:33-34).

7. Auditing and accounting standards

Auditing standards are necessary to evaluate the performance of the auditor in terms of his implementation of his responsibilities (cf. paragraph 6). Before formal standards were set, the situation was such that every auditor could decide how to interpret his responsibilities. The result of this lack of standards was a wide range of individual interpretations ranging from very strict to casual interpretations (The principles and practice of auditing, 1992:34).

7.1 Auditing standards

The International Auditing Practices Committee is responsible for formulating international auditing standards. Members of the IAPC represent a broad geographical base (e.g. member countries include Australia, France, Canada and South Africa, to name just a few) and members represent different types of firms. The Committee has to reach consensus on an issue before accepting it (International Auditing Practices Committee, 1996).

The adherence of auditors to internationally recognised auditing standards has a number of advantages, e.g. it contributes to an increase in public confidence in their work and in the credibility of financial statements. In developing countries where auditors sometimes work in a free-enterprise system for the first time, they can use these standards as guidelines. A further advantage is more consistent handling of international financial transactions. This is important in light of a fast-growing global economy. The codification of the International Standards on Auditing and Related practices (ISAs) made it more user-friendly and accessible. The standards are arranged according to the way in which a typical audit is conducted. The standards provide general and specific guidance on auditing practices, starting at the planning phase and continuing through field work to conclusion and reporting (for a more detailed discussion of the phases of the auditing process, see paragraph 5). Other issues are also addressed, e.g. the responsibilities of management and the auditor with respect to financial statements and the audit itself; and guidelines for specialised areas such as computer information systems auditing (International Auditing Practices Committee, 1996).

The ISAs are dynamic in the sense that they are continually updated to ensure that it reflects current business and accounting trends (International Auditing Practices Committee, 1996).

7.2 Accounting standards

The International Federation of Accountants (IFAC) is responsible for developing "uniform professional and ethical standards and encourages national bodies of accountants world-wide to adhere to these standards so they may more effectively serve the public interest". The more than 60 technical pronouncements that have been issued by the IFAC cover almost all aspects relevant to the auditing profession. Care has been taken to ensure that the needs of those who are served by auditors are considered in the development of these pronouncements (IFAC, 1996a). The final pronouncement issued by the IFAC is available at a charge from their publication department. An overview of the pronouncements that have been issued is included as Addendum B.

Another body that is involved in the development of more uniform, internationally accepted standards on accounting and reporting, is the International Accounting Standards Committee (IASC). The efforts of the IASC are supported by the IFAC (IFAC, 1996a). Membership of IASC is the same as that of the IFAC and the Mutual Commitments into which these two bodies have entered, state that IASC "has full and complete autonomy in the setting and issue of International Accounting Standards" (Preface to statements of International Accounting Standards, 1996).

It is however, significant to take note of the fact that, in contrast to national accounting standards, neither the IASC nor the international accountancy profession has the power to enforce the International Accounting Standards. Similarly neither the IASC nor the accountancy profession can require compliance with International Accounting Standards (Preface to statements of International Accounting Standards, 1996). The researcher therefore comes to the conclusion that accountants from across the globe use the International Accounting Standards as guideline standards.

7.3 Quality control

In addition to auditing standards, auditing firms must implement quality control procedures to ensure effective audits. These quality control procedures are related to generally accepted auditing standards but differ from the latter in that quality control procedures focus on the organisational structure and performance of the entire firm. Auditing standards apply to each individual audit (The principles and practice of auditing, 1992:36).

7.3.1 The South African situation

Since adherence to international auditing and accounting are not mandatory, the researcher will look at specific issues when it comes to Quality control. These are relevant to the South African situation.
The South African Institute of Chartered Accountants lists nine elements of quality control that auditing firms should take into account when formulating quality control procedures and policies. All nine elements apply to all types of auditing firms but the manner in which each of the elements is implemented is determined by factors such as the size, organisational structure and services rendered by the firm (The principles and practice of auditing, 1992:37).

Each of the nine elements of quality control will be discussed briefly:

7.3.1.1 Independence

In terms of independence it is necessary to ensure that audit personnel do not have prohibited investments nor prohibited relationships with the firm's clientele. The independence principle should therefore form part of auditing firm staff policy (The principles and practice of auditing, 1992:37).

7.3.1.2 Recruitment

An auditing firm needs enough properly qualified personnel in order to function effectively and profitably. Staff requirements and hiring policies can form part of a manpower programme. The key to this is that "[staff] requirements at all levels of experience should be based on current clientele and anticipated growth, personnel turnover and promotion within the firm" (The principles and practice of auditing, 1992:37).

7.3.1.3 Professional development, training and advancement

The purpose of procedures and policies relating to professional development, training and advancement is to ensure that personnel are qualified to successfully perform the tasks allocated to and/or expected of them. These policies and procedures can also support the implementation and maintenance of a professional development programme, i.e. an orientation and ongoing education programme within the particular firm. This quality control procedure also relates to on-the-job training (The principles and practice of auditing, 1992:38).

7.3.1.4 Allocation of partners and staff to assignments

For each audit assignment, the firm must determine the number of staff members needed as well as the type of tasks they will have to perform. Each scenario then determines the allocation of staff members. "Assignment policies and procedures should [therefore] provide reasonable assurance that work will be performed by persons having adequate technical training and proficiency" (The principles and practice of auditing, 1992:38-39).

7.3.1.5 Planning, supervision and review

Continuing the reasoning from the discussion above, it is important for firms to have policies and procedures for planning, supervision and review. As is the case with the other elements discussed thus far, the policies and procedures mentioned here "provide reasonable ensurance that the work is performed to appropriate standards of quality" (The principles and practice of auditing, 1992:39).

7.3.1.6 Consultation

In instances where auditors encounter professional and/or technical problems during an audit, consultation procedures ensure that the staff will obtain the necessary assistance from internal and/or external experts (The principles and practice of auditing, 1992:39-40).

7.3.1.7 Acceptance and continuation of service to clients

An auditing firm must carefully select its clients. Policies and procedures can be laid down to protect a firm from clients who wilfully misrepresent their financial statements, or who are involved in illegal business transactions. For example: policies and procedures relating to the professional relationships of a firm will stipulate that a potential client's business reputation be investigated, or will confirm the firm's independence of a prospective client (The principles and practice of auditing, 1992:40).

7.3.1.8 Quality review

Quality review procedures ensure the availability of evidence of a firm's adherence to its policies and procedures regarding all aspects of quality control discussed above. Often large firms appoint a review team (made up of partners from different branch offices) to conduct a quality review of each office. This is done approximately once every three years (The principles and practice of auditing, 1992:41).

7.3.1.9 Communication

It is of the utmost importance to inform all the personnel of an auditing firm of its quality control policies and procedures. This can be done by means of a various methods of communication (The principles and practice of auditing, 1992:41).

7.3.2 The international scene

As far as Quality control on the international scene is concerned, a statement of policy "Assuring the quality of audit and related services" has also been issued by the IFAC (see Addendum B) (Final pronouncements issued by the IFAC, 1996).

8. Conclusion

Following a discussion on other types of audits (Chapter 3) and the information audit (Chapters 4 and 5), the researcher will investigate whether principles and characteristics of financial audits can be applied to the process of information auditing (Chapter 6).