

Part I

Basic Theory and Methods of Auditing

Part I includes five chapters, and explains the basic theory and methods of auditing, including audit definition and classification, audit mode, audit testing and materiality, audit evidence, and audit sampling.



Chapter

1

Audit Definition and Classification

Learning Objectives

- Understanding the definition of audit.
- Understanding the classification of audit.

1.1 Definition of Audit

1.1.1 Demand of Audit

The demand of audit generates mainly from the agency problems caused by the “separation of ownership and control”. In an agency relationship, the principles who act as owners hold the ultimate property rights over resources, such as economic wealth, and authorize agents to take care of these resources to maximize principles’ benefits. The agents, while taking the whole responsibility of the management of resources, do not bear full ownership. This divergence between property rights and management rights inevitably creates an information asymmetry between principles and agents, which prevents principles from accurately evaluating the management condition of resources. Even worse, to pursue their own personal benefits, the agents could further take advantage of this information asymmetry to falsely report information to mislead principles. Therefore, in order to get a true picture about agents’ management performance, principles are eager to find an independent and competent third party who can provide assurance on the credibility of information prepared by agents, hereby generating the demand of audit. Audit thus can be viewed as a service aiming to improve information credibility.

The above description reveals a key and distinct characteristic of audit, namely, it involves three parties: the responsible party, auditors and users. In a typical financial statement audit, the responsible party, normally firm management, prepares and is responsible for the fairly presentation of financial statements. Auditors perform an audit on the prepared financial statement to provide reasonable assurance on its credibility, while financial statement users read the audited statements to make their decisions. In addition to the Certified Public Accountants (CPAs) who primarily perform financial statement audits, depending

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on the professional groups who conduct audits, other well-known types of auditors include government auditors and internal auditors. In this book, our main focus is to introduce the financial statement auditing services provided by CPAs, while also briefly review the services of the other two types of auditors. Chart 1-1 shows you the auditing relationship.

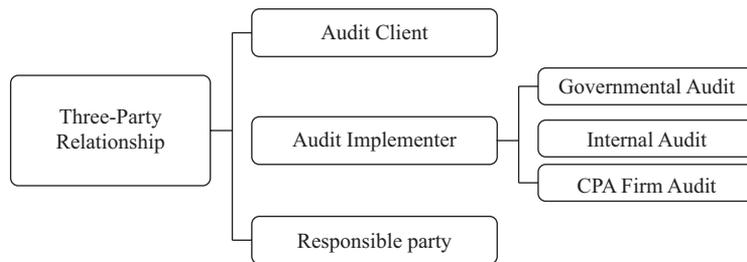


Chart 1-1 Auditing Relationship

The origination of CPAs professional can be dated back to the 16th century. In the 16th century, because of the advantages of its geographical location, Venice had become the commercial center of the Western world. Along with the rapid commercial development, businesses strived to obtain more capital for their daily operations and expansions. As a result, entities formed as partnership gradually appeared. In these entities, all the partners serviced as owners and made their own investments. However, due to the lack of expertise or time limitation, some partners did not directly participate in, but entrusted others to take charge of entities' daily operations. To ensure the investments they made to be appropriately used, these partners appointed independent accountants to verify the accounting information generated by their entities. In 1581, a group of accountants, who were specialized in auditing and supervision, founded the Venetian accounting Society in Venice.

In the second half of the 18th century, accompanied with the rapid development of capitalism in the U.K., joint-stock companies had emerged and kept growing larger. Compared with partnership entities, the divergency between property rights and management rights got even larger in these joint-stock companies, as most shareholders only had diffused property rights and never actually engaged in company operation or management. The only way for them to understand company operation performance and financial condition is through reading the financial statements prepared by company's management. Therefore, the

need for professional accountants, who are able to assure financial statements credibility, became even severe. In 1721, the South Sea Company in the U.K. filed for bankruptcy after acknowledging the massive frauds it had made during prior years, which caused huge losses to investors and revealed the serious consequences of financial frauds. We present the detail information of the fraud event of South Sea Company as following.

[Case 1-1]

The South Sea Company was established in 1711 with the main purpose of facilitating the British government's trade expansion in South America. By 1718, the total national debt of Britain had accumulated to 31 million pounds. In order to quickly raise debt repayment funds, the overwhelmed British government made a bold decision to sell the stocks of "South Sea Company" to the public. The business scope of South Sea Company included slave trade and whaling business in South America, but no one of the company's directors was proficient in either field. The true purpose of the company's founders was to take advantage of people's eager of becoming rich to deceive them and make money. At that time, the South Sea Company was largest creditor of the British government, holding treasury bonds worthing nearly 10 million pounds. The annual interest rate of these treasury bonds in a certain period was 6%, and the British government paid interests to the South Sea Company using its incomes from taxing on alcoholic beverages, vinegar, Indian goods, refined silk, tobacco, shark fin, and other commodities. In addition, the British government also granted the South Sea Company franchise rights of monopolize trades and operations. In order to raise funds, the South Sea Company had woven a set of beautiful lies: the South Sea Company could send goods from England to the eastern coast of South America, while the countries at the eastern coast of South America, such as Peru and Mexico, had huge underground gold and silver mines. The local people were willing to buy the British goods using much more valued gold and silver ingots, and tens of thousands of "silver bricks and stones" would be continuously transported back to England. Moreover, the Spain government also allowed the South Sea Company to use its four ports along the coasts of Chile and Peru for transportation purposes. In fact, the South Sea Company could only profit from the trade of black slaves, and the Spain government had never promised the South Sea Company to use Spain's ports for free trade. However, the public's

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confidence in South Sea Company had not wavered at all. The public only knew that this company could make big money and had government support, making it a good investment target. There was a fanatical atmosphere in the air, and people just wanted to invest. Investors, including more than half of the members of the House of Representatives, flocked. Even the King could not resist the temptation and subscribe the company's stocks worthing 100,000 pounds. Due to enthusiastic purchasing, the stocks were in short supply, causing the stock price skyrocketed, from £128 per share in January to over £1,000 per share in July, an increase of nearly 700% during the short 6 months. The stock price continued to rise, gradually becoming a foam, which is known as the "South Sea foam". Even worse, under the influence of the soaring stock price of the South Sea Company, the stocks of over 170 newly established joint-stock companies, as well as other companies, had become objects of speculation. People from all walks of life, including military personnel, housewives, and even physicist Newton, had been involved in this vortex. People had completely lost their rationality and did not care about the business scope, operating conditions, and development prospects of these companies. They only believed that these companies could obtain huge profits, and were afraid of missing out opportunities to make money. For a moment, the stock price of all companies in the U.K. skyrocketed. In his book "*The Great Panic*", the American economist Galbraith described this situation: "Politicians forget politics, lawyers forget courts, traders give up buying and selling, doctors abandon patients, shopkeepers close shops, godfathers leave the altar, and even noble ladies forget arrogance and vanity." In early August 1720, when learning that some directors of the South Sea Company had sold their original shares, investors began to be dissatisfied and became wary. At September 2nd, the company's stock price was only £700 per share and kept falling. At September 12th, with the coordination of Secretary General, Mr. Craig, the directors of the South Sea Company and those of the Bank of England held several meetings. After then, rumors that the Bank of England was willing to provide a loan of £6 million to the South Sea Company had emerged, which led the company's stock price rising to £670 per share. However, the rumors were shortly clarified, and the stock price fell in response, all the way to £400 per share. This situation had caused panic, and people put their hope on the Bank of England to provide some help to the South Sea Company to alleviate this crisis. The Bank of

England was very reluctant to cause trouble, but under the unanimous demand of the public, it had to take steps to save the situation. After negotiations between both parties, the Bank of England had agreed to pre-purchase 3 million bonds of the South Sea Company to restore public confidence. However, such efforts did not save the South Sea Company. People still lacked confidence on the South Sea Company, and the company's stock price continued to fall. In June 1720, in order to limit the expansion of all kinds of "foam companies", the British Parliament passed the "Foam Companies Ban Law", causing a large number of companies dissolved. Many investors were beginning to wake up and sell the stocks they hold. The stock investment fever began to cool down, causing the stock price of the South Sea Company to fall all the way. At the end of 1720, the British government counted the assets of the South Sea Company and found that its capital was very small. Later, the South Sea Company declared bankruptcy. The bankruptcy of South Sea Company was like a bolt from the blue, shocking the investors and creditors of the company. Tens of thousands of shareholders and creditors suffered losses. In addition to require compensations, these shareholders and creditors also asked British Parliament to implement strict punishment on the fraudsters. The scientist Newton, who suffered heavy losses in this incident, exclaimed, "I could calculate the trajectory of celestial bodies, but it was difficult to predict how crazy people were."

Soon after the bankruptcy of the South Sea Company, the British Parliament set up a special committee consisted of 13 people to investigate the reason behind this bankruptcy. The committee appointed Charles Snell, an accounting teacher at Horstreth School in London, to examine the South Sea Company accounts. Later, Charles Snell issued an audit report entitled "*Opinion of Charles Snell, a teacher and Accountant at Horstreth School, London, on the Examination of the Accounts of Sobridge Business Society*", in which Charles Snell presented his findings of the accounting malpractices in the South Sea Company. According to this report, the British Parliament sanctioned all the directors of the South Sea Company by confiscating their personal wealth and put those directly involved in the accounting malpractices into the prison of Tower of London. Because of his excellent work in the South Sea Company fraud event, Charles Snell was deemed as the first CPA, and the audit report he issued was the first audit report in history. In 1853, the first professional

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body of CPAs, the Edinburgh Institute of Accountants, was founded in Edinburgh, Scotland.

At the beginning of the 20th century, the global economic center slowly transferred from the U.K. to the U.S. In 1887, the American Institute of Public Accountants was established, which was later reorganized as the American Institute of Certified Public Accountants (AICPA) in 1916. During that period, the capital needs kept growing as the scale of businesses got bigger. As the stock markets were still underdeveloped, the main channel for a company to obtain capitals was through lending from banks, which primarily relied on balance sheet to assess the companies' abilities of paying back their loans. Accordingly, auditors in that period put their main focus on auditing company's balance sheet to ensure that it truly reflected the financial condition and solvency of the company. In addition, as the business scale kept growing larger and the transactions got even more complicated, performing detail audits on each financial accounts of statement, as what auditors did in the past, became cost-forbidden. As a result, auditors relied more and more on sampling in their daily auditing work to save audit costs and improve audit efficiency.

As the capital markets gradually grew mature, in addition to lending, issuing stock became another important channel for companies to obtain capital. Compared with bank lenders, investors who bought and sold company stocks cared more about company profitability. In this situation, the audit focus of auditors included not only balance sheet, but also income statement and other financial statements. During the period between 1930s and 1940s, the U.S. had gone through a series of serious economic crises, which led a large number of enterprises failed and caused tremendous losses to investors and creditors. One important reason behind these economic crises was the accounting malpractices conducted by companies, especially listed companies, since selecting auditors to audit their accounting information was only voluntary rather than mandatory. To change this situation, In 1933 and 1934, the U.S. government enacted "*Securities Act of 1933*" in 1933 and "*Securities Exchange Act of 1934*" in 1934, respectively, which required listed companies to have their financial statements to be audited by auditors. The *Securities Act of 1933* required listed companies to have the financial statements included in their register files to be audited when applying IPO, and empowered investors who purchased company

initial securities offerings to launch a litigation against companies and their auditors once discovering financial misstatement, whereas the *Securities Exchange Act of 1934* stipulated a mandatory audit on company's annual financial reports, and enlarged the scope of investors who can sue auditors to not only those who purchased initial securities offerings, but also the people who bought and sold securities in following years.

Relative to that in the Western countries, the formation of CPA professional was much later in China. In the long history of feudal society, the entities with the "separation of ownership and control" had not existed, so as the CPA professional. It was not until the Xinhai Revolution of 1911, the capitalism started to emerge and develop in China. In September 1918, *the Ministry of Agriculture and Commerce of the Beiyang Government* promulgated China's first regulation on CPAs, the *Provisional Regulations for Accountants*, and approved Mr. Xie Lin as the first CPA. In 1921, the first audit firm in Chinese history, *Zhengze Accounting Firm*, was found by Mr. Xie Lin in Beijing. In 1930, the National Government further promulgated *the Regulations on Accountants*, which by law stipulated the obligations and rights of CPAs, and thereafter, a number of accounting firms were established in Shanghai, Tianjin, Guangzhou and other cities. Since then, the CPA professionals had played an active role in and made significant contribution to the Chinese economic development. However, soon after the establishment of P.R.C, the CPA professionals withered away, as an highly centralized planned economy had been set up.

In 1978, China launched a series of far-reaching economic reforms. To attract foreign investments, in December 1980, the Ministry of Finance promulgated *the Provisional Regulations on the Establishment of Accounting Advisory Offices*, re-establishing the CPA professionals in China. One month later, the first audit firm after the re-establishment of the CPA professionals, the *Shanghai Accounting Firm*, was formed. In 1987, *the Regulations of the People's Republic of China on Certified Public Accountants* was promulgated, and at the end of 1988, the China Institute of Certified Public Accountants (CICPA), the national professional organization for the Chinese CPAs, was established. In October 1993, the first law for the Chinese CPAs, *the Law of the People's Republic of China on Certified Public Accountants*, was promulgated. Since then, the CPA professionals in China has gone through a rapid growth. To regulate