Learning objectives

After studying this chapter, you should be able to:

1. Discuss the influence of environmental factors on the auditor’s role in the capital market economy.
2. Evaluate developments in auditing and explain the economic intuitions behind assurance services.
3. Give an overview of the theoretical reflections and philosophy of auditing.
4. Outline the features of auditing as a scientific discipline.
5. State the effect of recent changes proposed by regulatory bodies on the auditor’s role.
6. Know what assurance services are, define their different types and understand why they are important.
7. Explain the nature and objectives of attestation services performed by public accountants.
8. Contrast assurance services and other professional services, including financial-statement audits and non-assurance services provided by independent auditors.
9. Define the conditions that distinguish an attest engagement from other services.
10. Know historical and anticipated future developments related to assurance services.
CHAPTER 1 AN INTRODUCTION TO AUDITING AND ASSURANCE

Introduction

This chapter gives prominence to the conceptual development of auditing over the past decades. It outlines some reflections on auditing as a discipline rather than discussing only the practices of auditing. It also discusses the features of assurance services. Because of the importance of theoretical aspects and the need for a new perspective in auditing, this introductory chapter starts by discussing auditing as a field of knowledge and its philosophy. Some readers may prefer a discussion of practical notions of auditing as the starting point, this book puts the theory and philosophy first because they are, after all, the foundations of audit practices. The objective is not to simply add to the great store of information about audit practices, but to understand and explain them and hopefully predict the road ahead.

This chapter starts with a number of questions about the critical role of auditors in a changing environment. Here, the idea is to adopt a critical approach to auditing and try to build up an appropriate framework for the fundamental areas of auditing that will be discussed in the following chapters. Even if, because of the introductory nature of this chapter, not all the fundamental issues are included, some essential theoretical aspects of auditing, its foundations and the demand for assurance and attestation services are debated. For the other important topics (expectation gap, auditor independence, ethics, etc.) a reference has been made to the discussions in later chapters.

By opening with questions on the role of the audit, this chapter attempts to provide a road map for discussion in later chapters. The discussion on other fundamental issues of auditing in the chapter (theoretical aspects, assurance, attestation, etc.) tries to provide a carefully balanced presentation of auditing theory and practice, similar to that in the following chapters.

Questions about the critical role of auditors

It is rather unusual to start a textbook on auditing with questions on the role of auditors. However, understanding auditing and its prominent place in the economy are better done by taking a critical approach to the industry and the audit process. Part of the confusion today surrounding the role of auditing stems from a misunderstanding of its nature and precise role.

Business is subject to continuous changes brought about by technological advances, globalization and internationalization, and the way entities are organized and conduct their business. Management’s increasing discretion over corporate accounts, and unprecedented competitive pressure have also increased the danger of fraudulent financial reporting. The scandals and financial failures of recent years have been a force driving change, especially in the attitudes of market regulators. Corporate reporting and the auditing profession are being swept along by this change.

In the aftermath of recent scandals, there have been calls for enhanced corporate governance and risk management, as well as increasing quality and scrutiny in auditing. There has been a raft of laws, regulations, listings requirements and reporting standards.
Standard-setters and market regulatory bodies seem determined to keep financial reporting and auditing standards under close and continuing review.

Whether all the changes in auditing are necessary is an important question facing the business community, particularly the accounting profession, and academics interested in this area. Everyone concerned with financial reporting is now rethinking how they look at auditing, what auditors do and what they should be doing.

The following are some core questions. Reflection on them will contribute to a better understanding of the role of the auditor and how this should evolve to keep pace with a changing environment.

- Are auditors crucial economic actors in the capital market economy?
- Is auditing an added-value function?
- What does the business community expect of external auditors?
- With several areas of conflict of interest surrounding the auditor’s function and his/her performance, how can independence be assured?
- How should auditors respond to continuous environmental changes?
- How should auditors handle complex information systems with linked business processes?
- Will auditors need to move from an ‘archival’ approach, where the auditor comes in at the end of the year, examines financial statements and issues an opinion on the statements, to an approach based on the process during which the financial information is compiled?
- Will auditing need to move from an annual assurance to a continuous assurance?
- How should the audit profession respond to structural changes in the capital market economy?
- What short-term measures should be undertaken by auditors?
- How should auditors respond to changes in the long term?
- How efficient are the traditional auditing techniques today?
- What changes, if any, should be made to improve the efficacy of auditing?

These questions need to be discussed. Most of them will be debated in the context of discussions around the topics such as expectation gap in auditing (Chapter 2), auditing, business environment and governance (Chapters 3 and 4), international auditing and assurance services (Chapters 5 and 6), auditor independence and ethics (Chapter 7), risk management (Chapter 8), the role of auditing in technological environments (Chapter 13), continuous auditing (Chapters 14 and 19), quality control in auditing (Chapter 15), auditing and financial market (Chapter 17) and auditors and corporate scandals (Chapter 18).

These chapters try to emphasize that auditors and academics interested in auditing, can no longer develop ruling standards and practices in an ad hoc way to respond to environmental changes and satisfy public expectations. For years a debate has rumbled along in auditing over what ‘ought to be’. Practitioners generally argued that auditing was an applied discipline and meeting market expectation by expressing the opinions on corporate financial statements was sufficient. Consequently, although research in auditing has been increasing, particularly in the past two decades, little has been done to outline a theory of auditing. The research in auditing has been directed more towards the analysis or theoretical soundness of investigation practices, and to the application of other fields of
The nature and objectives of auditing

The nature of auditing and accounting has changed dramatically over recent years as a result of environmental changes. However, these disciplines are still defined by the traditional roles.

Auditing is the process of providing assurance about the reliability of the information contained in a financial statement prepared in accordance with generally accepted accounting principles or other rules. The financial statements are first and foremost the responsibility of the management of the reporting entity. But the independent auditor plays a crucial role in financial reporting. Users of financial statements expect external auditors to bring to the reporting process technical competence, integrity, independence and objectivity (see Chapter 7 for further discussion).

Definition of an audit

An audit of historical financial statements has been defined as a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to interested parties. It is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are in material conformity with generally accepted accounting principles or other recognized criteria. The fundamental aspects of the objectives of financial statements in the context of providing the users with sincere financial information about the entity, and consequently the audit of such statements, remain unchanged in spite of the significant changes that have taken place in the business environment and financial markets.

The main objective of an audit of financial statement is to enable the auditor to express an opinion on whether the overall financial statements (the information being verified) are prepared, in all material respects, in accordance with an identified financial reporting framework. Normally, this framework can be defined as the generally accepted accounting principles (GAAP) such as the US GAAP or the equivalents in other countries. The International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board (IASB) can also be considered for this purpose. The financial statements most often included are the statement of financial position, income statement and statement of cash flows, including accompanying footnotes. The phrases used to express the auditor's opinion are 'give a true and fair view' or 'present fairly, in all material respects,' which are equivalent (see Chapter 12 and Glossary for discussion on audit reporting and related terms).
Recent changes in the audit environment

The business environment is always changing and accounting and auditing practices have to keep pace. Standard-setting bodies and market regulators must therefore monitor and update standards. Several important events have characterized the audit environment in recent years. First, the market for audits has been expanded as the number of statutory entities requiring audit has grown considerably. The spread of audits corresponds to a fundamental shift in patterns of governance in advanced capital market economies. This has led the market regulators to enhance their role in the audit market over the past decade, requiring also that the financial audit of listed companies becomes more highly regulated.

Second, the audit function and audit market have been directly affected by a more international securities market, leading to the expansion of the audit market and higher levels of monitoring by market regulatory bodies on the securities markets.

An additional change in the audit environment that has affected auditing practices is the advance in information technologies. The acceleration of these developments in recent years has been so significant that its path is not comparable with any preceding period. Not surprisingly, the audit market and scope of audit services have been significantly influenced by such developments.

External auditors are required to anticipate and keep up with the changing needs of the public, as well as changes in financial markets, corporate structure and information and communication technologies. Thus, the audit profession should evolve to meet new market needs, taking into consideration regulators’ measures regarding the types of services provided by auditors and the changes the standard-setters and regulators envisage in the areas of accounting and auditing standards.

The corporate financial scandals that occurred at the beginning of this century in the US and other developed countries have underlined the need for immediate reforms. These changes are in response to the desire for better protection of investors, a higher
quality of information (in terms of accuracy and timeliness) for the financial markets, as well as greater accountability and control over the actions taken by corporate executives and auditing firms. Regulatory measures have also been intended to reinforce the role of auditors in the audit of publicly listed companies, particularly with regard to auditor independence and internal control over financial reporting (see Chapters 7 and 11 for further discussion). Uncertainty and ambiguity raise a number of issues and this is why the recent revelations of corporate abuses in the US have even led many to question the usefulness of the audit as an efficient control instrument.

The effect of the above determinant factors on the audit function and its environment has sometimes been immediate, such as enhancing the role of regulators in scrutinizing the audit market, restrictions in providing assurance services by accounting firms and higher regulators’ demand for auditor independence and objectivity. The audit market will certainly be the scene of changes in different areas, particularly in real-time reporting, continuous auditing, audit scope, internal control and perhaps more direct involvement of auditors in investing and lending decision-making processes, and/or at least more concentration on ‘user-chosen information’.

For this reason, moves have been made to prohibit the provision of audit and non-audit services rendered simultaneously by an auditing firm to a publicly listed company, to make audit rotations mandatory and to strengthen corporate governance in general. It is regrettable that suspicion has fallen on the profession as a community and on specific firms. The audit and accounting profession has suffered greatly from these abuses and this has even led to questioning of the usefulness of audited accounting data as a sound basis for financial assessments and evaluations by investors, bankers, financial analysts, regulators and other users.

In spite of all the criticism of the auditing profession, the auditor still plays an essential role as an intermediary between the issuers and the various users of financial information. Indeed, at a time when the importance of financial markets to the economy has increased considerably, it is more necessary than ever to have an independent opinion on the fairness of the financial statements prepared by a company’s management.

It is also important to note that separation of ownership and control offers the potential for conflicts of information (see Chapter 3 for further discussion). A company’s management has access to, and controls, all of the information regarding the company. It generally decides what information might be of interest to the owners. As a result, the information at the disposal of the owners may not be as complete as the management’s. Since the goals of the management may not be completely congruent with those of the owners, there is good reason to suspect that the manager will not always act in the best interests of the owner, as Jensen and Meckling observed (1976). The demand for verification (and attestation) of financial statements arises because otherwise managers might have an incentive to misrepresent the financial situation. This might arise because the owners of enterprises use financial reports to evaluate the management’s performance.

In modern capital markets characterized by the creation of highly sophisticated financial instruments, conflicts of interest may lead managers to manipulate the financial statements at the expense of a company’s shareholders. In such circumstances, the role of the auditors becomes decisive because they increasingly need to provide investors with the
assurance that financial statements conform to recognized accounting criteria. In this regard, auditing may be demanded firstly if the audit report can be used to ‘help’ motivate truthful reporting and secondly if it produces information that will assist potential users (e.g. investors or bankers) in valuing the company. In such circumstances it is inevitable that the role of the auditor can also be considered as a sharer of risk with the users of financial statements, principally the company’s shareholders.

A theoretical approach to auditing

Auditing is generally thought of as a practical discipline dealing with control mechanisms and instruments within organizations of different types. The audit profession, its associated bodies and public firms, have played an important role in developing the various standards, rules and practices in this field. However, to discuss the usefulness of audit practices, it may be interesting to look at auditing issues from a different angle because most of the techniques and instruments have evolved with the behaviour of the various parties involved in making economic decisions. Failure to devote sufficient attention to the theoretical foundations of auditing can not only limit its perspectives, but may also prevent appropriate development of the field in relation to its changing environment.

The need for theory in auditing, as with any other discipline, is associated with the willingness of the interested parties (shareholders, managers, bankers, auditors, analysts and so on) to form a solid basis for making financial decisions. Each of these parties is considered as an economic actor seeking to maximize its wealth and in doing so, they want to know all the possible ways to achieve this goal. To acquire the necessary knowledge about these options requires a thorough understanding of the economic variables and of the relationship between them. This can only be done through the use of a theoretical framework, which provides sufficient explanation and reasoning of the variables, their association with each other and the environment in which the economic action is taking place.

Theory provides a cornerstone for explaining auditing practices. For example, theory explains the importance of concepts such as auditor reputation, auditor judgement and decision-making, auditor independence, audit quality control, truthful reporting and litigation. It explains why some companies use large audit firms while others do not. Such theory is important as it helps members of audit firms to make better decisions when conditions change. Moreover, the effectiveness of an audit depends on many factors and variables, and only the association of these variables will lead to a successful audit. Theory is particularly helpful in interpreting the variables involved in the audit function. The idea is not to simply add to the information about audit practices, but to understand, to explain and to predict these practices.

Theory is not intended as a substitute for the practical and technical guidelines of auditing, or to undermine the pre-eminent place of the audit profession in a market economy, but rather it aims to reinforce the profession’s position by enabling it to respond in a more appropriate manner.
In general terms, 'explanation' and 'prediction' are fundamental values of any theory because they allow the development of an understanding of actions and their consequences for the environment: explaining the way the world works and the effects of the theory’s predictions on the user. With regard to auditing, explanation means suggesting reasons for the practices observed, whereas prediction makes it possible to anticipate unobserved auditing phenomena. Unobserved phenomena in auditing may include those events that have occurred but for which systematic audit evidence has not been collected.

The practical experience of auditors is a factor in elaborating the audit function but this will be conditioned by the particularities of the cases and the environments in which they have occurred. Theoretical implications and empirical testing in auditing can help to provide more explanations and better understanding of the process, even if this again depends, to large extent, on the assumptions, models and substantive hypotheses taken into account.

In summary, theory provides a framework for interpreting accounting and auditing concepts, which is useful to many individuals. Managers and auditors generally have an implicit understanding of certain theoretical aspects of accounting and auditing, but they may not have the overall picture. Using theory provides a framework for the solutions, or at least clues to the solutions, to problems which the auditors are faced with in capital markets. As far as the members of the audit profession are concerned, an understanding of the basic ‘laws’ that govern the organization and also of the various activities of the profession is crucial.

**Debating the historical perspective of auditing concepts**

Auditing has evolved in the capital market economy, particularly over the last century. The original purpose of the audit was to assure that honest and accurate accounting for money and property had been performed in the affairs of state, in the services of governments and other public bodies, and in the affairs of early businessmen. As time has passed, the concept of auditing has enlarged in line with economic and industrial developments. Auditing concepts have also been affected by the expectations of various parties. The scope of auditing has expanded to include more than the practical aspects and technical tools.

In the 1920s and 1930s, Professor Theodore Limperg of the University of Amsterdam developed a theory of replacement cost accounting that has deeply influenced accounting and auditing practices in the Netherlands. At the second International Congress of Accountants in 1926, Limperg also presented a set of auditing concepts, which became known as the **theory of inspired confidence**. Later, his theory was called the **theory of rational expectations** (Blokdijk, 1979). Limperg’s theory can be characterized as dynamic. It connects the society’s needs for reliable financial information to the technical possibilities of auditing to meet these needs. It also takes into account the evolution of the needs of the business community and of auditing techniques. According to this theory, changes in the needs of the business community result in changes in the auditor’s function.
Private companies that incur the cost of having their financial statements audited generally do so because there are external users, such as lenders or a small group of investors, who have a need for reliable financial statements to aid their decision-making. The views of these external users about the confidence inspired by an audit are currently formed by the general understanding in society of the assurance provided by an audit. If audits changed so that they inspired different levels of confidence depending on the needs of particular users and particular circumstances, the social usefulness of the audit would be destroyed because an audit would no longer stand for a reasonably uniform level of assurance. A user could not be confident that the normally expected level of assurance was obtained.

Comments on Limperg’s theory (Carmichael, 2004: 133)

Mautz and Sharaf (1961) developed similar ideas. Flint (1988) proposed an innovative addition to attempts at determining what auditing should be. The next sections discuss briefly the most important aspects of the philosophy and principles of auditing.

■ The theory of rational expectations (‘inspired confidence’, Limperg 1920s)

In a series of essays published over 70 years ago (see also Limperg Institute, 1985), Professor Limperg set forth a dynamic theory that connects society’s need for reliable financial information to the ability of auditing methods to meet that need. Limperg explained how changes in the needs of society and changes in auditing methods interact to bring about changes in the auditor’s function. ‘Limperg based his theory on the science of business economics and viewed the development of the audit function from an economic perspective’ (Carmichael, 2004: 128).

The theory of rational expectations (Limperg, 1926) states that the auditor’s report derives its added value (confidence) from expert work, on which the audit opinion is to be founded. The auditor, in performing his/her task, should be governed by the rational expectations of those who may use his/her report. In other words, the auditor should act in such a way that he/she does not disappoint these expectations (general auditing norm), while, on the other hand, he/she should not arouse greater expectations in his/her auditor’s report than his/her examination justifies. As a consequence, every consideration about the contents of the auditor’s report should be tested in the light of this requirement.

(Blokdijk et al., 1995: 23–24)

The seminal work of Limperg is characterized by several important elements. The central area of Limperg’s work is related to the social responsibility of the independent auditor and possible mechanisms for ensuring that audits meet society’s needs. Limperg’s work highlights the importance of the social significance of auditing and the implications for how an audit should be performed. Limperg emphasizes the role of the auditor in relationship with the users of financial statements in the sense that the independent auditor acts as a confidential agent for society.

Limperg observed that the confidence inspired by the independent auditor was the essence of the function, its very reason for existing. He pointed out that if the function of the independent auditor is to achieve its objective, then no more confidence may be placed in its fulfilment than is justified by the work carried out, and by the competence of the auditor.
Limperg’s framework is based on the greatest possible level of satisfaction of users of financial statements with regard to the auditor’s work. In achieving this objective, the auditors are to perform enough work to meet the expectations they have aroused in society. Thus, as stated by Carmichael in his commentary on Limperg’s work on the social responsibility of the independent auditor, ‘the most important factor is society’s needs, and the related factor that interacts with it is the ability of auditing methods to meet society’s needs. However, society’s needs are not fixed and change over time. Also, auditing methods can change and improve over time (Carmichael, 2004: 129).’

The normative core of the theory of inspired confidence is therefore this: the [auditor] is obliged to carry out his work in such a way that he does not betray the expectations which he evokes in the sensible layman and; conversely, the [auditor] may not arouse greater expectations than can be justified by the work done.

(Limperg, 1985)

Philosophy of auditing

The audit process is a well established and recognized control mechanism of the capital market economy. It is a process on which the users of financial reporting call and rely. However, little is known about the circumstances of its creation and the conditions necessary for its existence and continuing development. In 1961, Mautz and Sharf published The Philosophy of Auditing – a project whose origins can be traced back to 1930s. When Mautz and Sharaf wrote this monograph, auditing theory, unlike accounting theory, had received little attention. They outlined an extensive discussion on auditing philosophy, methodology of auditing and postulates of auditing. They also discussed the central areas in auditing such as evidence, due audit care, fair presentation, independence and ethical conduct.

Auditing could no longer be permitted to develop on an ad hoc basis if it were to fulfil its mission and satisfy public expectations. Accordingly it was argued that a ‘philosophy’ of auditing was needed both to provide a direction for auditing practice in an advanced economic society, and to underwrite the claim to ‘add credibility’ to the financial statements of enterprises.

(Michael Power, 1990: 71)

Due to its innovative approach, the study of Mautz and Sharaf (1961) was a seminal work regarding the theoretical foundations of auditing, and is considered as a milestone in auditing. In their view, the development of a philosophy of auditing requires a study of its nature and problems in the light of principles. This calls for an examination of its methods, presuppositions and concepts. In this respect, they proposed a philosophy of auditing that elaborated first principles and thereby attempted to provide a systematic organization of a hitherto loose structure of practices and ideas. They investigated the possibility of an integrated body of auditing theory.

Mautz and Sharaf argued that auditing has its methodological roots in a scientific logic whereby the evidence process depends upon a rational structure of observation, examination and evaluation.

Some aspects of Mautz and Sharaf’s work are discussed in the following sections.
Auditing as a field of knowledge

The question of whether auditing can be described as a ‘science’ is important in defining the theoretical foundations of auditing. It can provide insights into understanding the nature of this field. By using Robinson’s definition of science (1947), Mautz and Sharaf attempted to highlight the scientific nature of auditing. In their view, the status of auditing as a science depends more upon the meaning of the term ‘science’ than on anything else. If we conceive science as an organized body of knowledge, then auditing can lay some claim to meeting the requirements. If science is interpreted to mean the application of a method requiring the rigorous weighing of evidence and the application of a systematic method to a variety of situations, again auditing may qualify. But if we accept as sciences only those fields with the power to explain, predict, and control given phenomena, then auditing falls well short.

With regard to the relationships between auditing and other fields, we can point out that ‘the nature of evidence and the formation of audit opinions are dependent on the theory of knowledge; reliance on tests and samples is based on probability theory and mathematics; fair presentation draws upon accounting principles, financial analysis, and communication theory; due audit care recognizes ethical and legal relationships. At the same time, auditing is an applied field, making its ultimate contribution at the practice level. Thus it has an organized body of theory supporting a professional type of application. On the theory side it must have regard for the nature of its theoretical structure; on the practice side it must respect the requirements of professional status and ethical conduct.’

(Mautz and Sharaf, 1961: 244–245)

Mautz and Sharaf (1961: 245–248) believed that to obtain a comprehensive view of auditing, one should see it as a five-level structure. At the base lies its philosophical foundation, which in turn rests on the most fundamental disciplines, the abstract sciences. Out of this philosophical foundation can be drawn the postulates, which in turn provide a groundwork for the development of essential concepts. Next appears its conceptual structure, the elemental generalizations around which the bulk of its theory is organized. Out of these concepts and deriving their strength from them appear certain more or less obvious directives for the guidance of the practitioner, which may properly be described as precepts. Finally, there is the superstructure of practical applications in which the precepts are applied to actual situations. Thus levels one, two, and three, the basic philosophy, postulates, and conceptual structure, produce the precepts that guide practice. Practice is concerned directly with the precepts only, but as the precepts are based on the other levels of the structure, if practice follows the precepts and if the precepts are properly developed, practice also rests on a strong foundation of theory.

Auditing, like any other field, must have its philosophical foundation and it must never permit itself to become separated from the elemental disciplines from which it draws its strength.

However, it seems that auditing, like any applied field, has become so concerned with the problems of practice that auditors sometimes neglect theoretical aspects. A practitioner who has no use for theory is inadvertently choosing the most difficult of paths; he is abandoning those essential guides developed so laboriously and carefully. In the
field of auditing, there is a close relationship between theory and practice, and a sure solution to practical problems can be found through the development and use of theory. Theoretical concepts can provide the practitioner with assurance of consistency and propriety in audit work. Moreover, with a well-developed theory the auditor can become a real economic agent of the capital market economy.

■ Auditing as a social phenomenon

Although the conceptual approach proposed in the study of Mautz and Sharaf (1961) was based on principles of more general application, they were primarily concerned with the audit of business corporations and not with the concept of audit in a wider sense. Mautz and Sharaf’s work has been enormously influential for subsequent auditing writers. The work of David Flint is an important attempt to elaborate general principles or postulates of auditing.

The work of Flint is based on Limperg’s stimulating Theory of Inspired Confidence and other efforts to establish a theoretical foundation for auditing. This work has examined the audit function from the perspective of society in general. Proceeding from this broad concept, Flint examines the theory, authority, process and standards of audit. In his forward to Flint’s book, Mautz asked: What is the role of auditing in society? What is society’s need that auditing can meet? Does society expect too much of auditing? In effect, what are the mutual obligations of auditing and society to one another so that society’s needs for this service may be met adequately and indefinitely? In seeking answers to these questions, Flint looks at auditing from the point of view neither of an auditor nor of an auditee, but from that of one whose concern is for the well-being of society, and of auditing as an element in that society.

Flint claims that the ‘primary condition’ for an audit is that there must be a relationship of accountability* between two parties arising explicitly by agreement or by some form of construction. This formulation is certainly an advance on Mautz and Sharaf and connects Flint’s thinking to that of agency theory. But whereas agency theory views the role of the auditor in an economically reductive way as a monitoring cost between two parties, Flint emphasizes the ethical as well as the economic dimension of audit practice. The auditor is not merely an economic agent but has a moral mission which must somehow be safeguarded – whether by regulation or otherwise. Although Flint considers the ‘economic or social benefit’ of the audit process, in contrast to agency theory, he regards this as a ‘postulate’ rather than an open empirical question.

(Michael Power, 1990: 72)

* Emphasis added.

■ Auditing as a separate discipline from accounting

Mautz and Sharaf (1961) opposed the idea that auditing should be considered as a subdivision of accounting. In their view the relationship of auditing to accounting is close, yet their natures are very different. Of course, the auditing field has close links with accounting, but it takes much from other fields too, perhaps more than from accounting. Accounting includes the collection, classification, summarization and communication of financial data; it involves the measurement and communication of business events and
conditions as they affect and represent a given enterprise and its relationship with other entities. The task of accounting is to reduce a tremendous mass of detailed information to manageable and understandable proportions. Auditing does none of these things. Auditing must consider business events and conditions too, but it does not have the task of measuring or communicating them. Its task is to review the measurements and communications of accounting for propriety.

Auditing is analytical, not constructive; it is critical, investigative, concerned with the basis for accounting measurements and assertions. Auditing emphasizes proof, the support for financial statements and data. Thus auditing has its principal roots, not in accounting, which it reviews, but in logic, on which it leans heavily for ideas and methods.

(Mautz and Sharf, 1961: 14)

Observations on differences between auditing and scientific disciplines

There are several differences between auditing and the scientific disciplines. The first of these follows from the differences in the two fields with respect to the quality of evidence required. The auditor must frequently be content with something less than the best possible evidence pertinent to a given problem, whereas the scientist can be satisfied only with conclusive evidence. However, the scientist, unless content that final proof had been obtained, would offer a judgement as tentative only until time and technological resources permitted the continuation of the research and brought the necessary evidence. An auditor always works in the short term. The auditor’s conclusions are more often than not tentative. It is a rare audit engagement in which there is no limit on time, staff or charges. Auditors must live with the hard facts of economics in the conduct of their investigations. This is a part of the environment of auditing that has an important effect on the ultimate validity of audit judgements.

Auditing is like other applications of scientific thinking in its reliance on probability theory. The traditional influence of probability theory in auditing is best exemplified by the use of the term ‘opinion’ in describing the auditor’s final overall judgement with respect to the financial statements examined. It appears also in his employment of tests and samples, a necessary and accepted practice.

(Mautz and Sharaf, 1961: 33)

A second and more significant difference between the work of an auditor and what has been described as the scientific method has to do with the possibility of controlled experiments. In science, the testing of hypotheses is frequently, but not always, performed through laboratory experiments under which some conditions can be controlled so that the effect of a given factor or factors can be more closely noted. This is not true of an audit. Only under the most unusual conditions would an audit be performed twice, and even if it were, the results would not be equivalent to running a laboratory experiment twice. The timing of audit work is of the essence.

A third difference between applications of the scientific methodologies and auditing is that in auditing the basic assumptions or postulates on which the validity of reasoning rests are not well stated.
The postulates in auditing exist and contribute to our understanding of auditing issues, otherwise we could not reason or come to conclusions in this discipline. The postulates in auditing provide the foundations the researchers in this field need to develop a logical, integrated theory of auditing. The examples of such postulates are as follows:

- Financial statements and financial data are verifiable;
- The existence of a satisfactory system of internal control eliminates the probability of irregularities;
- Consistent application of generally accepted principles of accounting results in the fair presentation of financial position and the results of operations;
- When examining financial data for the purpose of expressing an independent opinion thereon, the auditor acts exclusively in the capacity of an auditor;
- The professional status of the independent auditor imposes commensurate professional obligations.

The demand for assurance services: an economic explanation

While financial statement audits provide interested decision-makers with assurance, they are hardly the only ‘assurance service’ that independent auditors perform. Assurance is a much broader concept than auditing. Assurance engagements come in many shapes and sizes. ‘Assurance services are independent professional services that improve the quality of information, or its context, for decision-makers’ (AICPA, 1997). The International Federation of Accountants (IFAC) addressed the issue of assurance services in more technical terms. ‘Assurance engagement means an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria’ (IFAC, 2004a: 150).

According to IFAC, the subject matter, and subject matter information, of an assurance engagement can take many forms, such as:

- Financial performance or conditions (for example, historical or prospective financial position, financial performance and cash flows) for which the subject matter information may be the recognition, measurement, presentation and disclosure represented in financial statements.
- Non-financial performance or conditions (for example, performance of an entity) for which the subject matter information may be a key indicator of efficiency and effectiveness.
- Physical characteristics (for example, capacity of a facility) for which the subject matter information may be a specifications document.
- Systems and processes (for example, an entity’s internal control or IT system) for which the subject matter information may be an assertion about effectiveness.
- Behaviour (for example, corporate governance, compliance with regulation, human resources practices) for which the subject matter information may be a statement of compliance or a statement of effectiveness.
Assurance services will be an advantage to all business reporting. That includes all information flows to parties whose decisions affect an entity – including investors, creditors, management, employees, customers, and governmental bodies. Managers in charge of business decisions seek assurance services to help improve the reliability and relevance of the information used as the basis for their decisions. Assurance services are valued because the assurance provider is independent and perceived as being unbiased with respect to the information examined.

To understand clearly the concept of assurance services, it is important to define several components. First, the definition given by the AICPA refers to independent services, which are those performed by person(s) who have no economic or other interests that create a temptation to render biased services with respect to the subject matter of the engagement. To satisfy this requirement, it is essential to rely on the analysis and judgement of sufficiently competent and experienced professional accountants.

Information quality is another essential point in defining assurance services. It is a basic characteristic of information that increases as its relevance and reliance increase. Relevance concerns the extent to which information is capable of influencing reasonable decision-makers. Relevant information will reduce the decision-maker’s assessment of the uncertainty of the outcome of a decision even though it may not change the decisions itself. ‘Information is relevant if it provides knowledge concerning past events (feedback value) or future event (predictive value) and if it is timely’ (Delaney et al., 2001: 24).

Reliability is another essential qualitative characteristic concerning the neutrality of information and the extent to which it represents what it purports to represent. For instance, to be reliable, financial statements must portray the important financial relationships of the firm itself. Information is reliable if it is verifiable and neutral and if users can depend on it to represent what it is intended to represent (representational faithfulness).

The concept of reliability is often confused with the concept of credibility. Credibility is defined in terms of the assurance attributed by the user of a practitioner’s opinion or conclusion on the subject matter. In this sense, the reliability of information relates to its accuracy and precision, whereas the credibility of information relates to the degree to which the user perceives it likely that the information is as reliable as needed or as reliable as it purports to be. (FEE, 2003: 28)

Objective of the assurance engagement

The objective of an assurance engagement is for a public accountant to evaluate or measure a subject matter that is the responsibility of another party against identified suitable criteria, and to express a conclusion that provides the intended user with a level of assurance about that subject matter (IFAC, 2004b: 879). Subject matter includes the data (financial and non-financial), internal control systems, and information regarding corporate governance, compliance with regulation and human resource practice. Criteria are the standards or benchmarks (such as GAAP or IFRS) used to evaluate or measure the subject matter of an assurance engagement.

The existence of assurance engagements begs the question as to why these are carried out rather than other engagements. While there may be a number of factors involved, the underlying factor
appears to be economic. Assurance rather than other engagements are performed in certain circumstances because users are willing to pay or exert political or economic pressure to have responsible parties pay for the risk reduction associated with the issuance of an overall professional opinion by the practitioner on the conformity of the subject matter with the identified suitable criteria.

(FEE, 2003: 4)

Assurance engagements (see also Chapter 5) are intended to enhance the credibility of information about a subject matter, thereby improving the likelihood that the information will meet the needs of an intended user. The level of assurance provided by the professional accountant’s conclusion conveys the degree of confidence that the intended user may place in the credibility of the subject matter.

In the context of future assurance services, the volume of real-time information created by new technological tools is shifting the need for assurance from historical financial statements to assurance about the reliability of processes generating information in a real-time format. Consequently, the traditional opinion on financial statements broadens to assurance on information chosen by the user.

Different assurance services

While the borders between types of services offered by public accounting firms are sometimes difficult to pinpoint, these professional services can be broken down into three main categories: assurance, tax and consulting. Assurance can be categorized into attestation and non-attestation services. Attestation services always involve a report that goes to a third party. The narrowest service is an audit of a company’s financial statements. In such engagements, attesters ascertain and provide written reports on the degree of correspondence between written assertions (made by a party other than the attesters) and pre-established criteria. In contrast to attest engagements, non-attest assurers either improve the relevancy of information that originates with other parties, or create information for interested parties.

In general, there is a broad range of assurance engagements, which includes any combination of the following:

- Engagements to report on a large number of subject matters covering financial and non-financial information.
- Engagements intended to provide high (examinations) and moderate (reviews) levels of assurance.
- Attestation and direct reporting engagements.
- Engagements to report internally and externally.
- Engagements in the private and public sector.

Professional accountants perform other engagements that are not assurance engagements, such as the following:

- agreed-upon procedures;
- compilation of financial or other information;
■ tax services, including the preparation of corporate and individual tax returns where no conclusion is expressed, and tax consulting;
■ management consulting;
■ other advisory services.

More traditional professional services include tax services and consulting services. For public accounting firms, the tax services involve tax-planning strategies for estate, gift, domestic and foreign income taxes. Consulting services involve providing clients with advice in a variety of areas including ways to improve accounting systems, manage production and inventory storage costs, monitor customer satisfaction and improve employee compensation packages.

Different levels of assurance engagements

The public accountant’s conclusion provides a level of assurance about the subject matter. In theory, it is possible to provide a wide range of assurance, from a very low level of assurance to an absolute level of assurance. It is not ordinarily practicable to design an engagement to provide such fine graduations of assurance or to communicate the level of assurance in a clear and unambiguous manner. In addition, absolute assurance is generally not attainable as a result of factors such as the use of selective testing, the inherent limitations of control systems, the fact that much of the evidence available to the auditor is persuasive rather than conclusive, and the use of judgement in gathering evidence and drawing conclusions based on that evidence.

Under the International Framework for Assurance Engagements (IFAC, 2005), in performing the assurance engagement, the auditor expresses a conclusion that provides a level of assurance including reasonable assurance and limited assurance. These are briefly explained below.

1 Reasonable assurance: A relative term whose content depends upon the circumstances. Reasonable assurance is less than absolute assurance. ‘The objective of a reasonable assurance engagement is a reduction in assurance engagement risk to an acceptably low level in the circumstances of the engagement as the basis for a positive form of expression of the practitioner’s conclusion’ (IFAC, 2005: 127). The assurance report should include a description of the engagement circumstances and a positive form of expression of the conclusion. To be in a position to express a conclusion in the positive form required, it is necessary for the auditor to obtain sufficient appropriate evidence as part of a systematic engagement process that includes:
■ obtaining an understanding of the engagement circumstances;
■ assessing risks;
■ responding to assessed risks;
■ performing further procedures using a combination of inspection, observation, confirmation, recalculation, reperformance, analytical procedures and inquiry;
■ evaluating the evidence obtained.
Reasonable assurance varies not only across different subject matter, criteria, evidence and engagement processes, but also across jurisdictional boundaries and within jurisdictions over time. With regard to evidence-gathering procedures, ‘reasonable assurance’ is a concept relating to accumulating evidence necessary for the auditor to conclude in relation to the subject matter information as a whole.
Reducing assurance engagement risk to zero is rarely attainable or cost beneficial as a result of factors such as:

- use of selective testing;
- inherent limitations of internal control;
- the fact that much of the evidence available to the auditor is persuasive rather than conclusive;
- the use of judgement in gathering and evaluating evidence and forming conclusions based on that evidence;
- the characteristics of the subject matter.

(IFAC, 2004c: 916)

2 Limited assurance engagement: This term is associated with engagements in which the decision was taken to obtain less assurance than otherwise could have been reasonably obtained. ‘The objective of a limited assurance engagement is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the engagement, but where that risk is greater than for a reasonable assurance engagement, as the basis for a negative form of expression of the practitioner’s conclusion’ (IFAC, 2005: 127). The nature, timing and extent of procedures for gathering sufficient appropriate evidence in a limited assurance engagement are, however, deliberately limited relative to a reasonable assurance engagement. The assurance report in this case should include the description of the engagement circumstances, and a negative form of expression of the conclusion.

Apart from the two above types of assurance engagements, the term of moderate assurance can also be used in the case of a review engagement (e.g. review of financial statements). In such a case, a moderate level of assurance refers to the circumstances in which the information subject to review is free of material misstatement, which is expressed in the form of negative assurance. This indicates that the auditor has obtained sufficient appropriate evidence to be satisfied that the subject matter is plausible in the circumstances, and therefore the auditor’s report conveys a moderate level of assurance regarding the conformity of the subject matter with identified suitable criteria.

Attestation services

The accounting profession provides a variety of services. An attestation is the process of providing assurance service in which the public accountant issues a report about the reliability of any information provided by one party to another. Financial statements can be considered a specialized set of assertions, and auditing is a specific form of attestation.

An attestation, in a general sense, is an expert’s communication of a conclusion about the reliability of someone else’s assertion. The examples of attestation are a financial statement audit and the auditor’s attestation on management’s assessment of the effectiveness of the company’s internal control over financial reporting.
The above definition implies four conditions that distinguish an attest engagement from other services:

- Attestation services require written assertions and a written auditor’s report. One party must make the assertion, the accuracy of which is of interest to another party. This assertion may be quantitative or qualititative in nature.
- Attestation services require the formal establishment of measurement criteria or their description in the presentation. The agreed-upon and objective criteria can be used to assess the accuracy of the assertion. All parties must agree as to how the assertion is to be evaluated using a common unit of measure and measurement technology. The measurement approach should be refined enough to allow different individuals to arrive at conclusions that are not materially different.
- The accountant must be able to obtain adequate, diagnostic evidence to support or refute the assertion being made.
- The levels of service in attestation engagements are limited to examination, review and application of agreed procedures.

There are four categories of attestation services: **attestation examination or audit** of historical financial statements, **review** of historical financial statements, attestation on internal control over financial reporting, and **agreed-upon procedures**. The professional accountant (attestor) who is providing an attestation does not usually generate original information; that is the responsibility of the party reporting the information. The role of attester is adding credibility to this information by providing an opinion about the reliability of the information. In an **examination**, an auditor expresses positive assurance about an assertion; that is, the assertion is presented in accordance with established criteria in all material respects. A **review** provides less assurance than an examination because the auditor expresses only negative assurance about the assertion, that is, he/she is not aware of any reasons to conclude the assertions are not in conformity with established criteria. Finally, an **agreed-upon procedures engagement** involves issuing a report on specific findings obtained by performing specific procedures agreed to by all parties prior to the start of the engagement.

**Audit of historical financial statements**

The audit of financial statements can be considered an attestation examination. An audit is described as providing high but not absolute assurance on assertions made to another party. An audit of financial statements is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are free of material misstatements. The financial statement audit involves obtaining and evaluating evidence about an entity’s financial affairs in order to establish the degree of correspondence between the management’s assertions and the established criteria, such as legal requirements and accounting standards.

The audit of financial statements is a special type of assurance engagement that deals primarily with accounting information. In a financial statement audit, the auditor attests to the fairness of a company’s financial statements, which are assertions by management regarding the financial performance and financial condition of the company.
CHAPTER 1  AN INTRODUCTION TO AUDITING AND ASSURANCE

The assurance engagement in the form of audit of financial statements gives investors and creditors confidence in their decision-making process. External users, who rely on those financial statements to make business decisions, consider the auditor’s report as an indication of a statement’s reliability. The auditors must be qualified and able to exercise their skills in an independent and objective manner. The users of financial statements value the auditor’s assurance because of his/her reputation for independence from the client and knowledge of financial statement reporting matters.

Auditors also provide assurance services on other historical and prospective financial information as well as nonfinancial information. These may include reporting on prospective financial statements, pro forma financial information, compliance with laws and regulations, and agreed-upon procedures. The following is an overview of these services.

Reports on prospective financial statements
Auditors may compile or examine prospective financial statements, including forecasts and projections. Forecasts are based on management’s expected financial position, results of operations, and cash flows.

Reports on pro forma financial information
Auditors may review or examine pro forma information, which shows what the significant effects might have been had a proposed transaction (or event) occurred at an earlier date. The example of pro forma information is the information concerning a proposed merger or acquisition of another company or disposition of a significant portion of the existing business.

Review of historical financial statements
A review of historical financial statements is another type of attestation service performed by independent auditors. Whereas an audit provides a high level of assurance, a review service provides a moderate level of assurance on the financial statements, and therefore requires less evidence. A review is often adequate to meet users’ needs and can be provided at a much lower fee than an audit.

A review engagement provides some assurance about the quality of information included in the financial statements but does not provide as much assurance as an audit, nor does it require the same burden of evidence as for that of an audit.

Attestation on internal control over financial reporting
The implementation of appropriate internal control systems is an important part of management function within an organization, and an auditor is directly involved in the assessment process of the effectiveness of these systems. For this reason, an in-depth discussion of internal control over financial reporting and the responsibilities of management and auditors will be presented in Chapter 11. However, this section discusses the auditor’s responsibilities with regard to the assessment of a company’s internal control as part of attestation services.
Internal control over financial reporting consists of policies and procedures within the company that are designed and operated to provide **reasonable assurance** – that is, a high but not absolute level of assurance – about the reliability of a company’s financial reporting and its process for preparing and fairly presenting financial statements in accordance with generally accepted accounting principles or other specific criteria. It includes policies and procedures that pertain to the maintenance of accounting records, the authorization of receipts and disbursements and the safeguarding of assets.

A company’s management is responsible for establishing an appropriate internal control system and providing the external auditors with necessary information on the design and operation of the system. Management is required to base its assessment of the effectiveness of the company’s internal control over financial reporting on a suitable, recognized control framework established by recognized bodies such as the Committee of Sponsoring Organizations (COSO) of the Treadway Commission in the US.

External auditors should attest to management’s assertion about the effectiveness of internal control over financial reporting. A publicly traded company is required to include management’s report on the effectiveness of internal control over financial reporting in its annual report, along with the audit firm’s attestation on that report. The auditor’s evaluation of the effectiveness of internal control over financial reporting is integrated with the audit of the financial statements.

### Changes in the auditors’ evaluation of companies’ internal control systems

Because of the importance and effect of the assessment of internal control in the audit of financial statements, and following the Sarbanes-Oxley Act of 2002 [Section 404(b)]

the Public Company Accounting Oversight Board (PCAOB 2004) has issued an auditing standard, entitled 'An audit of internal control over financial reporting performed in conjunction with an audit of financial statements'. Similar steps have been undertaken by the International Federation of Accountants and the European Commission.

The auditor’s objective in an audit of internal control over financial reporting is to express an opinion on management’s assessment of the effectiveness of the company’s internal control over financial reporting. To form a basis for expressing such an opinion, the auditor must plan and perform the audit to obtain reasonable assurance about whether the company maintained, in all material respects, effective internal control over financial reporting as of the date specified in management’s assessment.

To obtain reasonable assurance, the auditor evaluates the assessment performed by management and obtains and evaluates evidence about whether the internal control over financial reporting was designed and operated effectively. The auditor obtains this evidence from a
number of sources, including using the work performed by others and performing auditing procedures himself or herself.

(PCAOB, 2004, Auditing Standard No. 2: A-6 and A-7)

The auditor should acquire sufficient knowledge about the concepts and guidance proposed by specialized committees and regulatory bodies in the audit of internal control over financial reporting. The auditor should understand how these controls are designed and operated within an organization, and try to evaluate and test their effectiveness. The auditor obtains a lot of this understanding when evaluating management’s assessment process. An audit of internal control over financial reporting is integrated with the audit of the financial statements in an extensive process involving several steps. These steps include: planning the audit; evaluating the process management uses to perform its assessment process; obtaining an understanding of the internal control; evaluating the effectiveness of both the design and operation of the internal control; and forming an opinion about whether internal control over financial reporting is effective (PCAOB 2004).

■ Engagement applying agreed-upon procedures

Assurance can pertain to the reliability of information and encompasses most of the services described as auditing or attestation. However, assurance also applies to elements of decision-making that do not relate to a specific assertion. External auditors provide numerous other attestation services. They are often asked to examine one or more specified accounts or elements of the financial statements using limited but specific audit procedures, without conducting an audit of the entire financial statements. Many of these services are a natural extension of the audit of historical financial statements, as users seek independent assurance about other types of information. Such attest engagements are **agreed-upon procedures** engagements.

An agreed-upon procedures engagement is narrower in scope than an audit or review. Reports on agreed-upon procedures include a list of the procedures performed, related findings, and a restriction on the use of the report to specified parties. Such an engagement involves reporting findings based upon the procedures, rather than a conclusion.

The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings (IFAC, 2005: 939). As the auditor simply provides a report of the factual findings of agreed-upon procedures, no assurance is expressed. The auditor should only deliver the report of the factual findings to those parties that have agreed to the procedures to be performed. The recipients of the report form their own conclusions from the report by the auditor.

The auditor should comply with the Code of Ethics for Professional Accountants (issued by the International Federation of Accountants) governing the auditor’s professional responsibilities for this type of engagement including integrity, objectivity, professional competence and due care, confidentiality, professional behaviour and technical standards.

(IFAC, 2005: 939–940)
Examples of specific elements that could be the subject of the agreed-upon procedures engagement include:

- Detailed accounts receivable data used for loan collateral.
- Narrative description of an entity’s compliance with specific laws, regulations, rules, or contracts.
- Bank requirements for debtors to engage external auditors to provide assurance about the debtor’s compliance with certain financial covenant provisions stated in the loan agreement.
- A representation by management that all investment securities owned by an entity were traded in markets in a manner specified in the entity’s investment policies.
- Detailed analysis of property and equipment for insurance purposes.
- Attestation by external auditors to the information in a client’s forecasted financial statements, which are often used to obtain financing.

Concluding remarks

As the twentieth century came to a close, information technology and other environmental factors brought dramatic changes to business processes, business organization and to auditing. These changes demand reconsideration of the auditor’s role in the capital market economy. Auditing practice has evolved over the decades from a relatively straightforward historical verification of books and accounts, to a dynamic economic agent in owner-auditor-manager relationships. This chapter has provided an overview of the auditing environment.

This chapter, apart from some fundamental theoretical concepts of auditing and its scientific background, has discussed types of assurance and attestation services that an auditor can provide. Assurance engagements come in many forms and general guidelines become more difficult to specify as engagements become more specialized. Nevertheless, all assurance and attestation engagements are governed by the general and specific rules of accounting and auditing bodies such as IFAC, PCAOB, and AICPA.

It is now widely believed that the ‘archival audit’ – where the auditor comes in at the end of the year, examines financial statements, and issues a brief audit opinion – will inevitably be supplemented, if not replaced, by a more timely function. The future of auditing and assurance services lies in developments already under way and the audit market’s interaction with its evolving environment. Technological development and the need for real-time financial reporting have also demonstrated a shift in public expectations, especially in terms of the auditor’s role and the creation of a new assurance environment. As in the case of the demand for the early audit of financial statements, electronic business reporting will create demand for audit and assurance services.

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CHAPTER 1  AN INTRODUCTION TO AUDITING AND ASSURANCE


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Notes

1 The term ‘practitioner’ as used in the IFAC Framework (2004) is broader than the term ‘auditor’ as used in the International Standards on Auditing, which relates only to practitioners performing audit or review engagements with respect to historical financial information. The term ‘auditor’ is usually used throughout this chapter when describing persons performing audit, review, other assurance and related services. Such reference is not intended to imply that a person performing review, other assurance or related services needs to be the auditor of the entity’s financial statements. Other terms such as practitioner, professional accountant and/or public accountant may also be used.

2 In this section, the term ‘assurance engagement’ is used as defined by IFAC rather than ‘assurance services’.
3 High assurances (‘examinations’) are related to all financial-statement audits. Examinations provide decision-makers with a high level of assurance as to the reliability of information.

4 Reviews (moderate assurance) are substantially narrower in scope than examinations and they provide only a moderate level of assurance to decision-makers concerning the reliability of information.

5 The purpose of this International Standard on Assurance Engagements (ISAE) is to establish principles and essential procedures for, and to provide guidance to, professional accountants in public practice for the performance of assurance engagements other than audits or reviews of historical financial information covered by International Standards on Auditing (ISAs) or International Standards on Review Engagements (ISREs).

6 Compilations involve assembling the prospective statements based on management’s assumptions. The compilation report provides no assurance about the financial statements or the reasonableness of the assumptions.

7 The examination report includes an opinion on the statements and underlying assumptions. Examinations involve evaluating the preparation of the statements, the support underlying the assumptions, and the presentation of the statements.

8 The Committee of Sponsoring Organizations (‘COSO’) of the Treadway Commission has published ‘Internal Control: Integrated Framework.’ Known as the ‘COSO report,’ it provides a suitable framework for purposes of management’s assessment.

9 The Sarbanes-Oxley Act, in Section 404, requires managers to assess and report on a company’s internal control. It also requires a company’s independent, outside auditors to issue an ‘attestation’ to management’s assessment – in other words, to provide shareholders and the public at large with an independent reason to rely on management’s description of the company’s internal control over financial reporting.

10 This auditing standard relates to the Standard No. 2 on attestation engagements referred to in Section 404(b) as well as Section 103(a)(2)(A) of the Sarbanes-Oxley Act.

11 International Standard on Related Services (ISRS) 4400 (IFAC 2005) entitled ‘Engagements to perform agreed-upon procedures regarding financial information (previously ISA 920).’
CHAPTER 1
AN INTRODUCTION TO AUDITING AND ASSURANCE

Questions

REVIEW QUESTIONS

1.1 What types of assurance services are provided by the public accounting profession? What factors create a need for assurance services?

1.2 What is an attestation function? What major factors create a demand for the performance of attestation services by public accounting firms?

1.3 What is the essence of the ‘theory of inspired confidence’ developed by Limperg in 1930s.

1.4 What are the main objectives of audits of financial statements? How does an audit enhance the quality of financial statements?

1.5 How do assurance services differ from audit services? How have these differences developed in recent years?

1.6 What are the main differences between reasonable and limited levels of assurance engagements?

1.7 Explain the objective of agreed-upon procedures engagement and provide five examples of such procedures.

1.8 To what extent is it reasonable to view the external auditor as a guarantor in the capital market economy? Explain.

1.9 In your opinion, what are the potential threats facing an external auditor when conducting all types of assurance services?

1.10 What are the major aspects of the relationship between the structure of audit market and its regulation?

1.11 What is the primary rationale for market regulatory bodies to require mandatory reporting on internal accounting controls and the auditor’s involvement in this respect?

DISCUSSION QUESTIONS

1.12 To what extent do factors such as:
(a) economic developments;
(b) globalization and internationalization of capital markets;
(c) the complexity of financial operations; and
(d) information technology advances,
 affect the demand for and the performance of auditing services?

1.13 Discuss the historical perspective of auditing with regard to Limperg (1930s) and Mautz and Sharaf (1960s).

1.14 Discuss the arguments supporting the idea that auditing is a field of knowledge. What are the contributions of Mautz and Sharaf in this area?
QUESTIONS

1.15 A company's management, shareholders and creditors (mainly financial institutions) are directly concerned with the auditors' function and performance, particularly in the case of publicly traded companies.
   (a) Briefly discuss who among the above groups is the most important beneficiary of an auditor's report on a company's financial statements.
   (b) Describe the circumstances in which there are potential conflicts of interest between these groups. How should auditors resolve such conflicts in the needs of the above parties?

1.16 Market concentration has been a feature of auditing in the past few decades. Large accounting firms have come to dominate audit and assurance services. Discuss the effect of market concentration on audit quality in the context of capital market efficiency.

1.17 What is the role of regulatory bodies such as the SEC and PCAOB in the US and the European Commission in the audit market? Discuss this in terms of:
   (a) setting audit standards;
   (b) monitoring and performing the quality control reviews.

1.18 Discuss the following statement with regard to internal control over financial reporting within publicly traded companies. Evaluate the importance of this issue from the viewpoint of various interested parties (shareholders, manages, external auditors, regulators, potential investors, etc.).

   The PCAOB notes in its release (Auditing Standard March 2004 United States) that: The primary benefit [of an effective internal control structure] . . . is to provide the company, its management, its board and audit committee, and its owners and other stakeholders with a reasonable basis on which to rely on the company's financial reporting.

1.19 Discuss the following statement:

   Michael Power states that the rise of auditing has its roots in political demands for accountability and control. He argues that the new demands and expectations of audits live uneasily with their operational capabilities. Not only is the manner in which they produce assurance and accountability open to question but also, by imposing their own values, audits often have unintended and dysfunctional consequences for the audited organizations.

1.20 Visit the websites of the AICPA (www.aicpa.org), IFAC (www.IFAC.org) and PCAOB (www.pcaobus.org). Identify attestation services that have been recently defined by these accounting bodies. Prepare a report describing the nature of those services, and include a brief description of the criteria that have been developed for auditors to use in providing those services. Indicate significant differences between US and international approaches in terms of definitions for assurance and attestation services.