Auditing and assurance
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Undergraduate study in
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This is an extract from a subject guide for an undergraduate course offered as part of the University of London International Programmes in Economics, Management, Finance and the Social Sciences. Materials for these programmes are developed by academics at the London School of Economics and Political Science (LSE).

For more information, see: www.londoninternational.ac.uk
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This is one of a series of subject guides published by the University. We regret that due to pressure of work the author is unable to enter into any correspondence relating to, or arising from, the guide. If you have any comments on this subject guide, favourable or unfavourable, please use the form at the back of this guide.
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Chapter 1: Introduction

The topic of auditing and assurance has a reputation for being dry and tedious, but this is far from the reality. Auditing in practice and in the classroom should be an intellectual challenge and a rewarding one too, provided you apply yourself to the material set out in this subject guide.

Auditing will be a new subject for most of you. However, you are likely to have a general idea of what you think auditing is all about. Nevertheless, there will be surprises as we go through the course. Whatever your preconceived ideas, try to approach the subject with an open mind. If you do so, I think you will find it an interesting and exciting area of study.

One reason that auditing has a dull reputation is that students are sometimes presented with, and sometimes tempted to memorise, lists of procedures. This sort of approach drives the life out of the subject and can only be useful if you think that you will face exactly the same question in some future test or examination. As with any subject, it is much better to focus on understanding the topic so that you are better able to adapt what you know to the particular situation facing you. The examination is designed to test your understanding of the topic rather than your ability to memorise lists of points, facts or cases.

1.1 Route map to the guide

The aim of this guide is to help direct you in your studies. If you are currently studying as part of a course with lectures and seminars/tutorials, then this guide will supplement your studies and coursework. The guide will be especially useful if you are studying on your own. You may face the difficulty of working out which of the many sources of information you need to concentrate on – the guide will direct you to those areas that will best repay your attention.

Every effort has been made to keep the text accessible, not over-complicating the technical aspects and not contradicting the textbooks. It should be stressed that the guide is not a substitute for the texts which are both very comprehensive in their coverage of numerous topics. There would be little point in trying to write yet another textbook but what I have done is to select those issues which are really worth concentrating on. The guide is not a substitute for diligent study nor is it a shortcut for the lazy student. You still need to be motivated and self-disciplined. You need to be diligent in the pursuit of your studies and be prepared to put in the time and the effort. I have tried to make the text and the guide more engaging by inserting activities and ‘pause and think’ style questions. Please do not skip over these exercises. They are designed to grab your attention and get you working and, most of all, thinking.

The rest of this first chapter is a general introduction to the guide itself. Chapter 2 looks at the basis of auditing and its development over the years and ends with consideration of what has become known as the ‘expectations gap’ – this still causes the profession problems many years after it was first recognised that what auditors meant by an audit was not always the same as what the public thought was involved. Chapter 3 is quite a challenge, looking as it does at the topic of theoretical notions underpinning the concept of an audit; what makes this difficult is that the discussion is
mainly in the abstract rather than dealing with the practical aspects of auditing, but do not let that put you off. The next three chapters deal with three of the four main concepts – independence, auditor reporting and audit evidence. Taking some of the points from the theoretical basis, the discussion and evaluation begins to focus in on the practicalities of auditing. Chapter 7 concerns the audit process and the approach of concentrating audit resources on those areas most likely to be at risk of misstatement. It is important to realise that the guide does not attempt to go into the level of detail which you will find in the textbooks but this does not mean that you can ignore the relevant chapters in those books. A thorough understanding of auditing practices and procedures is necessary if you wish to be best placed to tackle the scenario-based questions in Section A of the examination paper. Chapter 8 deals with the complex and difficult area of legal liability. Again no attempt has been made to better the textbooks’ coverage of the case law but a different perspective is offered on how one may interpret the various decisions of the courts. Chapter 9 deals with the topics of regulation of auditing and the expansion of auditing notions into other forms of professional service. In particular, I highlight a few areas with which students should be familiar. Chapter 10 acts as an overview and tries to bring together a number of lessons and principles concerning examination technique – these have been introduced throughout the guide but are worth repeating. It cannot be overstated how important it is that you work on developing good style and good technique. All too often Examiners are dismayed by students’ poor performance, not their lack of knowledge but their lack of ability to tailor their knowledge to answer the particular question set. Please do not bypass this last chapter, it could seriously affect your final grade!

1.2 Introduction to the subject area

The word ‘audit’ is usually used to refer to the process of providing an opinion on the accuracy or validity of some subject matter specifically, from our point of view, financial information. In particular, a regulatory ‘external’ audit provides an opinion on the financial statements of an organisation for users who are outside the organisation’s management. The auditors’ opinion helps these users to decide how much to rely on the financial statements when making decisions. External financial audit has a long history and has become highly organised and regulated. It therefore forms the main focus of this subject guide. However, audit is only one form of assurance, and demand for other forms, not limited to financial information, has greatly increased with accountants and others being engaged to offer assurance on all sorts of information or processes. Some aspects of financial audits are very much relevant to these other forms of assurance.

If you are not sure what other forms assurance can take, just look around your home. In my kitchen, for instance, I have some food which is certified by the Soil Association, a UK-based charity dedicated to promoting environmentally safe methods of food production. The Association certifies that certain food stuffs are being organically grown and this reassures consumers who may be worried about mass-farming methods which may harm our health and the planet. Other food is marked as ‘Freedom Food’ by the Royal Society for the Prevention of Cruelty to Animals (a charity which aims to promote good standards of animal welfare). The purpose of the fair trade organisation is to promote responsible relationships between large producers in developed countries and growers in less developed countries by reviewing whether the prices which the farmers have been
paid are ‘sustainable’ rather than exploitative. As consumers, we are reassured by the involvement of these credible intermediaries, without whom we would only have the unsubstantiated claims of the producers. These are examples of a type of ‘audit’ exercise which may even involve accounting firms even though the material or processes being corroborated have little to do with accounting matters. Accountants have established a reputation for honesty and fairness which means that their clients and the public can generally trust them to evaluate organisations in an objective way. The fact that the matter under investigation is not accounting-related means that these accounting firms need to employ other specialists.

Companies are also increasingly reporting on their environmental and social impacts – this is sometimes referred to as corporate social responsibility (CSR) reporting – alongside their financial statements. Some companies choose to have their environmental or sustainability reports audited and this is a service that is often provided by the big accounting firms.

1.3 Syllabus

Reasons for auditing. The concept of accountability. Economic demand for auditing. Auditing as a monitoring device.

Principles and postulates of auditing. Conditions for auditing to be possible. The concept of independence.

The legal and professional environment. Approaches to the regulation of auditing practice, in particular legal rules and professional guidelines. International regulation of auditing. (Note: candidates will be expected to be aware of the range of different approaches to auditor regulation and the general content of such regulations but will not be expected to know the detailed requirements of any specific country’s audit regulations.)

The duties of auditors. The changing responsibilities of auditors for fraud detection and financial statement attestation. The extent of auditors’ duties to primary clients and third parties. The ‘expectations gap’ between what users of financial statements believe the audit provides and what the audit is capable of offering. Auditor liability and the case for and against limiting liability. Different levels of assurance that may be expressed.


Conduct of audits and assurance services. The concept of evidence. Compliance and substantive testing. The concept of internal control. Identifying key controls and testing them. Statistical and other sampling approaches to testing. Specific audit techniques, such as observation, directional testing, cut-off tests, third-party confirmations. The application of techniques in the context of the main revenue and cost activities of the enterprise. Auditing the balance sheet. The significance of management representations. Assessment of errors and weaknesses. Documenting the audit or assurance service, preparation and review of working papers.

Computer-based systems. Auditing ‘round’ and ‘through’ the computer. Internal control in a computer environment. Computer-assisted audit techniques. The use of computers in conducting the audit or assurance service, in particular spreadsheets, word-processing and automated working papers.
The report of the auditors or assurance service providers. The form and content of the auditors' report. The qualified auditors' report (also referred to as the modified report or opinion). The hidden meanings behind an auditors' report. The report as an educational document.

Current developments in auditing and assurance services. Audit committees. Internal audit. Management audit. The economic value of auditing to society. The spread of auditing and other assurance services into non-financial contexts: the 'Audit Society'. The role of auditors in the banking crisis and other scandals. Possible changes to enhance auditor independence and competence.

1.4 Aims of the course

The course aims to:

• introduce students who have passed AC1025 Principles of accounting to the principles of external auditing and other assurance services
• provide students with an understanding of the nature of the function of auditing and other assurance services and the principles of the related processes.

We will be dealing with both theoretical and practical aspects of the audit process, but you should always try to relate the two rather than treat them as discrete parts.

1.5 Learning outcomes for the course

By the end of the course and having completed the Essential reading and activities, you should be able to:

• explain why external audits and other types of assurance services are conducted
• discuss the duties of auditors and other assurance providers and how these have changed over time
• explain the meaning of concepts that are fundamental to auditing and assurance services, such as 'independence', 'audit evidence', 'audit risk', 'materiality'
• describe, in general terms, the processes involved in auditing and other assurance services
• distinguish between compliance and substantive testing and describe various audit tests
• discuss the form, content and importance of auditors' reports provided at the end of the audit or assurance service
• discuss the issue of legal liability arising from audits and other assurance services
• discuss current developments in auditing and other assurance services – in order to do this you must be prepared to read widely in the financial press and also in the academic journals.

1.5.1 Changes to the syllabus

The material contained in this subject guide reflects the syllabus for the year 2016–17.

The field of accounting changes regularly, and there may be updates to the syllabus for this course that are not included in this subject guide. Any
such updates will be posted on the virtual learning environment (VLE). It is essential that you check the VLE at the beginning of each academic year (September) for new material and changes to the syllabus. Any additional material posted on the VLE will be examinable.

**1.6 Overview of learning resources**

If you are aiming to study for this subject over the course of one academic year, you need to spend, as a minimum, six or seven hours per week on these studies. This could include reading each chapter in this subject guide, the related part or parts of the recommended texts and relevant articles, making notes and practising writing short, and then longer, answers to activities or questions in preparation for your examination. It will be very clear to the Examiners which candidates have prepared themselves well by reading around the subject as opposed to memorising a set of notes. The more you know about your chosen subject, the better you are able to relate your knowledge to any given examination question.

**1.6.1 The subject guide**

This subject guide has 10 main sections, covering the course syllabus and examination techniques. Everyone has their own way of working, so the following steps are only suggested as a guide. Work through each of the remaining chapters (2 to 10) in the guide in the order in which they are presented.

- Read the notes in the chapter to gain an overview of the topic.
- Read the notes in the chapter again. This time also read the relevant material in the textbook(s), standards, regulations, or articles, making your own notes as you do your reading. These notes will form the basis of your learning.
- Re-read the notes in the subject guide. Take time to pause and think about the issues that have been raised (you will also be prompted to do this at various stages). Reflecting on these issues will improve your understanding of the material. Noting the key points presented in the subject guide will help you to focus on the areas which are most important. Add to or amend the notes you made on the reading as you do this; for example, highlight the sections of your notes which receive more emphasis in the subject guide. Pause and think hints are provided at the end of each chapter.
- Test yourself by attempting the activities as you work through each chapter. Also have a go at the activities in the textbook(s) as well as those in the subject guide. Keep your answers in a safe place so that you can refer back to them in future.

If you cannot even begin an activity, go back and re-read the parts of the chapter, and the relevant background reading, which cover the material in that activity.

- Check back to the learning objectives that are set out at the start of the chapter you have read. Can you do all the tasks noted? If not, re-read the relevant part(s) of the chapter and the relevant background reading.
- Complete the other study tasks provided in this subject guide, for example, the sample examination questions at the end of each chapter.

It is essential that you try to gain a thorough understanding of each topic rather than simply learning by rote. Do not accept what you read at face value. Rather, try to distinguish between statements of fact and statements
of opinion, and ask yourself whether the opinions you read are reasonable – do you agree, and why (or why not)?

Throughout the course you should also try to think about a wide range of different organisations and the audit issues that are likely to arise. To do this, draw upon your own knowledge from work experience or from any other contact you may have – as a consumer or otherwise – with businesses and other organisations. This will help you to provide answers to examination questions that reflect current practice, rather than textbook descriptions from the past.

1.6.2 Essential reading

You should obtain or have regular access to one or other of these two textbooks:


You are also recommended to read:


Each of these texts contains references to articles and other sources, so there is no shortage of direction to further reading. Both Gray et al. and Porter et al. provide a good introduction to auditing, covering its theoretical underpinning and some of its practical aspects. There is no need to read both books since they cover essentially the same material in similar depths. Each of these books has the benefit of being written specifically with reference to the international auditing standards and each is written with an undergraduate audience in mind. The work of Sherer and Turley is not so much a textbook as a collection of chapters written by different authors, mainly academics. It is provocative but is also in need of some updating. You should always bear in mind that auditing is a dynamic subject; it is always changing, with new rules, new legislation, new cases and new scandals. So any book will quickly become outdated. However, the principles of auditing have remained virtually unaltered. These principles are also common across different countries and different legal frameworks.

Detailed reading references in this subject guide refer to the editions of the set textbooks listed above. New editions of one or more of these textbooks may have been published by the time you study this course. You can use a more recent edition of any of the books; use the detailed chapter and section headings and the index to identify relevant readings. Also check the VLE regularly for updated guidance on readings.

The United Kingdom regulatory system and international auditing standards

It should be noted that the two essential texts and the third recommended text, as well as this subject guide, are based on the legal and regulatory system in the United Kingdom, although they include reference to international auditing standards and other important international developments. The syllabus for this course states that you are not expected to know the detailed requirements of any specific country’s audit regulations, but the situation in the UK tends to be similar in many
respects to that in other parts of the world. The situation in the UK is therefore presented by way of illustration of the many issues surrounding auditing.

You should also obtain a set of either International Standards on Auditing (ISAs) (www.ifac.org/publications-resources/2013-handbook-international-quality-control-auditing-review-other-assurance-a) or your own country's Auditing Standards (if you are not sure then check on www.ifac.org/about-ifac/membership/members to find the name of your local accounting body and follow the links from there). In most countries, international and national standards are very similar, and in some cases international standards have been adopted in place of national standards.

### 1.6.3 Further reading

Please note that the Essential reading will only equip you with the bare essentials. You should always try to read around the subject area, regularly reviewing up-to-the-minute stories in the financial press. Many of the old-style newspapers now have free online access. In addition there are accounting-based newswire services on the web which will post regular bulletins to you. You will need to support your learning by reading as widely as possible and by thinking about how these principles apply in the real world. To help you read extensively, you have free access to the VLE and University of London Online Library (see below).

The large 'Big 4' accounting firms are involved in both audit and assurance. Use these firms' and others' websites to gain an understanding of the role of the firms and the different sorts of assurance services they offer:

- Deloitte: www.deloitte.com
- Ernst & Young: www.ey.com
- KPMG: www.kpmg.com
- PricewaterhouseCoopers: www.pwc.com

You are strongly encouraged to keep up to date by reading the professional press in your country and internationally. In the UK, this includes magazines such as *Economia* (http://economia.icaew.com) and newswires such as AccountingWeb (www.accountingweb.co.uk) as well as other sources.

In addition, if you wish to delve more deeply into the subject then the following provides a critical review of the role of the auditor and the explosion of audit/assurance into other areas:


A constant critic of the auditing profession in the UK has been Professor Prem Sikka, who runs a website (http://visar.csustan.edu/aaba/aaba.htm) which contains material on auditing 'failures'. Use this sort of perspective to balance the views given in the more conventional sources.

The internet is a useful, virtually free resource and you are encouraged to use it to further your studies and to satisfy your curiosity. However, as with any use of the internet, you need to pay particular attention to the reliability of the source of the information; official websites are more likely to give reliable information than amateur-hosted ones.

In Chapter 3 you are also recommended to read:

1.6.4 Online study resources

In addition to the subject guide and the Essential reading, it is crucial that you take advantage of the study resources that are available online for this course, including the VLE and the Online Library.

You can access the VLE, the Online Library and your University of London email account via the Student Portal at: http://my.londoninternational.ac.uk

You should have received your login details for the Student Portal with your official offer, which was emailed to the address that you gave on your application form. You have probably already logged in to the Student Portal in order to register! As soon as you registered, you will automatically have been granted access to the VLE, Online Library and your fully functional University of London email account.

If you have forgotten these login details, please click on the 'Forgotten your password' link on the login page.

The VLE

The VLE provides a range of resources for EMFSS courses:

• **Electronic study materials:** All of the printed materials which you receive from the University of London are available to download, to give you flexibility in how and where you study.

• **Discussion forums:** An open space for you to discuss interests and seek support from your peers, working collaboratively to solve problems and discuss subject material. Some forums are moderated by an LSE academic.

• **Videos:** Recorded academic introductions to many subjects; interviews and debates with academics who have designed the courses and teach similar ones at LSE.

• **Recorded lectures:** For a few subjects, where appropriate, various teaching sessions of the course have been recorded and made available online via the VLE.

• **Audiovisual tutorials and solutions:** For some of the first year and larger later courses such as Introduction to Economics, Statistics, Mathematics and Principles of Banking and Accounting, audio-visual tutorials are available to help you work through key concepts and to show the standard expected in exams.

• **Self-testing activities:** Allowing you to test your own understanding of subject material.

• **Study skills:** Expert advice on getting started with your studies, preparing for examinations and developing your digital literacy skills.

Note: Students registered for Laws courses also receive access to the dedicated Laws VLE.

Some of these resources are available for certain courses only, but we are expanding our provision all the time and you should check the VLE regularly for updates.

Making use of the Online Library

The Online Library (http://onlinelibrary.london.ac.uk) contains a huge array of journal articles and other resources to help you read widely and extensively.
To access the majority of resources via the Online Library you will either need to use your University of London Student Portal login details, or you will be required to register and use an Athens login.

The easiest way to locate relevant content and journal articles in the Online Library is to use the Summon search engine.

If you are having trouble finding an article listed in a reading list, try removing any punctuation from the title, such as single quotation marks, question marks and colons.

For further advice, please use the online help pages (http://onlinelibrary.london.ac.uk/resources/summon) or contact the Online Library team: onlinelibrary@shl.london.ac.uk

1.7 Examination advice

**Important:** the information and advice given in the following section are based on the examination structure used at the time this guide was written. Please note that subject guides may be used for several years. Because of this we strongly advise you to check both the current Programme regulations for relevant information about the examination, and the VLE where you should be advised of any forthcoming changes. You should also carefully check the rubric/instructions on the paper you actually sit and follow those instructions.

The examination is of three hours' duration. The paper consists of eight questions, of which candidates must attempt four. The paper is split into two sections. Section A contains four case studies. You must attempt at least two of them but you cannot do all four questions from Section A. Section B contains four essay questions. You must attempt at least one question from Section B but you cannot do more than two. This means that you will either answer two questions from each section, or three questions from Section A and one question from Section B. In the examination itself if you fail to comply with these requirements, your attempt will not be marked (e.g. if you attempt all four case studies from Section A, only the first three will be marked or if you write three essays from Section B only the first two will be marked).

Intelligent students know that since each question carries the same number of marks, they must divide their time equally between the chosen questions. Well-disciplined candidates are able once they have run out of time on one question, to move on to the next question. All too often Examiners see one very extensively answered question followed by three brief answers to the remaining questions – this is invariably evidence of poor time management by the candidate concerned.

Past examination papers are a good guide to the level of questions you may expect to face. They are also good revision material, although many of the questions have been reproduced in this subject guide. You are strongly advised to obtain examples of past papers as part of your revision, but I advise equally strongly against using the papers to ‘question spot’ (that is, trying to anticipate what may come up in the future). Be aware also that new developments may have rendered past questions or references therein obsolete. Moreover, the emphasis in, or contents of, the syllabus may have changed since the paper was originally set.

Diligent application to your studies will be rewarded. The main aim should be to acquire knowledge and understanding. If you simply memorise lists of items, you are unlikely to be able to use this ‘knowledge’ effectively.
This subject guide will highlight the areas that you need to concentrate on. Be disciplined in going through the guide in a methodical manner, doing the reading and making sure that you attempt the exercises and activities. Finally, in the examination itself, do justice to the effort you have put in preparing for the examination; do not be timid and skip parts of questions for fear of making mistakes. There is no negative marking so you will not be penalised if what you have written is deemed to be irrelevant, and there is a good chance that in most cases what you have put down will be worth something even if it is not quite what the Examiners are looking for. On the other hand, if you write nothing that is exactly what you will get in return. So you have nothing to lose.

Further guidance on examination technique is provided in Chapter 10. Sample examination papers are provided on the VLE along with Examiners’ commentaries.

Remember, it is important to check the VLE for:

• up-to-date information on examination and assessment arrangements for this course

• where available, past examination papers and Examiners’ commentaries for the course which give advice on how each question might best be answered.

If you work through this guide and the associated reading before the examination, you should have no need of anything more. Nevertheless I wish you all good luck and success in your studies.
Chapter 2: Reasons for auditing

2.1 Introduction

An obvious starting point in the discussion of any topic is the definition of the term to be discussed or studied. So what do we mean by ‘auditing’?

Auditing has at its root a fundamental mistrust of other people. We cannot be sure that passengers on a subway train have a valid ticket so we have ticket inspectors to check or automatic barriers to prevent passengers passing except on the presentation of a valid ticket. This is a form of check or control or ‘audit’. This sort of activity has a number of benefits; it prevents or reduces fare-dodging (a preventative effect), it means that more passengers will purchase a valid ticket since they may fear being caught (a deterrent effect) and it lends a sense of credibility and fairness to the whole system in the eyes of the public who one way or another are financing the system.

This is a simple form of check or control. I am sure that you can think of many more examples from everyday life. A common feature will be mistrust, even though we may not like to see things in that way. Audits therefore have the ability to add trust to a situation and they come in many forms, including:

- financial audits
- compliance audits
- management efficiency audits
- environmental audits
- energy audits
- social audits
- academic audits
- religious audits
- software licence audits
- circulation audits for newspapers.

Although the term ‘audit’ is used in conjunction with each of the above items, it is probably more correct to consider most of them under the general heading of ‘assurance’. The audit of financial statements is one form of assurance service but assurance services are not limited to financial information.

All these different types of assurance have different objectives and different contexts, but they generally share one common feature – they involve some notion of an independent check by one person upon the actions or activities of another.

Now read


Pause and think 1

Why do we need to check up on the activities of another person?
2.1.1 Aims of the chapter

The aims of this chapter are to get you thinking about the subject of the audit of financial statements specifically and of other assurance services more generally. It is also intended to give you a better understanding of the development of the discipline, with particular focus on the audit of company financial statements.

2.1.2 Learning outcomes

By the end of this chapter, and having completed the Essential reading and activities, you should be able to:

• explain what auditing and assurance services are
• describe how different forms of check or audit occur in many aspects of life
• briefly outline the development of company auditing since the mid-19th century
• explain what we mean by the expectations gap
• discuss some of the concerns about the role of auditors in the wake of the financial crisis of 2007–08 and what has been done to bridge that expectations gap.

By reading around the subject and keeping an openly curious mind, you will also see how the broad concept of audit is applied in many different contexts.

2.1.3 Essential reading


2.1.4 Further reading


Pasewark, W., R. Shookley and J. Wilkerson, Jr. ‘Legitimacy claims of the auditing profession vis-à-vis the behaviour of its members: an empirical examination’, Critical Perspectives on Accounting 6(1) 1995, pp.77–94.
2.2 Financial audits

Financial audits have a long history. From what we can decipher of the remaining records, the need for this type of audit has been recognised since the first civilisations. The Egyptians, the Greeks and the Romans all had notions of accounting, accountability and audit because in organised societies generally there were structures and organisations that placed individuals in positions of power and authority over other people's money and resources. When money was received or spent on behalf of the king, emperor or the people generally, there was a strong incentive for the individual government official to keep records that showed that the money had been properly and honestly handled. To add credibility to these records, an independent check, or audit, was carried out. Without this sort of check, no one could be sure that the officials had properly discharged their responsibility.

Activity

Identify situations when one person has possession of resources belonging to other people but no control or check is thought to be necessary. What is different? Why are no checks or controls thought to be necessary?

Now read

Porter et al. (2014) pp.8–18.

The audit of company financial statements is the main focus of this course because it is the oldest, most developed and regulated form of assurance. Because all forms of assurance share the common characteristics of an independent check by one person upon the information supplied by another, lessons learned in financial audit may be applied to other forms of assurance. Also, the 'success' of financial audit may in part be the cause of the growth in other forms of assurance, in what is sometimes referred to as the 'audit society' (Power, 1999).

Now read


Pause and think 2

What are auditing and assurance services and what role do they play in society?

2.3 Development of the company audit

A review of the development of UK company legislation, as it affects auditors, will help consolidate your knowledge of the background to the auditing of financial statements in the private sector. Obviously it is specific to one country but the changes which have taken place there have tended to reflect or be reflected in similar legislation elsewhere. The development of company audits is discussed in detail in Chapter 2 of Porter et al. The main points are highlighted here.

1844 Joint Stock Companies Act

This early legislation was quite far-sighted since it recognised the need for investors, who might not be involved in the running of their companies, to receive reliable information from those who did play a part in company
management. The Act required all incorporated companies to produce an audited balance sheet. The auditor was required to report on whether the balance sheet showed a ‘full and fair view’ of the reporting company’s position.

A major problem, however, was that there was nothing in the form of an organised accountancy or auditing profession in existence at that time. It was therefore hard for investors to tell whether the auditor was either competent or independent of management.

**1856 Companies Act**

This Act withdrew the compulsory annual audit and instead gave the Board of Trade, a government department, the right to investigate a company upon the application by one-fifth of the shareholders. It is not known how many investigations were carried out, but clearly this ad hoc inspection system was less reliable than regular audits of companies.

The 1856 Act did contain model articles of association (part of the constitution of companies) which allowed for an audit along the lines of the 1844 Act. The difficulty was that these were not mandatory and companies could choose to adopt alternative articles with no audit requirement.

During the middle of the 19th century there were financial scandals involving the management of banks, railways, friendly societies, industrial and provident societies. Parliament intervened to impose specific legislation and regulations, including accounting and audit requirements, on such industries.

**1900 Companies Act**

This Act introduced a compulsory audit for the generality of companies. There was no requirement for auditors appointed to audit company accounts to be professional. There was a bar, however, on directors and officers acting as auditors, so some attempt was made to ensure auditors enjoyed a degree of independence from management. In a similar vein, this Act gave auditors a right of access to all accounting records and information.

Under the 1900 Act, auditors had to report on whether the accounts showed a ‘true and correct view’.

**1948 Companies Act**

The scope of the audit was extended by this Act to cover both balance sheet and profit-and-loss accounts. In addition, auditors had to be members of one of the professional bodies. This was the first attempt to improve the competence of those who acted as auditors to companies in general.

Auditors were to report on whether the accounts showed a ‘true and fair view’; whether adequate books of account had been kept; whether the accounts agreed with the books; and whether all the information and explanations necessary for the audit had been received.

**Pause and think 3**

Why do you think the criterion for judging financial statements was changed from ‘true and correct’ to ‘true and fair’?

**1967 Companies Act**

This Act had the effect of reducing the length of standard ‘unqualified’ (unmodified) audit reports: from now on auditors would only refer to the additional matters on which they had to form an opinion if they were
not satisfied; for example, if they considered that the financial statements were not in agreement with the books of account. This meant that auditors’ reports typically amounted to a single paragraph containing the opinion on whether the accounts showed a true and fair view.

1976 Companies Act
The 1976 Act strengthened the position of auditors by requiring an auditor who had been removed or had resigned to make a statement setting out the circumstances of the termination of the position or a statement that there were no circumstances which should be brought to the shareholders’ attention. This provision was aimed at ensuring that auditors who had had serious disagreements with directors and no longer wished to remain as auditor could not slip away quietly without making their concerns known to those who were entitled to that information, the shareholders.

The Act also sought to enhance the quality of data that auditors checked by imposing requirements to improve the adequacy of companies’ accounting records.

1981 Companies Act
This major piece of legislation brought UK company law into line with that of other European countries. It increased the emphasis on the need for financial statements to show a ‘true and fair view’ and in fact made this an overriding requirement, meaning that companies could, in some circumstances, depart from the detailed requirements of the Act if compliance would have produced a result which was not true and fair.

The Act extended auditors’ work to require a review of the directors’ report to ensure that it was not inconsistent with the financial statements which it accompanied.

1985 Companies Act
The 1985 Act merely consolidated previous acts into one piece of legislation. No new law was introduced.

1989 Companies Act
The 1989 Act was another Europe-inspired statute. It introduced requirements for auditors to be more formally regulated than before. It required disclosure of fees paid to auditors for non-audit services as well as audit fees and allowed for the indemnity insurance premium of an auditor to be paid by the audit client.

2004 Companies (Audit, Investigations and Community Enterprise) Act
This Act further enhanced the regulation of, and monitoring of compliance with rules by, auditors.

2006 Companies Act
The biggest single piece of legislation to be passed by a UK Parliament, this Act allows companies and auditors to agree to place a ‘cap’ on amounts that may be claimed against auditors. It also makes it a criminal offence for auditors knowingly to issue a misleading audit report.

Now read

Then if you have access to a library, locate and read the article cited by Porter et al., pp.20–21 and Lee, 1998.
2.4 Expectations versus auditing reality

There is much confusion in the investing public's mind about the true nature of auditing and the assurance that auditors are expressing in their reports. Major misconceptions about the role of auditors continue, the most common being:

- Auditors are 'fraud detectives'.
- Auditors provide a guarantee of corporate solvency.
- Auditors conduct a management efficiency review.

All professions suffer from some sort of expectations gap (e.g. lawyers, doctors and surveyors), but the difference is that these groups tend to deal on a one-to-one basis with their clients, whereas auditors have a mass audience: the body of shareholders of their audit client, and others who may rely on audited financial statements. One mistake by an auditor could damage the financial fortunes of thousands. Thus there is a greater public interest not only in the proper performance of an auditor's duties, but in auditors meeting the expectations of the public. To some extent this is never going to be achieved since public expectations may be unreasonable, for example the expectation that an auditor is able to detect and prevent every fraud no matter how trivial.

Now read


Then locate and read the articles cited by Porter et al. on pp.53–56; Chandler et al., 1993; Chandler and Edwards, 1996 (this is available in the Online Library).

Pause and think 5

a. Why is it that lay (non-expert) people often expect professional people to be able to do more in the practice of their profession than is actually feasible?

b. Does it matter that the public has a different view from that of practitioners?
2.4.1 What can be done to close the expectations gap?

Steps that can be taken to reduce the gap between public expectations and audit performance include:

- improve auditors’ performance
- educate the public
- do something else, for example develop lower-level assurance services such as the Independent Professional Review, which was tried in the UK, although it was a short-lived experiment.

2.5 The auditors’ role in the financial crisis

In the UK, a Select Committee of the House of Lords has conducted an investigation into the role of auditors in the financial crisis. The report is available here:

www.publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/11902.htm

You should review Chapters 6 and 7 of the report (and more if you have the time and the energy!). This is a hard-hitting report and it made the profession sit up and take notice. In particular the dominance of the Big Four was a major source of concern not only because it appears to be an oligopoly which raises the fear of collusive pricing but also because if one of the Big Four were to fail (i.e. collapse) it would lead to a dangerously high concentration in the market for bank audits. It is a fact that the Big Four dominate the financial services industry as well as others and it is difficult to defend the position.

When it comes to the role of auditors causing the crisis, or at least contributing to it, there is more scope for debate. The banks were run by highly paid directors and managers. Some of these people essentially took risks with shareholders’ and depositors’ money without fully understanding or caring about the consequences if their bets did not pay off. Their objective was to create profits for their banks so that they could enjoy bigger bonuses and bigger pay packets. Shareholders themselves were happy provided the share price kept rising and dividends continued to be paid. Ordinary, private individuals probably are not sufficiently skilled to be able to understand the risks the banks were running but the majority of shares are held by financial institutions like pension funds. These institutions employ highly paid analysts and fund managers who are expected to have the skills and training to assess accurately the financial statement and other information coming on to the market – yet these too failed to raise any concerns about the state of bank finances or their banking strategies. Finally government and regulators whose jobs include monitoring the changing positions of major industries should also accept some portion of the blame. While none of these parties has completely escaped criticism it is noticeable that it is the role of the auditors in the financial crisis which has received so much attention.

For a balanced view of the situation, see both the ICAEW’s submission to the House of Lords Committee:
And the ACCA's at:

The point of recommending these things to students is twofold: first it makes you aware of the recent concerns which have been voiced at the highest levels in Parliament rather than simply presenting academic arguments which can sometimes be rather removed from the real world; and second, it alerts you to the current stage of evolution of the perceptions of the role of auditors.

Pause and think 6
To what extent do you think auditors of banks should bear some responsibility for the global financial crisis of 2007–08?

2.6 A reminder of your learning outcomes
Having completed this chapter, and the Essential reading and activities, you should be able to:

• explain what auditing and assurance services are
• describe how different forms of check or audit occur in many aspects of life
• briefly outline the development of company auditing since the mid-19th century
• explain what we mean by the expectations gap
• discuss some of the concerns about the role of auditors in the wake of the financial crisis of 2007–08 and what has been done to bridge that expectations gap.

By reading around the subject and keeping an openly curious mind, you will also see how the broad concept of audit is applied in many different contexts.

2.7 Test your knowledge and understanding

2.7.1 Sample examination questions
1. Discuss how and why the primary objective of the company audit has changed over time.
2. Evaluate the extent to which the performance of company auditing meets public expectations and consider the implications of any divergence between performance and expectations.
3. ‘The need for auditing is based on the assumption that no one can be trusted to be honest.’ Discuss the extent to which you believe this to be true.
4. When companies fail shortly after receiving an unmodified auditors’ report, there is nearly always criticism of the auditors. To what extent do you think such criticism is valid?
5. Critically evaluate the purpose of an audit of financial statements.
2.8 Hints

2.8.1 Pause and think questions

1. If we could trust other people to act as they should then there would be little point in having a check upon them. But people make mistakes sometimes; and a few people are dishonest so that we can never be sure that they have done what they are supposed to. Having a check upon other people means that we have added assurance that mistakes and or dishonesty are less likely – but we can never be totally sure.

2. Auditing and assurance services are part of the process of adding assurance that processes have been properly conducted. They add assurance because an independent, competent auditor/reviewer has examined the process and/or output from the process and has communicated a level of satisfaction. With more satisfaction, there is more confidence in the system and therefore more people are likely to engage with the process whether that is investing in company shares or buying goods which have been organically cultivated.

3. It is difficult to see the difference between the words ‘true’ and ‘correct’. There is also the problem that the truth can be presented in a misleading way. The word ‘fair’ means that financial statements should be as objective as possible.

4. The powers and rights of auditors have been increased. There is now less chance that they may have information withheld from them. On the other hand, it is now a criminal offence to issue an audit report without genuine belief in its accuracy, so the position of the careless auditor has not improved.

5. a. Lay people clearly cannot fully understand the technical procedures that go into a process and they often find it difficult to accept that judgements are required and that no one is perfect. There is also the hope that someone else can solve our problem.

   b. If people’s expectations are routinely disappointed, it might have a negative impact on the standing of that profession. Other competing professions may seek to move into that area by offering to do a better service. So while it may be inevitable that professions all suffer from the expectations gap to some extent, it is important that they take steps to manage the gap.

6. The fault of course lies with the perpetrators of bad banking practice – the bankers themselves. Supervisory authorities too must bear some of the blame since their job was to monitor the banking sector. But auditors have not escaped and while it has not been alleged that they were irresponsible, the extent to which the large audit firms earned substantial fees for non-audit work has called into question their objectivity. The crisis has also aroused concern that there are too few of these large firms, which exposes the system to the risk that should something happen to one of the Big Four, the remaining three firms would find it difficult to sustain the illusion that there is a fair market for audit services.

2.8.2 Sample examination questions

1. You should reflect on the move from fraud detection to financial statement verification. Consideration also needs to be given to the difficulty of effectively detecting fraud.
2. You need to rehearse the various arguments based on the evidence that suggest that the public expects more of auditors than auditors can deliver (fraud, going concern and management efficiency are three of the main areas). You also need to think about the consequences for the profession if public expectations remain unsatisfied.

3. Sadly this comment contains more than a grain of truth. If everyone could be trusted then auditing would have little value. However, if ‘no one’ could be trusted then there would be no point in having auditors since they too could not be trusted.

4. Auditors cannot see into the future any better than anyone else. However, the audit (or part of it) takes place after the year end when more information is available. Auditors will have to look at cash flow forecasts, order books and so on to judge the liquidity status of the client but they can never be expected to guarantee solvency.

5. The phrase ‘critically evaluate’ carries the connotation that you have to consider both sides of the argument. In this case, you would need to expand on what the audit can and cannot achieve.
3.1 Introduction

For many years, the study and practice of auditing centred on the pure mechanics of conducting an audit, concentrating on how to perform an audit. However, as it became more of an established profession and, more recently, accepted as an academic discipline, more attention was focused on the theoretical and conceptual underpinnings of the practice. Thus, questions were explicitly raised about why certain procedures were carried out.

The first coherent attempt came from American academics, Mautz and Sharaf, who in 1961 published *The philosophy of auditing*. This was an important development as it helped gain some measure of academic acceptance for auditing. Mautz and Sharaf drew from established fields of study such as philosophy, the sciences and law in producing a theory which helped to explain much of the accepted practice in auditing. Their theory also helped to highlight areas of practice that did not stand up to critical review, notwithstanding that such areas were generally accepted.

In the UK more than 10 years later, a Scottish academic, Professor Tom Lee, built on and adapted the work of Mautz and Sharaf to produce his own ‘theory’ in *Company auditing*. This book was refined and polished into a third edition (last published in 1986). Sadly, Lee’s later book – *Corporate audit theory* (1993) – is aimed at the US market and much of the easy accessibility of the earlier versions has been lost.

Another Scot, Professor David Flint, has written *Philosophy and principles of auditing*, building on Mautz and Sharaf and on Lee. The accounting establishment has shown little interest in, or enthusiasm for, pursuing theoretical lines of enquiry. This is in contrast to the financial reporting field where over the years millions of dollars have been invested in seeking what some have called the holy grail of accounting – a conceptual framework – which currently takes the form of the *Framework for the preparation and presentation of financial statements* published by the International Accounting Standards Board (IASB). Similar statements have been issued by national standard-setters, such as the *Statement of principles* by the Accounting Standards Board (ASB) of the UK and the *Conceptual framework for financial reporting and the presentation of financial statements* by the Accounting Standards Council in Singapore. It is interesting to debate why the effort has been made to formulate theories about accounting but not about auditing, the process which renders accounting statements valuable; however, that is beyond the range of our studies at present.

Pause and think 1

a. What is a theory?

b. What purpose would be served by a theory of auditing?

3.1.1 Aim of the chapter

The aim of this chapter is to provoke thoughts about the general principles and concepts behind the practical procedures that we will study in depth later on. You will also be able to discuss aspects of theory construction and its relevance in the context of auditing.
3.1.2 Learning outcomes

By the end of this chapter, and having completed the Essential reading and activities, you should be able to:

- explain what constitutes a theory
- explain the difference between assumptions and concepts
- discuss the role a theory of auditing could perform
- list the main components of a possible theory of auditing.

3.1.3 Essential reading


3.1.4 Further reading


3.1.5 Works cited


3.2 The role of theory

The dictionary definition of a theory is:

- a supposition put forward to explain something; an exposition of the general principles of an art or a science as distinct from the practice and execution of it.

So an auditing theory, if one could be developed, would explain practice and put forward general principles. It has been argued that, if we had general principles, we could use these to develop practices and to adapt to new challenges and situations that might arise. Without principles, procedures may evolve in an ad hoc manner, with no cohesion or internal consistency.

In addition, if a theory could be developed, it could help to explain practice, could highlight deficiencies and inconsistencies in existing practice and could guide audit policy-makers and regulators in their governing of the audit profession. It could also help teachers of auditing to explain the practice of auditing to their students, who in turn could gain a better understanding of their subject. Without a theoretical basis, auditing would be the application of a series of procedures, more akin to the practice of a trade, rather than a profession.

Now read

3.3 Assumptions of auditing

Assumptions (theoreticians sometimes call them postulates) are the foundations of theory. Think back to your early studies of economic theories which only ‘work’ if you make certain assumptions (for example, the model for perfect competition assumes that consumers aim to maximise utility and producers aim to maximise profits). If these assumptions do not hold, the model fails. Let us now consider Flint’s seven assumptions.

Assumption 1: There is a need for an audit based on a relationship of accountability

The need could be based on a situation where one party owes a duty of acceptable conduct to another or an audit has been imposed by one party on another (for example, companies, government, charities).

In other situations, the need for an audit may come about because one party wishes to establish the reliability and credibility of information for which they are responsible and which will be used by another party; a ‘voluntary audit’ (for example, partnerships, companies which engage environmental auditors, newspapers that have their circulation figures audited).

In still other situations, the public interest in the proper and adequate performance of some party may require an audit; this is sometimes referred to as a ‘public interest audit’ (for example, academic audits designed to test the robustness of the systems employed by educational establishments in delivering services to their students).

Pause and think 2

Think of other examples of situations where an ‘audit’ may be necessary.

Assumption 2: The subject matter is too remote, too complex or too important to accept without an audit

Remoteness: those relying on information may not physically be able to check the validity of the information themselves, perhaps because they are remote from the company.

Complexity: the nature of the subject is so complex that it requires special expertise to investigate and check. For example, most ordinary shareholders do not possess sufficient accounting knowledge and skills to be able to conduct the audit themselves.

Significance: the matter under audit has such economic significance that an audit is required to lend it credibility. Note in contrast that unincorporated entities are often not required to have an audit, because lenders have recourse to the assets of the owners in the event that the business entity cannot meet its liabilities.

Pause and think 3

Do you think that it would be possible for ordinary shareholders with no accounting or auditing qualifications to perform tests on the information in the financial statements themselves?
Assumption 3: An audit must be conducted with independence and without constraints either over conduct or in reporting findings

If an audit is to add credibility then it must be done independently, without bias or prejudice. A prime example is that of state auditors, who since the time of Aristotle have had to be independent of the government which they are auditing. In the words of Emile Woolf, for many years a leading authority on auditing matters: ‘The auditor who has lost his independence has lost his raison d’être; he has become ‘dependent’, and a dependent auditor is a contradiction in terms’ (Woolf, 1997, p.349).

The independence of auditors has been called into question once again following the banking crisis. Inquiries into the current state of auditing have caused politicians in the UK and elsewhere to ask tough questions of the auditing firms which not only audited the banks but also provided them with other professional services which earned the firms large fees. In addition, other links between clients and auditors have cast doubt on the objectivity of the latter, for example, when senior staff leave an audit firm and join an audit client.

Pause and think 4

What other sorts of situations might lead to a loss of auditor independence?

Assumption 4: The subject matter of an audit can be verified by collection of evidence

Auditors report the results of their investigations. Without evidence they have nothing on which to base their report, to make judgements or criticisms. An audit is impossible if evidence is not available or cannot be obtained. In practice, audit evidence comes from many sources. It varies in its persuasiveness depending on quantity collected and quality (source).

Pause and think 5

What sorts of evidence might be available in the audit of a retail outlet for, say, sales (revenue) and expenses?

Assumption 5: Standards of accountability, performance, etc., can be set and actual performance can be measured against these standards

Parties to an accountability relationship must agree on what is acceptable performance. Without this, auditors have nothing to go by. They cannot set their own standards since these may be rejected by either party. In company auditing some of these standards have been set down (by statute or by professional guidance), but grey areas still remain. What constitutes a ‘true and fair view’? What should auditors do when they discover a client has committed an illegal act?

Pause and think 6

Is the giving of a bribe wrong when it is the only way for the company to get business in some parts of the world?

Assumption 6: The purpose of the audit is sufficiently clear that its results can be communicated clearly

The purpose of an audit is to add value to information. If the nature or purpose of the information itself is not clear, it cannot be audited. If the audit findings cannot be communicated effectively then inevitably the value of the audit will be diminished.
Over the years a lot of debate has taken place over the contents of the auditors' report. Starting in the late 1980s we began to see an expansion of the auditors' report which had been a simple statement of one or two paragraphs into a document that covered two or more pages with many more items being covered within. Since the global financial crisis of 2008, the audit regulators around the world have been moving towards further radical changes in order to grapple more successfully with the problem of better communicating the messages which auditors are trying to convey to interested parties (this topic will be covered in more detail later).

Assumption 7: An audit produces an economic or social benefit

Since audit is a social control mechanism it should only be undertaken if the benefits outweigh the costs. Auditors are expected to provide the benefit at minimum cost. In most audit situations the major part of the work involves the collection of evidence. While a minimum level of confidence must be achieved, absolute certainty is unattainable. There is a point at which the marginal benefit of obtaining additional evidence is exceeded by the marginal cost. The direct costs of auditing are known but the benefits are not so easily measured.

Pause and think 7

Do you think that the purpose of the company audit is well understood? What sort of misunderstandings about the purpose of an audit have been shown to exist?

Pause and think 8

Auditing the financial statements of the largest companies costs industry huge sums of money. Apart from the audit firms, who benefits from this auditing activity and how do they benefit?

3.4 Auditing concepts

A concept is an abstract notion or idea. The role of concepts is to create a better understanding of the subject. Concepts form the basis for developing general working principles and practices by which theories are articulated and put into operation.

These concepts, or general ideas, can be grouped into four categories, according to whether they relate to the auditor's credibility, the audit process, the communication of the audit outcome (reporting), or the performance of the auditor's work. These general ideas form the basis of the next four chapters. They are:

- reporting
- independence
- evidence
- responsibility.

Different authors have come up with different names for these concepts and some have broken each one down into further sub-concepts but these four will suffice for our purposes.

Now read


3.5 Recognition of theoretical issues in practice

There is no generally agreed theory or conceptual framework for auditing in the UK or elsewhere for that matter. The only authoritative reference to general ideas on the values behind the audit process that can be found in official documents in the UK is in the form of a one-page list of desirable qualities, The auditors’ code. The code sets out nine fundamental principles of independent auditing, as follows.

**Accountability**

Auditors act in the interests of primary stakeholders, while having regard to the wider public interest. The identity of primary stakeholders is determined by reference to the statute or agreement requiring an audit: in the case of companies, the primary stakeholder is the general body of shareholders.

**Integrity**

Auditors act with integrity, fulfilling their responsibilities with honesty, fairness and truthfulness. Confidential information obtained in the course of the audit is disclosed only when required in the public interest, or by operation of law.

**Objectivity and independence**

Auditors are objective. They express opinions independently of the entity and its directors.

**Competence**

Auditors act with professional skill, derived from their qualification, training and practical experience. This demands an understanding of financial reporting and business issues, together with expertise in accumulating and assessing the evidence necessary to form an opinion.

**Rigour**

Auditors approach their work with thoroughness and with an attitude of professional scepticism. They assess critically the information and explanations obtained in the course of their work and such additional evidence as they consider necessary for the purposes of their audit.

**Judgement**

Auditors apply professional judgement, taking account of materiality in the context of the matters on which they are reporting. (See Chapter 7 of this guide for further discussion of materiality.)

**Clear communication**

Auditors’ reports contain clear expressions of opinion and set out information necessary for a proper understanding of that opinion.

**Association**

Auditors allow their reports to be included in documents containing other information only if they consider that the additional information is not in conflict with the matters covered by their report and they have no cause to believe it to be misleading.
Providing value

Auditors add to the reliability and quality of financial reporting; they provide to directors and officers constructive observations arising from the audit process; and thereby contribute to the effective operation of business, capital markets and the public sector.

Activity

Read the author comments on the code in Gray et al., Table 1.2 ‘The Auditor’s Code’, on pp.26–28.

You will note that the word ‘should’ does not appear at all in the code. This is because it is felt that instructions on what auditors should, and should not, do can only be given in auditing standards.

It is worth pointing out that, as with any of the topics on the syllabus, you would not be expected to memorise, let alone reproduce, the entire set of ideas. If the topic of auditing theory were to appear on the examination paper, it is likely to be an essay question worth 25 marks for which you should allot no more than 45 minutes. The well-prepared candidate is likely to be able to write on the topic for much longer than this but to do so would not be an effective use of time. The typical error in examination answers committed by candidates who are clearly knowledgeable on the subject is to write all they know. This often takes the form of lists of points, for example, a list of the underlying postulates or assumptions. While such lists may be complete in as much as they cover all the points, they do not constitute a properly structured and well argued essay. Consequently such answers are unlikely to obtain more than a bare pass mark. What the intelligent candidate always seeks to do is to answer the question within the allotted time. If this means that some points cannot be covered then so be it. But you must always attempt to address the particular question and not just reel off your revision notes.

3.6 A reminder of your learning outcomes

Having completed this chapter, and the Essential reading and activities, you should be able to:

• explain what constitutes a theory
• explain the difference between assumptions and concepts
• discuss the role a theory of auditing could perform
• list the main components of a possible theory of auditing.

3.7 Test your knowledge and understanding

3.7.1 Sample examination questions

1. Explain what you would consider to be the main components that a theory of auditing would include.

2. Consider the benefits of having a sound theoretical basis from which to develop auditing standards.

3. The IASB has issued its Framework for the presentation of financial statements and the ASB has issued a Statement of principles for financial reporting. To what extent do you think it would be possible to produce a ‘statement of principles’ for auditing?
3.8 Hints

3.8.1 Pause and think questions

1. a. A theory is an abstract set of ideas which helps us to understand the part of the world we are contemplating.

   b. A theory of auditing would help us understand what an audit seeks to achieve and more importantly how it can achieve the desired end. Auditing standards are practical guides but they are not theoretical.

2. There are so many different examples of situations where we need some form of check but they will nearly all fit into one of these three categories.

3. It would be difficult to see how it would be practical for a company to open its books to all shareholders and since most investors lack accounting skills, it would be a worthless exercise. So the answer to the question is almost always going to be 'No'.

4. There are a number of threats to audit independence: close personal relationships, long working relationships or financial involvement with an audit client are just some examples of situations which might impair audit independence.

5. The evidence that auditors might look for to support sales revenue would include the till receipts but of course this only reflects the transactions which have been recorded and there is the possibility that items have been sold and the proceeds have been stolen. So auditors would look at things like turnover ratios and profit margins to see if there were any distortions. For expenses, invoices and evidence that the goods had actually been received would provide evidence. For both income and expense quite a lot of emphasis would be placed on the auditors' assessment of control systems.

6. This is a very sensitive area and one where answers can validly differ depending on one’s ethical and cultural background. The furore that has followed revelations in westernised countries about bribery and corruption committed by respected companies would suggest that the public and political perception of this problem is that it is not acceptable. In the UK, auditors who discover illegal acts committed by clients are expected to report those acts to the appropriate authorities which may include the police.

7. The evidence suggests that the audit of financial statements is almost certainly not well understood. The public still associate the process of auditing with the detection of fraud. They also imagine that auditors somehow are able to ‘guarantee’ that clients are financially sound.

8. It could be argued that we all benefit from having greater confidence in the accuracy of the information being fed to the markets. A better informed stock market is more stable and this will be more likely to stimulate economic growth, creating more jobs and more wealth.

3.8.2 Sample examination questions

1. You would need to have a good grasp of the various theories of auditing and be prepared to discuss the different assumptions and concepts not as a list, but as a flowing explanation. It is unlikely in the time available in the examination that you could produce a comprehensive review so it would be important to make sure that you touched on the main parts.
2. An accepted theory of auditing would help everyone from teachers to students to practitioners and to standard-setters. It would provide a sound basis for understanding what auditing is about and how it could be better done.

3. This is quite a tricky question and one that you should not tackle by simply repeating the lists of assumptions and concepts. There is no obvious reason why a theory of auditing has not evolved. However, it would not be a simple task because notions of auditing may vary, albeit slightly, in different countries. In addition it would take time and money to get agreement. The fact that it has been achieved for financial reporting suggests that, if there were the ‘political will’, it should be possible to come up with a ‘statement of principles’ for auditing.
Chapter 4: Independence

4.1 Introduction

There are a number of different perspectives from which one can view audit independence. The conventional four main aspects of independence that we will consider are:

• programming independence
• investigative independence
• reporting independence
• real and perceived independence.

The first three of these were identified by Mautz and Sharaf (1961) as relating to individual auditors (or audit firms). Mautz and Sharaf also discussed independence at the level of the audit profession itself.

Now read


Activity

Make a list of as many potential threats to independence as you can that may affect an individual auditor. For each threat, note down what measures you think that the following could take to address these threats:

• an individual auditor
• the profession as a whole.

Many attempts to address auditor independence have been made over the years. In the USA, the Sarbanes–Oxley Act seriously curtailed the provision of other services to audit clients (following Enron and other scandals). More recently searching questions have been asked of the role of the big auditing firms in the banking crisis of 2007–08. Much of that concern centred on the provision of other services by audit firms to banks which were audit clients.

It would seem that independence remains a contentious issue long after the first independence rules and ethical codes were established.

What follows are extracts from the current legislation in the UK, the Companies Act 2006. Obviously the legislation in your own country may be different but it is likely to contain similar provisions on most of the important issues. Nevertheless, whether you are learning about your own national laws and regulations or reviewing the position in the UK, great care needs to be taken to ensure that you are not relying on material that is out of date. Government websites usually allow easy access to the most relevant legislation and you should always check your sources against them. Very often major changes in legislation will be flagged up in the professional press before they become effective, so you should try to keep up to date by regularly reading the journals of the relevant accountancy bodies. Although the legislation is of course only relevant in the UK, there are other countries around the world which often implement similar legislation.
In the UK, the Companies Act 2006 has made changes to provisions affecting auditors, but many of the principles from the previous Act remain (the section numbers in the new Act are of course quite different to those in the previous legislation).

Now read

4.1.1 Aim of the chapter
The aim of this chapter is to explain the essential quality of auditing – auditor independence – and the threats which exist to undermine that independence; as well as the safeguards which may be established to counter such threats.

4.1.2 Learning outcomes
By the end of this chapter, and having completed the Essential readings and Activities, you should be able to:
• explain what audit independence entails
• explain why audit independence is important
• examine the current concerns relating to auditor independence
• describe steps which have been taken to ensure that auditors retain their independence
• evaluate the effectiveness of these various measures
• suggest other possible means of achieving auditor independence.

4.1.3 Essential reading
Holland, K. and J. Lane ‘Perceived auditor independence and audit firm fees’, Accounting and Business Research 42(2) 2012, pp.115–41.
Chapter 4: Independence

4.1.4 Further reading
Sherer and Turley, Chapter 3.

4.1.5 Work cited

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4.2 Companies Act 2006, Part 42

The main purposes of this part of the Act are to ensure that only those who are properly supervised and appropriately qualified are appointed auditors and that audits are carried out properly, with integrity and a proper degree of independence (s.1209).

Eligibility (s.1212)
An auditor must be a member of a Recognised Supervisory Body (RSB) and must be entitled under the RSB's rules to act as auditor (this establishes the concept of a Registered Auditor).

Ineligibility (s.1213)
A person cannot act as auditor if they are ineligible. If someone is appointed and then becomes ineligible, they must resign immediately and give notice to the company.

Independence requirement (s.1214)
A person cannot act as auditor if they are an officer or employee of the company to be audited, or if they are the partner or employee of an officer or employee; or if they are an officer or employee of an associated undertaking (parent company or subsidiary).

Effect of lack of independence (s.1215)
If during his term of office, an auditor becomes prohibited from acting (under the independence requirement), he must resign immediately and give notice to the company in writing. It is an offence if he does not comply.

Effect of appointing a partnership (s.1216)
If a partnership is appointed, the firm is the auditor not the individual partner(s).

4.3 Companies Act 2006, Part 16

Appointment of auditors (s.475)
A company's accounts must be audited unless it is exempt or dormant. Members may require an exempt company to have its accounts audited.

Section 485 Private companies
The company's directors may appoint its first auditor, or its first auditor after it ceases to be exempt or to fill a casual vacancy. In all other cases, it is the members who appoint the auditor.

Section 487
Auditors hold office until they are replaced or they resign.
**Section 489 Public companies**

Auditors must be appointed for each year by directors to begin with (as with private companies), then by ordinary resolution of the members.

**Section 491**

Auditors cease to hold office at the conclusion of the next accounts meeting after their appointment unless they are re-appointed.

**Remuneration (s.492)**

The auditors’ remuneration is fixed by shareholders unless the auditor was appointed by the directors or the secretary of state. The term ‘remuneration’ includes expenses and benefits in kind.

**Disclosure of terms and remuneration (ss.493–4)**

The secretary of state may make regulations requiring disclosure of terms of auditors’ appointment and the nature of non-audit services provided by the auditor.

**Auditor’s duties (ss.495–8)**

These sections of the Act are aimed at ensuring reporting independence. Auditors must make a report to the company’s members on all annual accounts sent to them. The auditors’ report must include an introduction identifying the audited accounts and the reporting framework and a description of the scope of the audit identifying the auditing standards. Auditors must state clearly whether in their opinion the accounts give a true and fair view, have been properly prepared in accordance with the framework and prepared in accordance with the Act. The report must be unqualified (unmodified) or qualified (modified) and must include a reference to any matters to which the auditor wishes to draw attention without a qualifying (modifying) report. Auditors report on whether information in the directors’ report is consistent with the accounts. They also report on the auditable part of the directors’ remuneration report.

Auditors must carry out investigations to determine and report (in the negative) if adequate accounting records are not kept, if the accounts do not agree with records or if they fail to obtain all the information and explanations necessary for their audit.

Auditors must report if aspects of disclosure of directors’ remuneration do not comply with the relevant regulations. They must report if the company has prepared accounts under the small-company regime, but the auditors consider that the company is not entitled to use this regime (for example, because it is too large).

**Auditors’ rights (ss.499–500)**

These sections are to ensure investigative independence in that neither directors nor anyone else can restrict the evidence which auditors may require for the purposes of their audit.

- Auditors have the ‘right of access at all times to the company’s books, accounts and vouchers and may require such information and explanations as are necessary’.

- Auditors ‘may require a company to obtain from overseas subsidiaries information and explanations. Company directors must take all reasonable steps to obtain the requested information and explanations’.
Offence (s.501)

It is a criminal offence to provide recklessly or knowingly information which is misleading, false or deceptive in a material particular.

Meetings (s.502)

Auditors have the ‘right to be notified of any general meeting and to attend that meeting and be heard on any matter concerning them as auditors.

Removal/resignation of auditor (ss.510–26)

Only shareholders can remove an existing auditor (by ordinary resolution) in general meeting with special notice. Once the resolution is passed the company must notify the Registrar of Companies within 14 days.

It is possible that auditors in some circumstances may wish to resign – they are entitled to do this but they must deposit a written notice with the company.

When auditors cease to continue in office, either because they have been removed or have chosen to resign, they must make a statement containing a description of the circumstances. The company concerned must circulate this statement to members within 14 days (or it may apply to court for an order to prevent the circulation on the grounds that the auditor is using the report to secure needless publicity for a defamatory matter).

For a failed attempt to silence an auditor, see Jarvis v PwC 2000, outlined in Gray et al. (2015), p.161. For evidence that the market takes notice of auditor resignations and marks down share prices accordingly, even when auditors claim that there are no circumstances to be brought to the shareholders’ attention, see Dunn, Hillier and Marshall (1999).

The auditors must file a statement of circumstances at Companies House and both the auditors and the company must notify the appropriate authorities where the appointment which has ended relates to a major audit (a listed company or a major public interest company).

4.4 Auditing Practices Board ethical standards

Now read

Holland, K. and J. Lane ‘Perceived auditor independence and audit firm fees’, Accounting and Business Research 42(2) 2012, pp.115–41.

In the UK, the Auditing Practices Board (APB) was reorganised in 2012 as part of the restructuring of the Financial Reporting Council. Nevertheless, the Ethical Standards (ESs) issued in December 2004 remain as authoritative statements governing auditors in the UK. In substance the ESs conform to the revised independence code of the International Federation of Accountants and so will be similar in content to many independence rules around the world. These standards seek to deal with the various threats to auditors’ objectivity. These are:

• self-interest threat (e.g. investing in clients)
• self-review threat (e.g. producing a valuation for inclusion in the client's financial statements)
• management threat (e.g. taking a decision on behalf of management)
• advocacy threat (e.g. supporting management in litigation)
• familiarity threat (or trust) (e.g. close relationship with client personnel)
• intimidation threat (e.g. by dominant senior executive).

ES1 Integrity, objectivity and independence

Firms should have policies and procedures in place to identify threats to their actual and perceived objectivity and independence and to identify and assess the effectiveness of any safeguards.

In the case of listed company audits, an independent partner should review the firm's compliance.

ES2 Financial, business, employment and personal relationships

Financial relationships

Financial interests: An audit firm, a partner, or a person in an influential position in the firm (or an immediate family member) should not have a direct financial interest in a client. Neither should an auditor have a material indirect interest or an indirect interest through an intermediary where the auditor has the ability to influence the intermediary or knows of the underlying investment in the client.

If, for example, an auditor inherits under a will shares in an audit client, the shares must be disposed of immediately.

Interests held as trustee: Trustee holdings in an audit client are acceptable where the auditor is not a beneficiary of the trust, or the interest is immaterial to the trust, or the trust is not able to exercise significant influence over the client, or the auditor does not have significant influence over the trust.

Loans and guarantees: No loans should be made to – or received from – a client except in the ordinary course of business on normal business terms and the loan is not material either to the firm or its client.

Business relationships

General: Auditors should avoid doing business with audit clients unless the transaction involves the purchase of goods or services in the ordinary course of business on arm's-length terms and for values which are not material to either party. Firms should not provide audit services to any party able to influence the affairs of the audit firm or conduct of its audit.

Employment relationships

Management role: Auditors should avoid situations where they are employed by both the audit firm and the audit client. Such situations might arise when an audit client is faced with a sudden vacancy caused by the unexpected departure, illness or death of a key member of its staff. The client may turn to its audit firm for help in an emergency. Audit firms should not provide staff on secondment unless it is to a non-managerial post and the client accepts responsibility for directing the work of that staff member. On return to the audit firm, that individual should not be given responsibility for auditing the work that they did for the client (since this would ignore the self-review threat).
**Auditor joining client:** If a member of the audit firm leaves the firm to join an audit client, that individual must sever all links with the firm. Auditors should notify the audit firm’s management as soon as a move to an audit client looks likely. The individual concerned should stand down from the audit and their work on the current and last audit should be reviewed.

If the individual moving to the client is the audit partner and they are moving to take up a senior management post, then the audit firm should resign from the audit and should not allow itself to be considered for re-appointment for two years. If a more junior member of the audit team makes the move to a key management post with the audit client, then the audit firm should reconsider the composition of the team. It may be that those who remain on the audit team had developed such close ties with their former colleague that their objectivity, now that the colleague holds a senior post with the client, cannot be guaranteed.

The evidence on this aspect of independence is not compelling. Dart and Chandler (2013) find that institutional investors hardly seem concerned at all that ex-auditors often find work in a former audit client. And while there is more concern among private individuals as shareholders there is very little desire on the part of shareholders generally for the professional rules to be further tightened to prevent movement of personnel between audit firm and audit client. However, financial journalists are not slow to pick up on apparently cosy relationships as witnessed recently in the *Independent* newspaper in June 2013 when it reported warnings to the board of the Royal Bank of Scotland not to appoint any more former executives from its auditors, KPMG.

**Governance role:** Auditors should avoid being appointed to the board or a subcommittee of the board of an entity that holds more than 20 per cent of the voting rights in one of their audit clients.

**Employment with auditor:** It sometimes happens that audit firms wish to appoint to a staff position a former employee of an audit client. Where that individual had some influence over the accounting function in the client or the production of its financial statements, the audit firm should take care to ensure that the new employee is not allocated to the audit team responsible for the audit of their former employer for two years.

**Personal relationships**

Firms should institute policies and procedures to alert them to family and other relationships between audit team members and clients. For example, audit firms should inform their employees on a regular basis of their client portfolio and employees should be asked to make a declaration of their relationships and financial interests in clients of the firm.

**ES3 Long association with the audit engagement**

To ensure that the relationship between listed companies and their auditors does not become too familiar, the audit engagement partner should be replaced after five years (other partners who have a role in the audit should not serve the same listed client for more than seven years). For non-listed companies, audit firms need to consider whether the partner is or may be seen to be independent after 10 continuous years. If an audit client becomes listed then the five-year rule still applies, although a special arrangement allows an audit partner who has served the client for four years prior to listing to continue to serve for two years after listing.
**ES4 Fees, remuneration, evaluation policies, litigation, gifts and hospitality**

**Fees**
Fees should not be charged on a contingent basis, for example as a commission or as a percentage of some unknown amount, such as some future financial saving made by the client.

Firms should be aware that unpaid audit fees may threaten their independence (unless they are for trivial amounts). In effect, outstanding fees owed by the client to the firm are a form of loan by the auditors and may be used by the client as a lever to get the auditors to accept treatments they would not otherwise accept. The client may threaten not to pay these overdue amounts unless the auditors agree with the client.

A firm should not act where fees (audit and non-audit) from the client exceed 10 per cent of the firm’s total income.

**Remuneration and evaluation policies**
Firms should ensure that the objectives of the audit team do not include selling non-audit services, nor are their appraisals or pay dependent on persuading clients to engage the firm to perform such other services.

**Litigation**
When litigation in relation to an audit firm’s services, which is not insignificant, has been or is about to be started, the audit firm should not continue with or accept the engagement.

**Gifts and hospitality**
Auditors should not accept gifts from clients unless they are clearly of insignificant value, nor should they accept hospitality unless it is reasonable in terms of frequency, nature and cost. Audit firms should have policies to ensure that staff understand these principles and comply with them.

**ES5 Non-audit services provided to audit clients**
The audit partner must be informed of all non-audit services that the firm renders to the audit client. Before accepting a non-audit engagement, the audit engagement partner must consider the appearance of the firm’s independence (or lack of it), identify possible threats and assess effectiveness of the firm’s safeguards. Where there appears to be a conflict, a firm should either not accept the non-audit engagement or decline/withdraw from the audit.

The firm should inform those charged with governance (i.e. the audit committee or its equivalent).

There are restrictions on the kind of other services that the firm must also bear in mind:

- Internal audit services are generally thought not to be compatible with the external audit.
- Information technology services, again, are not thought to be compatible with the independent audit function.
- Valuation services should not be provided where the matter is highly subjective and material to the financial statements.
- Actuarial services should not be provided unless all significant judgements are taken by management or are immaterial.
• Tax services should not be provided where the audit partner has doubts about the appropriateness of any accounting treatments or the tax services are to be remunerated on a contingent fee basis which is material or is dependent on uncertain tax law.

• Litigation support services should not be provided where they involve giving an estimation of the likely outcome of a case, which is material and very subjective.

• Legal services should not be provided if the matter is material.

• Recruitment services should not be provided if they involve making a decision to appoint personnel to the client’s staff. For listed clients, no recruitment services should be provided in relation to key management positions. Auditors should not undertake to advise on remuneration packages of key management posts.

• Corporate finance should not be offered if it amounts to dealing or promoting shares, or if the firm has doubts as to the appropriateness of any accounting treatment, or if the service is to be remunerated on a contingent fee basis.

• Accounting services should not be offered for listed companies (except to cover emergency situations). Auditors may assist audit clients who are not publicly listed, provided transactions are not initiated by the audit firm employees, no decisions are taken by them and the firm implements safeguards to maintain their independence.

Holland and Lane (2012) report evidence that only when the level of non-audit fees becomes extremely high do shareholders get sufficiently concerned about the threat which non-audit services pose to auditors' independence that they sell their shares. They suggest that this behaviour indicates that investors are relatively comfortable with moderate levels of non-audit services even though in theory these might still compromise auditor independence.

A study by Barkess and Simnett (1994) of Australian companies’ use of their auditors for non-audit services produced no evidence that there was a link between non-audit services and either type of audit report or length of tenure – which suggests that in Australia non-audit services pose no real threat to auditor independence.

### 4.5 Other ethical concerns – professional clearance

The proposed new auditor should contact the existing auditor in order to obtain information about the circumstances of the proposed change in auditors. The existing auditor is under a professional obligation to supply that information. The new auditor needs to consider very carefully whether it is wise to accept the engagement if the client refuses to give authority to contact the outgoing auditor or if, having written to the existing auditor asking for information, either no reply is received or the reply indicates professional reasons for not accepting the appointment.

Now read


You should also be aware of the wider issues surrounding the concept of auditor independence. For example, audit committees are seen as being an essential part of a company's corporate governance arrangements as they help to enhance the auditors' independent status.

### 4.6 Audit committees

The role of audit committees has been significantly developed in the UK following the Cadbury Report on corporate governance in the early 1990s and the later Smith Report on the role of audit committees. The current framework is to be found in the UK Corporate Governance Code (see [www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf](http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-September-2012.pdf) and [www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-September-2012.aspx](http://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Guidance-on-Audit-Committees-September-2012.aspx)).

The code states that the committee should comprise at least three independent non-executive directors (not including the company chairman). The role of the committee is to:

- review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, review the company’s internal control and risk management systems
- monitor and review the effectiveness of the company’s internal audit function
- make recommendations to the board to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor
- review and monitor the external auditor’s independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements
- monitor the integrity of the financial statements of the company, and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them
- develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm
- report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

The committee should:

- have meetings which are only open to committee members
- be adequately resourced
- include at least one member with experience as an auditor or finance director
- report unsatisfactory findings to the board.
4.6.1 Possible problems

1. How are companies to ensure that only those with sufficient competence are appointed to serve on audit committees?

2. How are companies to attract candidates with sufficient independence from the company itself and from senior management (for example, questions have been raised about the independence of individuals in the Hollinger/Lord Black case in the USA and the Northern Rock affair in the UK)?

3. There has also been concern that additional governance structures such as audit committees will inhibit executive flair and entrepreneurial risk-taking.

4. The cost of compliance with the governance rules may dissuade some companies from seeking listings.

4.7 The Sarbanes–Oxley Act

Now read


The Sarbanes–Oxley Act has had a major impact on audit firms around the globe, not just in the USA. Although you do not need to know the many detailed requirements of the Act, you should have some knowledge of the main requirements that seek to improve auditor independence. These are described in Gray et al. (2015), pp.111–13.

In terms of perceptions, the work of Beattie, Fearnley and Hines (2013) informs us that most chief financial officers, audit committee chairs and audit partners seem to think that Sarbanes–Oxley has been a massive compliance exercise although there is a general feeling that audit committees have had a positive effect on audit quality.

Pause and think 1

To what extent do you think that the Sarbanes–Oxley Act is likely to achieve its aims of improving auditor independence? Does the Act go far enough, or too far?

4.8 More extreme suggestions

You should be generally aware that more extreme measures have been suggested as a way of better ensuring that auditors possess the required independence.

For example, rather than simply rotate the audit partner, critics of the profession have suggested that there should be a maximum period of tenure for the audit firm. After, say, five years, audit firms should be required to resign from the engagement. Such a plan would prevent relationships developing between management and audit personnel. However, it would be costly in that every so often a new firm would have to be appointed, would have to acquire the knowledge and understanding of the client and more mistakes would be made (there is evidence that audit ‘failures’ typically occur in the early years of an auditor's appointment).

Nevertheless, this sort of argument has gained ground in influential circles. The Corporate Governance Code now requires listed companies
to put their audits out to tender at least every 10 years. There is of
course no guarantee that companies will change their auditors, but at
least the question is being asked. This may not be sufficient for some of
the European Commissioners who have been talking about introducing
mandatory rotation of audit firms after only six years in post. At the time
of writing this suggestion is still being debated in political circles but it
must be a cause of concern for the Big Four firms. They will perhaps not
lose out as much as one might think since large companies would be
compelled to engage them so even if they lost some clients at the end of
their tenure, they would naturally pick up new clients as their auditors
came to the end of their tenure. But it is likely that the client's appetite
for additional advisory services might decline if they are routinely having
to come to terms with a new audit firm and so the firms' overall income
might suffer. It is almost certainly going to push up costs as each time
there is a change of auditors, a new learning process is involved in the
audit team assembling the necessary background data.

Other suggestions are that a government or quasi-governmental body
should take on the task of appointing and deciding the remuneration of
auditors. This would remove the temptation for auditors to be too familiar
with management or to be intimidated by them.

Another possibility is that government itself could employ auditors to
audit major companies. This sort of suggestion seems to buck the trend
of less government involvement in the regulation of business activities
but it is still worth considering as an option and you should be prepared
to consider these suggestions in answering general questions on ways of
making auditors independent of the companies they audit.

4.9 A reminder of your learning outcomes

By the end of this chapter, and having completed the Essential reading and
activities, you should be able to:

• explain what audit independence entails
• explain why audit independence is important
• examine the current concerns relating to auditor independence
• describe steps which have been taken to ensure that auditors retain
  their independence
• evaluate the effectiveness of these various measures
• suggest other possible means of achieving auditor independence.

4.10 Test your knowledge and understanding

4.10.1 Sample examination questions

1. a. Explain why auditor independence is an important quality for
   auditors to possess.
   b. To what extent do you consider that legal rules and professional
      regulations are able to ensure that auditors do possess this quality?

2. An audit committee is an indispensable aid to auditor independence.
   Critically examine the role of audit committees and consider what
difficulties such committees face in aiding auditor independence.

3. Auditor independence is fundamental to the very concept of
   accountability and audit. Examine the extent to which regulations
   ensure that company auditors can be seen to be independent.
4. Identify cases which have come to light where auditors' independence has been called into question and evaluate the case against the auditors and the audit profession.

5. Explain the extent to which you consider that it is important for auditors not only to be independent but also to appear to be independent; and critically evaluate the likely effectiveness of the methods proposed by the profession's critics for improving both real and apparent independence.

4.11 Hints

4.11.1 Pause and think question

1. This is a difficult question to answer without getting into the detail of the Act. However, restricting the sorts of other services auditors can supply to their clients must reduce the risk of independence being impaired and certainly increases the appearance of audit independence.

4.11.2 Sample examination questions

1. You should at least attempt to explain why independence is important even if you think it is obvious. You should mention actual and apparent independence and you should have a sufficiently detailed knowledge of the regulations in your country or internationally to be able to assess both the strengths and weaknesses of the regulatory regime. At the very least, you should refer to the fact that in most countries the audit fees are paid by the company being audited and that, to some, this does not look very independent.

2. You should understand and explain that the audit committee acts as a buffer between management and auditor. The presence of an audit committee is designed to project a greater element of independence. Audit committee members are caught in the middle between management and auditors and may have a difficult job to mediate conflicting views. It is also notoriously difficult to get high quality, objectively minded individuals to serve as audit committee members.

3. The word 'ensure' is always problematic. There can never be any guarantee that auditors will always behave as they should nor that the public will perceive them in the manner that is intended. In answering this question you should be prepared to comment on both the strengths and weaknesses of the regulations. For example, the 'rule' that one audit client should not provide more than 10 per cent of the recurring income to the audit firm may seem to favour the firm since 10 per cent is quite a large percentage; critics have argued that this threshold should be lowered to, say, 5 per cent.

4. This is a tricky question unless you have a very good knowledge of the infringements of ethical rules. There have been cases but there are not many. Key problem areas tend to be undue reliance on income from a client, audit firm members investing in the shares of clients, long association between audit firm and audit client and audit staff being recruited as employees by audit clients. You should be prepared to weigh up both sides. Consider, for example, the consequences of banning auditors from choosing to work for an audit client as an employee.
5. You should be able to argue that it is important for auditors to be independent of their clients otherwise they cannot examine the clients' financial statements with an objective eye. But equally, it is vital that the investing public perceive the auditors to be independent otherwise no value is added by having the audit. There are several suggestions for improving independence from banning other services or the compulsory rotation of audit firms to having a government department audit large companies. You should try to keep up to date with developments since in Europe at least some of these suggestions are now more main-stream than they once were.