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Auditing - Lecture 1

# Part I. Fundamentals of audit: Audit market

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# About the course

- Required literature:

- *International Standards on Auditing:* IAASB, 2015.
- ARENS, Alvin A., Randal J. ELDER a Mark S. BEASLEY. *Auditing and Assurance Services.:* Person Global Edition, 2014. 864 s. 15/E. (theory)

- Recommended literature:

- HAYES, Rick, Hans GORTEMAKER and Philip WALLAGE. *Principles of auditing :an introduction to international standards on auditing.* 3rd ed. Harlow, England: Prentice-Hall, 2014. xxi, 714 s.(theory)
- BEASLEY, Mark S., Frank A. BUCKLESS, Steven M. GLOVER and Douglas F. PRAWITT. *Auditing Cases: An Interactive Learning Approach.* 6/E. : Pearson, 2015. 448 pp. (practice)
- TRUSSEL, John M. and J. Douglas FRAZER. *Lakeside Company: Pearson New International Edition: Case Studies in Auditing.* 12/E. : Pearson, 2014. 162 pp. (practice)

# About the course

- Requirements for successful accomplishment of the course:
  - 90% participation at seminars is required.
  - 60% of final grade can be received during final exam and 40% of final grade can be received during seminars. 40% is splitted into 1 midterm test (20%) and 1 presentation (20%) or activity at the seminars (20%).
  - Topics for presentations should be agreed with a lecturer at the beginning of the semester.
  - Minimum required amount of for the midterm test is 60% of correct answers.
  - Final test is a written exam.

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# Content

- Auditing phenomena
- Types of audit and auditors
- Regulation of audit market and services
- Recommended reading

# Audit phenomena – history of audit

- **Scribes of ancient times** - Auditors existed in ancient China and Egypt. They were supervisors of the accounts of the Chinese Emperor and the Egyptian Pharaoh.
- **Profit maximization and double entry** - The attitude of profit maximization emerged at the end of the Middle Ages, with the emergence of large merchant houses in Italy. Trading was no longer the domain of the individual commercial traveler; it was now coordinated centrally at the luxurious desks of the large merchant houses in Venice, Florence or Pisa. Double-entry was introduced.
- **Economic conditions for audit reports** - The practice of modern auditing dates back to the beginning of the modern corporation at the dawn of the Industrial Revolution. In 1853, the Society of Accountants was founded in Edinburgh. Further developments of the separation between provision of capital and management led to a steady growth of the audit profession and regulation

# Audit phenomena – history of audit

Companies across the world experienced growth in technology, improvement in communications and transportation, and the exploitation of expanding worldwide markets. As a result, the demands of owner-managed enterprises for capital rapidly exceeded the combined resources of the owners' savings and the wealth-creating potential of the enterprises themselves. Capital markets were introduced.

Investors and creditors may have different objectives than management. Investors and creditors must depend on fair reporting of the financial statements. To give them confidence in the financial statements, an auditor provides an independent and expert opinion on the fairness of the reports, called an audit opinion.

# Audit phenomena – nature of audit

- **Def.:** Auditing is the accumulation and evaluation of evidence about information to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent, independent person.
- **Accounting vs. auditing** - Accounting is the recording, classifying, and summarizing of economic events in a logical manner for the purpose of providing financial information for decision making. To provide relevant information, accountants must have a thorough understanding of the principles and rules that provide the basis for preparing the accounting information. In addition, accountants must develop a system to make sure that the entity's economic events are properly recorded on a timely basis and at a reasonable cost.  
When auditing accounting data, auditors focus on determining whether recorded information properly reflects the economic events that occurred during the accounting period.

# Audit phenomena – role of audit

- **Information risk theory** - to illustrate the need for auditing, consider the decision of a bank officer in making a loan to a business. If the bank makes the loan, it will charge a rate of interest determined primarily by three factors: (1) Risk-free interest rate; (2) Business risk for the customer; (3) Information risk. The latter – information risk - reflects the possibility that the information upon which the business risk decision was made was inaccurate. A likely cause of the information risk is the possibility of inaccurate financial statements. Auditing has no effect on either the risk-free interest rate or business risk, but it can have a significant effect on information risk. If the bank officer is satisfied that there is minimal information risk because a borrower's financial statements are audited, the bank's risk is substantially reduced and the overall interest rate to the borrower can be reduced. The reduction of information risk can have a significant effect on the borrower's ability to obtain capital at a reasonable cost.



# Audit phenomena – role of audit

- Causes of information risk:
  - remoteness of information
  - biases and motives of the provider
  - voluminous data
  - complex exchange transactions
- Ways to reduce information risk:
  - user verifies information
  - user shares information risk with management
  - audited financial statements are provided

# Audit phenomena – theories

- **Policemen theory** - An auditor's job is to focus on arithmetical accuracy and on the prevention and detection of fraud.
- **Lending credibility theory** - Audited financial statements are used by management to enhance the stakeholders' faith in management's stewardship.
- **Theory of inspired confidence** - The demand for audit services is the direct consequence of the participation of outside stakeholders (third parties) in the company. These stakeholders demand accountability from the management, in return for their contribution to the company. Since information provided by management might be biased, because of a possible divergence between the interests of management and outside stakeholders, an audit of this information is required.
- **Agency theory** - A company is viewed as the result of more or less formal contracts, in which several groups make some kind of contribution to the company, given a certain price. A reputable auditor is appointed not only in the interest of third parties, but also in the interest of management.

# Types of audit

- **Audit of financial statements** – examining of financial statements to determine if they give a true and fair view or fairly present the financial statements in conformity with specified criteria. The criteria may be IFRS, US GAAP etc.
- **Operational audit** - a study of a specific unit of an organization for the purpose of measuring its performance. Operational audits review all or part of the organization's operating procedures to evaluate their effectiveness and efficiency. Effectiveness is a measure of whether an organization achieves its goals and objectives. Efficiency shows how well an organization uses its resources to achieve its goals.
- **Compliance audit** - A compliance audit is a review of an organization's procedures to determine whether the organization is following specific procedures, rules or regulations set out by some higher authority. Compliance audits are usually associated with government auditors – for example, a compliance audit is an audit of a bank to determine if they comply with capital reserve requirements.

# Types of auditors

- **Internal auditors** - employed by individual companies to investigate and appraise the effectiveness of company operations for management. Much of their attention is often given to the appraisal of internal controls. A large part of their work consists of operational audits; in addition, they may conduct compliance audits. Internal auditors have two primary effects on a financial statement audit:
  - their existence and work may affect the nature, timing, and extent of audit procedures.
  - external auditors may use internal auditors to provide direct assistance in performing the audit. If this is the case the external auditor must assess internal auditor competence (education, experience, professional certification, etc.) and objectivity (organizational status within the company).

# Types of auditors

- **External auditors** - have primary responsibility to the performance of the audit function on published financial statements of publicly traded companies and non-public companies. Independent auditors are typically certified either by a professional organization or a government agency.

The source of authority for the attest function comes from national commercial or company law in most countries, but in some cases (e.g. the USA and Canada) the individual provinces or countries exercise considerable control over who the auditor is and how he becomes qualified. Most countries have strong professional accountant organizations which may also influence who becomes an auditor.

# Regulation of audit market - organizations

## ■ USA

- Government - adoption of laws (e.g. Sarbanes-Oxley act of 2002)
- SEC and PCAOB – requirement to fill in special financial reporting forms (S1, 8K, 10K, 10Q) and perform internal financial reporting in accordance with PCAOB standards
- **AICPA** – development of assurance standards, including code of professional conduct and framework for quality control

## ■ World

- IASB - development of IAS/IFRS standards, including conceptual framework
- **IAASB** - development of assurance standards, including code of professional conduct and framework for quality control

# Regulation of audit market – authoritative pronouncements

## ■ USA

- SOX (by US government)
- **US GAAS and SAS (by AICPA)**
  - General standards
  - Standards of filed work
  - Standards of reporting
- PCAOB standards (by PCAOB)

## ■ World

- IFRS (by IASB)
- **ISA (IAASB)**
  - Contents
  - Audit and review of historical financial information
  - Assurance engagement other than audit and review of historical financial information
  - Related services

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# Recommended reading

- Arens et al. (2015) – chosen chapters will be uploaded to IS
  - Ch. 1 (1.1-1.3, 1.5-1.6), 2 (2.7.-2.8).
- Hayes et al. (2014) – chosen chapters will be uploaded to IS
  - Ch. 1 (1.1-1.6), 2 (2.1-2.2).
- Sarbanes-Oxley act of 2002