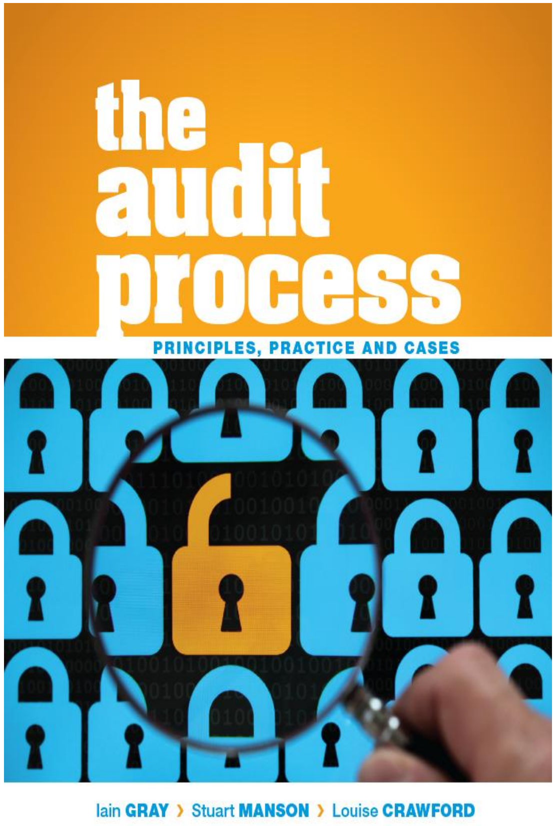
Chapter 1
Why are auditors needed?

Introduction to audit



CENGAGE Learning

Use with *The Audit Process: Principles, Practice and Cases,* 6th edn
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Learning objectives

- To understand in general terms what an audit is and to put into context some basic audit techniques.
- To explain what kind of person should carry out an audit.
- To suggest kinds of people who will benefit from an audit.
- To form view on kind of information that might be prepared by those having control of resources held on behalf of others.
- To recognize there are theoretical considerations underpinning audit practice.
- To explain wider setting of and be aware of some of the problems facing the audit profession.

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Opening remarks

- Auditing has become headline news
- Mainly because of scandals such as: Enron – WorldCom – Parmalat – Satyam – and 2007-8 financial crisis.
- Questions about competence / independence of auditors and apparent failure of corporate governance.
- Role of audit needs re-defining and questions raised as to its value to society.

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Introduction to basic principles through a simple case

- The Andrew and James case is of a simple organization, but brings out some important features of business and auditing developed later.

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Justification of audit

- ***Information hypothesis*** – information becomes more reliable and useful as the result of audit.
- Providers of resources cannot trust the managers to use the resources properly on their behalf (a basic idea of ***agency theory)*** – audit provides reassurance.
- ***Insurance hypothesis*** – people who have lost as the result of reliance on the opinion given by auditors may be able to recover damages from them, assuming negligence on their part.

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Agency theory basic ideas

- Both owners (principals) of organization and managers (agents) employed to manage it on their behalf try to maximize own wealth.
- As a result principals need a monitoring mechanism in form of a financial report.
- Agents likely to favour preparation of a financial report as principals will otherwise be unwilling to believe they are telling the truth.
- Agents recognize that, for the owners to believe the financial report is valid, it will need to be verified by a party (the auditor) independent of both principals and agents.
- Agency theory suggests the appointment of professional external auditors will be preferred as the most cost-effective of monitoring devices.
- A particular problem is that the auditor may also be regarded as a wealth maximizer, raising possible doubts about value of the audit report, but agency theory suggests the auditors will provide a true report to maintain their reputation.

Introduction to truth and fairness in accounting

- Financial statements (FS) should not mislead. E.g. if there are liquidity problems, FS should reveal. If the entity finances non-current assets by leasing rather than buying, the reader should be informed.
- FS – degree of accuracy built into them, but insignificant misstatements do not affect truth and fairness.
- FS must be supplemented by notes, explaining e.g. accounting policies adopted, and date of repayment of long-term borrowing.
- FS must give a reasonable view of financial affairs and results of the business.
- Auditors try to collect sufficient appropriate evidence to prove the FS are true and fair before giving an opinion.
- A major risk for auditors is that they may give an inappropriate opinion because they have failed to identify business risks and to collect the necessary evidence.

Basic audit framework

- Preliminary stage to set the scene, consider risks and agree the terms of the engagement.
- Systems work and transactions testing often at an interim examination, following which a management letter may be issued.
- Preparation for final work, including observation of inventory counts.
- Final work, including final analytical review and issue of audit report.

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Some initial ideas on an extended role for audit

- Examples of different kinds of audit work reporting:
  - Local authority providing services to people living in the area.
  - University providing educational services to students.
  - Water companies supplying water to private customers.
  - Hospital serving people in the surrounding area.
  - Nuclear power station feeding electricity into the national grid.
  - Charity collecting from the public to provide funds to specified good causes.

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Assurance services

- Assurance services: broad set of services designed to improve the quality of information.
- Kinds of services auditors provide: business risk assessments; measuring business performance against predetermined criteria; assessments of reliability of information and systems; assessments of viability of e-commerce and particular risks of this activity.
- Auditor in a particularly good position to provide such services.
- But potential threats to independence when auditors are engaged in activities for particular benefit of management.

Summary of principles

- Reliable financial statements very important. Reliability: aspect of truth and fairness.
- Audit is form of investigation, using a number of useful techniques.
- The auditor has to behave in an independent and competent manner.
- Audit is a *search for evidence* to arrive at what the auditor perceives to be the truth.
- An attitude of professional scepticism should be adopted.
- Do not assume business people are engaged in fraudulent activity.
- Not usually possible for provider of funds to carry out an audit themselves because of complexity of business organizations.
- Unwise to rely on unaudited financial statements, as they lack sufficient credibility to form a reliable basis for decision-making.
- Only a person entirely independent of the management and not financially involved with it can add the desired credibility to the financial statements – one of the prime ideas of agency theory.
- Uncertainty heightens risk for both managers and auditors, required to state whether financial statements give a true and fair view.

One definition of an audit of financial and other information

- An audit is an *investigation* or a *search for evidence* to enable *reasonable assurance* to be given on the *truth and fairness* of financial and other information by a person or persons *independent of the preparer and persons likely to gain directly from the use* of the information, and the *issue of a report* on that information *with the intention of increasing its credibility* and therefore *its usefulness*.

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The auditors' code: 9 fundamental principles of independent auditing

- Accountability
- Integrity
- Objectivity and Independence
- Competence
- Rigour
- Judgement
- Clear, complete and effective communication
- Association
- Providing value

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