CAPACITARTE

CAPACITARTE

Curso de inglés económico, de finanzas y tributos
Module 12

Auditing

What is a financial statement?

We can define an audit as an objective examination and evaluation of the financial statements of an organization to make sure that the records are a fair and accurate representation of the transactions they claim to represent.
It can be done internally by employees of the organization, or externally by an outside firm.

Internal Audit

After bookkeepers complete their accounts, and accountants prepare their financial statements, these are checked by internal auditors.

An **internal audit** is an examination of a company's accounts by its own internal auditors or controllers. They evaluate the accuracy or correctness of the accounts and check for errors.
They make sure that the accounts comply with or follow established policies, procedures, standards, laws and regulations.
The internal auditors also check the company's systems of control, related to recording transactions, valuing assets and so on. They check to see that these are adequate or sufficient and, if necessary, recommend changes to existing policies and procedures.

Internal auditors are part of the organization they audit and report to management (internal auditors are employees of the entity).
As they are members of a professional organization, they are subject to the same code of ethics and professional code of conduct as applicable to external auditors. These auditors are mainly responsible for the internal control procedures of an organization and the prevention of fraud. They have to appraise an entity's risk management strategy and practices, management (including IT) control frameworks and governance processes.

External Audit

On the other hand, public companies have to submit their financial statements to external auditors.

CAPACITARTE

An **external audit** is carried out by independent auditors who do not work for the company. They have to give an opinion whether the financial statements represent a true and fair vie of the company's financial situation and results.

External auditors examine the Company's systems of internal control to see if transactions have been recorded correctly. They check the existence of assets mentioned on the balance sheet and their valuation. They also check the annual stock or inventory and look for unusual items in the Company's account books or statements.

An **external auditor** is an audit professional who performs an audit in accordance with specific laws or rules on the financial statements of a company, government entity, other legal entity or organization. They performs reviews of financial statements and compilation and then prepare an auditor's report, which is normally addressed to the shareholders of a corporation. They also express an opinion on whether an entity's financial statements are **free of material misstatements**.

Furthermore, they review the entity's information technology control procedures when assessing its overall internal controls. They must investigate any **material issues** raised by inquiries from professional or regulatory authorities, such as the local taxing authority.
The manner of appointment, the qualifications and the format of reporting by an external auditor is defined by statute which varies according to jurisdiction of different countries. External auditors must be a member of one of the **recognized professional accountancy bodies**.

In some cases, external auditors also undertake **management consulting** assignments. Under statute, an external auditor can be prohibited from providing certain services to the entity they audit (in order to avoid **conflicts of interest**).

As you can see, external auditors must be independent from the company they are auditing. Therefore, any relationship between them and the entity, other than retention for the audit itself, must be disclosed in the external auditor's reports. They are also not allowed to **own a stake** in public clients.

External Auditors' liability to Third Parties

External auditors may be liable to 3rd parties who are damaged by making decisions based on information in audited reports.

This risk of auditors' liability to third parties is limited by **the doctrine of privity**. An investor or creditor, for instance, cannot generally sue an auditor for giving a favorable opinion, even if that opinion was knowingly given in error.

The extent of liability to 3rd parties is generally established by 3 **accepted standards:** Ultramares, Restatement, and Foreseeability.

- **Ultramares doctrine**, auditors are only liable to 3rd parties who are specifically named.
- **Restatement Standard** opens up their liability to named "classes" of individuals.
- **Foreseeability standard** puts accountants at the most risk of liability, by allowing anyone who might be **reasonably foreseen** to rely on an auditor's reports to sue for damages sustained by relying on material information.

CFOs (company accountants) and other employees are **NOT afforded** the same luxuries of the doctrine of privity. Their material actions and statements open them (and their companies) up to liability from third parties damaged by relying on these statements.

For public companies listed on stock exchanges in the United States, the **Sarbanes-Oxley Act** (SOX) has imposed stringent requirements on external auditors in their evaluation of internal controls and financial reporting. Securities and Exchange commissions of countries also impose specific requirements and roles on external auditors, including strict rules to establish independence.

In many countries external auditors of nationalized commercial entities are appointed by an independent government body such as the **Comptroller** and **Auditor General**.

Irregularities

During audits, external auditors examine if the control systems are adequate and accounting principles have been applied correctly. If the control systems are adequate and accounting principles have been applied, auditors produce an **audit report**.

When auditors find **irregularities** (systems are not adequate and principles have not been applied correctly or consistently), they write a **management letter** to directors or senior managers explaining what needs to be changed. If the Company follows this advice, auditors produce an audit report.

If the Company doesn't follow the advice given in the management letter, auditors produce a **qualified report**, stating that the financial statements do not give an entirely true and fair view and there are some problems.

Auditor's Report

As we've seen before, external auditors produce auditor's report. It is a detailed summary of every finding after an **auditing process**.

This report evaluates the financial statement's validity and reliability. It is intended to provide **reasonable assurance** that there are no material errors within an organization's financial statements.

As with almost all accounting documents, auditor's reports are required to adhere to generally accepted standards that are established by the local governing bodies. It would include:

- **A title of the document,** which must include the word **"independent"** (as the report was created by an **unbiased** third party).
- An **introduction,** a concise one-paragraph statement. It includes the name of the firm being audited and the dates that the audit covers.
- A spelling out of the **responsibilities of the directors** of the firm being audited, and of the auditor. The Company's **management team** must create and provide all financial documentation required for the audit to be successfully completed. That data must be, to the best of their knowledge, accurate.
- An indication of the **auditor's role**. Based upon that information, they must form and present an **opinion** of the financial status of the organization.
- A **basis of Opinion**, where the auditors deliver their opinion, explaining that the audit was conducted in a manner compliant with **applicable standards** and including a description of the entire **audit process**.

Types of Reports

There are four types: unqualified or clean, qualified, adverse and disclaimer of opinion.

Auditors can issue a **clean** or **unqualified** opinion, they conclude that the financial statements give a **true and fair view** in accordance with the financial reporting framework used for the preparation and presentation of the financial statements. They do not have any significant reservation in respect of matters contained in the Financial Statements.

On the other hand, when the auditor encountered one of two types of situations which do not comply with generally accepted accounting principles, however the rest of the financial statements are fairly presented, they issue a **qualified opinion**. The structure is similar to an unqualified opinion, but the report states that the financial statements are fairly presented with a certain exception which is otherwise misstated.
An **explanatory paragraph** is added to explain the reasons for the qualification. The opinion paragraph includes the phrase in the first sentence, so that the user is reminded that the auditor's opinion explicitly excludes the qualification expressed.

An **adverse opinion**, delivered when the auditor determines that the financial statements of the company are **materially misstated** and, when considered as a whole, **do not conform** with accounting standards. It states that the information contained is materially incorrect, unreliable, and inaccurate in order to assess the company's financial position and results of operations. Investors, lending institutions, and governments very rarely accept a company's financial statements if the auditor issued an adverse opinion, and usually request it to correct the financial statements and obtain another audit report.
This report is similar to the qualified report. An explanatory paragraph is added to explain the reason for the adverse opinion. The most significant change in the adverse report from the qualified report is in the **opinion paragraph**, where the auditor clearly states that the financial statements are not in accordance with accounting standards so they are unreliable, inaccurate, and do not present a fair view of the company's position.

A disclaimed opinion is issued when auditors could not form and consequently refuses to present an opinion on the financial statements. They tried to audit an entity but could not complete the work due to various reasons and **do not issue an opinion**.
This report provides very little information regarding the audit itself, and includes an **explanatory paragraph** stating the reasons for the disclaimer. In the introductory paragraph, the first phrase changes from "We have audited" to ***"We were engaged to audit"*** in order to let the user know that the company commissioned an audit, but does not mention that the auditor necessarily completed the audit. Additionally, since the audit was not completely or adequately performed, the auditor **refuses to accept any responsibility**.

CAPACITARTE
Es ser líder de tu vida