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Current Topics in Auditing

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Introductions

- Name
- Major
- Year
- Nationality
- Hobbies

Syllabus

- Memorandum
- Contact Information
- Objectives
- Background
- Grading
- Assignments
- Participation
- Examinations
- Academic Integrity
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- About the Instructor

Timetable

- Class
- Date
- Topic
- Readings
- Assignments

Timetable

- Social Science Research Fundamentals
- Economics of Auditing
- Audit Practice Topics
- Current Topics in Auditing

Sundry Misdirections

- We will not be studying auditing
- We will not be studying current topics
- I will not be teaching you the material

Sundry Misdirections

- We will not be studying auditing
- We will not be studying current topics
- I will not be teaching you the material
- *We will be studying auditing research*
- *We will cover classic topics and methods leading to current topics towards the end*
- *My role is to facilitate your learning*
- *You should be learning from each other not just from me, and not just by yourself*

The Big Picture

- I plan to lecture part of today and all of next Friday
- The Mid-term will be take-home, not in class
- The second part of Class 11 will be a group presentation by you all on a literature review you will perform
- The final class will be a free-for-all discussion of material identified by you
- Otherwise, each class we will discuss several papers; one student will present the paper; another will discuss it critically; and we will all debate it afterwards
- You will prepare a research *proposal*
- The point of the Final examination is to practice for the Qualifying Examination

The Big Picture

- Clearly the class is designed round the twin assumptions that you will all come to class prepared, and that you will all participate actively
- Trust me, there is no alternative!
- As well as learning new material we will be developing and practicing the professional skills of academic researchers

The Philosophies of Science and of Social Science

- Induction and probability
- Verification (logical positivists)
- Falsifiability (Popper)
- Paradigm Shifts (Kuhn)
- Incommensurability (Kuhn & Feyerabend)
- Under-determination of theory (Duhem-Quine)
- Data (evidence) is theory-laden

The Philosophies of Science and of Social Science

■ Reductionism

■ Positivism

- * Falsification
- * All knowledge founded in observation
- * Causation is just constant conjunction
- * There are no deep explanations
- * Unobservable, theoretical entities are suspicious
- * Opposition to Metaphysics

The Philosophies of Science and of Social Science

- Prediction versus explanation
- The Construction of Social Reality

What is Auditing?

- Auditing has been defined by the American Accounting Association 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 users.

What is Auditing?

- A very similar definition is given by Arens and Loebbecke:
 - * Auditing is the accumulation and evaluation of evidence about quantifiable information of an economic entity to determine and report on the degree of correspondence between the information and established criteria. Auditing should be done by a competent independent person.

What is Auditing?

- It is interesting to note, however, that although standards set by professional bodies such as the American Institute of Certified Public Accountants (AICPA) or the International Audit Practices Committee (IAPC) provide extensive guidance on how audits are to be performed, they contain no explicit definition of what an audit is. Both sets of standards state the *objective* of an audit as the expression of an opinion:

What is Auditing?

- The objective of the ordinary examination of financial statements by the independent auditor is the expression of an opinion on the fairness with which they represent financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles. (American Institute of Certified Public Accountants 1972)

What is Auditing?

- The objective of an audit of financial statements prepared within a framework of recognized accounting policies, is to enable an auditor to express an opinion on such financial statements. The auditor's opinion helps establish the credibility of the financial statements. (International Audit Practices Committee 1980)

What is Auditing?

- The process of auditing is *essentially* concerned with the aggregation of evidence in support of the auditor's opinion. Indeed, Arens and Loebbecke (1994) emphasize the central role of evidence-gathering:
 - * We believe that the most fundamental concepts in auditing relate to determining the nature and amount of evidence the auditor should accumulate after considering the unique circumstances of each engagement.
- Audit evidence is expected to be persuasive rather than conclusive.

What is Auditing?

- The extent of appropriate audit evidence accumulation is set out in the third standard of field work (American Institute of Certified Public Accountants 1972):
 - * Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination

What is Auditing?

- The value of such evidence is clearly variable:
 - * Evidential matter varies substantially in its influence on the auditor as he develops his opinion with respect to financial statements under examination. The pertinence of the evidence, its objectivity, its timeliness, and the existence of other evidential matter corroborating the conclusions to which it leads all bear on its competence. (American Institute of Certified Public Accountants 1980)

In God we trust, all others we audit

- According to: “A Statement of Basic Auditing Concepts” (American Accounting Association 1973), there are four conditions that create the need for the independent performance of the audit or attest function:
 - * *conflict of interest* (between the user and the preparer of financial information)
 - * *consequence* (significance to the decisions of the user of financial information)
 - * *complexity* (of the subject matter and the process of conversion into information)
 - * *remoteness* (of the user of financial information from the subject matter and the preparer).

In God we trust, all others we audit

- The economic role of the audit has been discussed by numerous authors, including Wallace (1980), who offers three alternative hypotheses:
 - * the *Stewardship (or Monitoring)* hypothesis: the audit provides assurance that numbers reported by stewards to enable monitoring by principals are carefully prepared and free of material fraud
 - * the *Information* hypothesis: the audit improves the quality of financial information used for investment decision making
 - * the *Insurance* hypothesis: the auditor is jointly and severally liable for losses attributable to defective financial statements, so that based on courts' inclinations auditors can provide protection from an otherwise uninsurable business risk of investment.

The Philosophy of Auditing

- Mautz and Sharaf conceive of auditing as a field of knowledge built on a central core of abstract thought including mathematics, logic and metaphysics. On this basis they build a hierarchical scheme consisting of:
 - I. philosophical foundations
 - II. postulates
 - III. concepts
 - IV. precepts
 - V. practical applications.

The Philosophy of Auditing

- At the next level of their scheme, Mautz and Sharaf (1961, p. 42) offer eight tentative postulates of auditing:
 1. Financial statements and financial data are verifiable.
 2. There is no necessary conflict of interest between the auditor and the management of the enterprise under audit.
 3. The financial statements and other information submitted for verification are free from collusive and other unusual irregularities.
 4. The existence of a satisfactory system of internal control eliminates the probability of irregularities.
 5. Consistent application of generally accepted principles of accounting result in fair presentation of the financial position and the results of operations.
 6. In the absence of clear evidence to the contrary, what has held true in the past for the enterprise under examination will hold true in the future.
 7. When examining financial data for the purpose of expressing an opinion thereon, the auditor acts exclusively in the capacity of an auditor.
 8. The professional status of the independent auditor imposes commensurate professional obligations.

The Philosophy of Auditing

- The implications of each of these postulates, and their relevance or otherwise to contemporary auditing, are issues well worthy of study, but would take us too far from the main purposes of this discussion. From the first of these postulates, concerning the verifiability of financial information, Mautz and Sharaf derive:
 - * the theory of evidence
 - * the procedure of verification
 - * the application of probability theory to auditing
 - * some bounds of the auditor's responsibilities.

The Philosophy of Auditing

- In order to do this, they bring to bear at the final level of their scheme five primary concepts of auditing (ibid. p. 67):
 - * evidence
 - * due audit care
 - * fair presentation
 - * independence
 - * ethical conduct.

The Philosophy of Auditing

- Flint (1988) gives a survey of the philosophy and principles of auditing more recent than Mautz and Sharaf's. The postulates he proposes as a basis for the development of audit theory are:
 1. The primary condition for an audit is that there is a relationship of accountability or a situation of public accountability.
 2. The subject matter of accountability is too remote, too complex and/or of too great significance for the discharge of the duty to be demonstrated without the process of audit.
 3. Essential distinguishing characteristics of audit are the independence of its status and its freedom from investigatory and reporting constraints.
 4. The subject matter of audit, for example conduct, performance or achievement or record of events or state of affairs, or a statement or facts relating to any of these, is susceptible to verification by evidence.

The Philosophy of Auditing

5. Standards of accountability, for example of conduct, performance, achievement and quality of information, can be set for those who are accountable; actual conduct, performance, achievement, quality and so on can be measured and compared with these standards by reference to known criteria; and the process of measurement and comparison requires skill and the exercise of judgment.
6. The meaning, significance and intention of financial and other statements and data which are audited are sufficiently clear that the credibility which is given thereto as a result of audit can be clearly expressed and communicated.
7. An audit produces an economic or social benefit.

The Philosophy of Auditing

- More recently, an extended theory of corporate audit has been provided by Lee (1993), who states the following postulates at greater length than Mautz and Sharaf or Flint:
 1. The quality of the accounting information reported in the financial statements of the generality of corporate organizations lacks sufficient credibility without formal verification and attestation to be used with complete confidence by shareholders and other report users as part of the corporate accountability process.
 2. When using the audit function as part of the process of corporate accountability, verification and attestation of the quality of reported financial statements to shareholders and others is the most desired audit in the generality of corporate situations.
 3. Verification and attestation of the quality of reported financial statements to shareholders and others is best achieved by regulation in the generality of corporate situations.
 4. In the generality of corporate situations, the quality of reported financial statements to shareholders and others can be satisfactorily attested by the verification process of an external audit.

The Philosophy of Auditing

5. In the generality of corporate situations, shareholders and others with a legitimate interest are not in a position to verify and attest personally to the quality of the reported financial statements.
6. There is no conflict of interest between the corporate auditor and corporate management which hinders his or her verification and attestation of the quality of reported financial statements to shareholders and other interested users.
7. There are no unreasonable legal or other regulatory restrictions placed upon corporate auditors which hinder their verifying and attesting the quality of reported financial statements to shareholders and other interested users.
8. The corporate auditor is in a suitably independent position, both mentally and physically, to verify and attest with sufficient objectivity the quality of the reported financial statements to shareholders and other interested users.
9. The corporate auditor is sufficiently skilled and experienced to competently conduct the audit function of verifying and attesting the quality of the reported financial statements to shareholders and other interested report users.

The Philosophy of Auditing

10. The corporate auditor can be held accountable as a professional expert for the quality of his or her audit work and related opinion on the quality of the reported financial statements to shareholders and other interested report users.
11. The over-riding quality of reported financial statements for corporate audit purposes is interpreted mainly in terms of their relevance and reliability, and there are standards by which the corporate auditor can determine the existence of such a quality.
12. There is sufficient competent and reliable evidential material available to allow the corporate auditor to properly substantiate an audit opinion on the quality of the reported financial statements to shareholders and other report users; and the corporate auditor can collect and evaluate this material within a reasonable time and at a reasonable cost.
13. The accounting information contained in the reported financial statements to shareholders and other report users is free of major fraud and error.
14. The relevance and reliability of reported financial statements to shareholders and other report users can be reported meaningfully to them by the corporate auditor.

The Philosophy of Auditing

- Prolegomena for a Theory of Audit Evidence
 1. Financial statements and financial data are verifiable by the audit process.
 2. The audit process requires the gathering and evaluation of audit evidence, which can be completed in a timely manner at an acceptable cost.
 3. Audit procedures are the techniques by which audit evidential matter is obtained.
 4. Audit evidence comprises the combined audit evidential matter evaluated and judged by the auditor.

The Philosophy of Auditing

5. Audit evidence influences the auditor's beliefs regarding the various audit objectives.
6. The audit opinion is rendered based on the degrees of beliefs of the auditor in the light of the audit evidence obtained and evaluated.
7. Audit value to society is provided by warranted audit opinions.

The Philosophy of Auditing

8. **The audit opinion rendered is warranted based on:**
- ❖ the coherence of subjective assessments of beliefs based on evidential matter, in the light of the auditor's experience
 - ❖ the consistency of subjective assessments of beliefs based on evidential matter with the assessments of expert auditors
 - ❖ the consistency of objective assessments of beliefs based on evidential matter with the canons of the selected representation of uncertainty (for example, for statistical sampling)
 - ❖ the consistency of the structure of the audit evidence with the judgments of audit experts
 - ❖ the consistency of the aggregation and combination of beliefs with the calculus appropriate to the selected representation of uncertainty
 - ❖ the consistency of the decision regarding the opinion to be rendered with the strength of belief produced by the audit evidence, as assessed by audit experts.

The Philosophy of Auditing

9. The level of assurance provided to users by an audit process is directly related to (but not necessarily identical to) the strength of the auditor's belief in the audit evidence.
10. Successful audits will result in audit risk that is inversely related with the strength of belief in the audit evidence.