Chapter 2

An overview of the postulates and concepts of auditing
Learning objectives

• To explain how auditing theory, concepts and principles underpin auditing practice.
• To identify the basic postulates of auditing and explain why they are important.
• To define auditing concepts under the general headings of credibility of the auditor, process of audit, communication by the auditor and performance of the auditor’s work.
• Explain the implications of truth and fairness in relation to financial statements and the work of the auditor.
• Define the audit expectations gap and identify its components.
• Understand that the regulatory framework of auditing provides the criteria by which audits are conducted and encompasses the concepts of auditing.
• Recognize how organizations attempt to control their internal environment in the context of external influences.
The importance of theory and concepts in underpinning auditing practice

• Mautz and Sharaf (1961):

One reason… for a serious and substantial investigation into the philosophy and nature of auditing theory is the hope that it will provide us with solutions, or at least clues to solutions, to problems that we now find difficult.

• A philosophy (or set of unifying theories) has three aspects of value to us:

1. Gets back to first principles, to the rationale behind the actions and thought which tend to be taken for granted.

2. Concerned with the systematic organization of knowledge in such a way that it becomes at once more useful and less likely to be self-contradictory.

3. Provides a basis whereby social relationships may be moulded and understood.
The postulates of auditing 1–4

1. The primary condition for an audit is that there is a relationship of accountability or a situation of public accountability.

2. The subject matter of accountability is too remote, too complex and/or of too great a significance for the discharge of the duty to be demonstrated without the process of audit.

3. Essential distinguishing characteristics of audit are the independence of its status and its freedom from investigatory and reporting constraints.

4. The subject matter of audit, for example, conduct, performance or achievement or record of events or state of affairs or a statement of fact relating to any of these, is susceptible to verification by evidence.
The postulates of auditing 5–7

5. Standards of accountability, for example, conduct, performance, achievement and quality of information, can be set for those who are accountable: actual conduct, etc. can be measured and compared with these standards by reference to known criteria and the process of measurement and comparison requires special skill and judgement.

6. The meaning, significance and intention of financial and other statements and data, which are audited, are sufficiently clear that the credibility given thereto as a result of audit can be clearly expressed and communicated.

7. An audit produces an economic or social benefit.
The concepts of auditing: credibility, process, communication, performance

- CREDIBILITY: competence, independence, integrity and ethics
- PROCESS: risk, evidence, audit judgement, materiality
- COMMUNICATION: reporting, truth and fairness, association
- PERFORMANCE: due care, standards, control of audit quality, rigour
Figure 2.1
Audit quality (1)

- DeAngelo (1981) definition: ‘the market assessed joint probability that a given auditor will both discover a breach in a client’s accounting system, and report the breach’.
- FRC (2006), acknowledges no single agreed definition of audit quality that can be used as a standard against which actual performance can be assessed.
- General acceptance that auditor competence and independence are key attributes of audit quality.
- FRC also noted in 2006 there is limited transparency about the audit process and what audit firms actually do – stakeholders cannot reliably assess audit quality – contributes to audit expectations gap.
Audit quality (2)

• Frameworks for audit quality published by FRC and IAASB:
  – focus on identifying elements that contribute to an effective audit and financial reporting environment (FRC 2008)
  – aim to raise awareness of the indicators of audit quality and of ways to improve quality (IAASB 2014)

• European Audit Directive and Regulation (2014) – objective of improving audit quality across the EU and to ensure auditors are key contributors to economic and financial stability

• Understanding the elements of the audit expectations gap can give us some insight into how different stakeholders might view audit quality.

• Discussion of audit quality extended in Chapter 18.
Corporate Governance (1) Definition

• Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders’ role in governance is to appoint the directors and the auditors, and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the board include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The board’s actions are subject to laws, regulations and the shareholders in general meeting (UK Corporate Governance Code, 2012, p. 1).
Corporate Governance (2)

- Corporate governance, in addition to corporate audit, is a mechanism for monitoring corporate behaviour on behalf of shareholders and other stakeholders.
- Part of Layers of Regulation and Control.
- Reporting on CG – Chapter 16
- Models of CG – Chapter 19
Components of the audit expectations gap

1. *Reasonableness gap*: arises because people expect more of audit than it can give in practical terms.

2. *Performance gap*: between what can reasonably be expected of auditors and what they are perceived to do. This gap split into two:
   
   – *Deficient standards gap*: gap between what auditors can be reasonably expected to do and what the profession and the law asks them to do.
   
   – *Deficient performance gap* arising because auditors have not behaved in a manner consistent with professional auditing standards.
Figure 2.1 Communication of accounting information

- Accountability
  - Subject matter: Economic events and actions
  - 1 Preparer/source
  - Accounting reports (economic information)
  - 2 Users of accounting information
  - 4 Regulatory framework

- Audit
  - Evidence
  - Assertions
  - Criteria
  - 3 Auditor
  - Audit report (opinion)
Figure 2.2 Structure of the audit expectation performance gap

- Perceived performance by auditors
- Society’s expectations of auditors
- Audit expectation-performance gap
- Performance gap
- Reasonableness gap
- Deficient performance
  - For instance, the auditor fails to refer in the audit report to a fundamental uncertainty concerning the going concern status of the client company.
- Deficient standards
  - For instance, auditors are not required to report to a regulatory authority on misappropriation of company assets by directors or senior management of companies not in the financial services sector.
- Auditors’ existing duties (defined by law and professional promulgations).
- Duties reasonably expected of auditors (compatible with auditors’ role in society and cost beneficial to perform).
- For instance, many people believe that the auditor examines every transaction entered into by a client company.
Figure 2.2

For instance, the auditor fails to refer in the audit report to a fundamental uncertainty concerning the going concern status of the client company.

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For instance, many people believe that the auditor examines every transaction entered into by a client company.

Auditors' existing duties (defined by law and professional promulgations).

Duties reasonably expected of auditors (compatible with auditors' role in society and cost beneficial to perform).
Layers of regulation and control
Figure 2.3

External environment
- Expectations of corporate governance
  - importance to economy in general
  - role of commercial enterprises in economy
  - greater transparency and the public interest
- Regulatory response
  - government regulation – national, European and elsewhere
  - regulation other than by government
    - stock exchanges
- Commercial pressures

Internal environment
- Control environment and related components
- Accounting, quality assurance/control systems
  - Control procedures
    - general control procedures
    - application control procedures