

Course: Financial Audit

Lecture 2: The Audit Market

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Introduction

Overview of Lecture 2

Modern Auditing Practices

- The rise of the modern audit profession can be traced back to the Industrial Revolution, which began in Great Britain around 1780.
- During this period, massive industrial enterprises emerged, characterized by complex administrative systems and an increasing need for external sources of finance to support expansion.

Management Control

- Corporate management has full control over the company's accounting systems, including the preparation of financial reports intended for investors.
- However, it is unreasonable to expect management to always be impartial, as the nature of these reports can significantly impact their interests, including compensation, shareholdings, and job security.

Financial Reports & Role of Auditors

- Financial reports serve as indicators of management's effectiveness in fulfilling their responsibilities, influencing their compensation, the value of their equity stakes, and even their continued employment.
- To enhance the reliability of these financial reports for investors and creditors, independent and qualified auditors are hired to provide an unbiased opinion regarding the accuracy and fairness of the presented information.

Theories Underpinning Auditing Services

- The demand for auditing services is supported by multiple theories, which provide different perspectives.
- Well-established theories like the Theory of Inspired Confidence and Agency Theory offer insights into the motivations behind audit services, while other theories, such as the Policeman Theory and the Lending Credibility Theory, reflect the public's perception of the audit profession, serving as a basis for discussion rather than a thoroughly researched framework.

The Policeman Theory

- . The Policeman Theory revolves around the question: Is it the auditor's duty to detect and prevent fraud, akin to the role of a police officer?

The Lending Credibility Theory

- According to the Lending Credibility Theory, financial reports audited by an independent professional bolster stakeholders' trust in management.
- This ensures that stakeholders, including shareholders, regulators, and creditors, can make decisions with confidence in the integrity of the information provided.

Theory of Inspired Confidence

- The Theory of Inspired Confidence addresses both the demand for and supply of audit services. According to this theory, stakeholders who contribute to the company expect management to be accountable.
- Auditors should strive to fulfill their duty within the limits of audit technology, ensuring their work aligns with public expectations.

Agency Theory

- Agency Theory, views the auditor as a means to align the interests of management (agents) and other stakeholders (principals).
- The theory highlights several costs associated with these relationships, including monitoring costs (to oversee management), bonding costs (incurred by management to assure stakeholders), and residual loss (the economic loss that remains despite oversight).

Agency Theory

- The principal-agent relationship involves complexities, primarily due to information asymmetry.
- Given that management relies on stakeholders for financial and operational support, they have a vested interest in ensuring that stakeholders have faith in the information provided, hence necessitating the appointment of credible auditors.

Agency Theory

- Agency Theory also helps explain the auditor's role on the supply side.
- The value of an audit depends on the likelihood of the auditor detecting and reporting errors or fraud, even against the client's wishes, this is tied to the concept of auditor independence..

Voluntary vs Mandatory

- Historically, the demand for audits in many countries was voluntary, with companies having the discretion to determine whether or not to audit their financial statements.
- Similarly, the supply of audit services was largely unregulated, meaning that anyone could offer audit services.

Voluntary vs Mandatory

- Audits are now legally required for certain types of companies in most countries.
- For instance, in the United States and European Union, large and, in some cases, medium-sized businesses must provide audited financial statements.

Oversight Boards

- In recent years, there has been an increase in the number of accounting oversight boards, including government and professional committees that establish and enforce auditing standards.
- Notable examples include the Public Company Accounting Oversight Board (PCAOB) in the USA, the Financial Reporting Council (FRC) in Australia, and the Review Board in the UK. The PCAOB, established by the Sarbanes-Oxley Act of 2002, oversees audits of public companies and enforces compliance with regulations.

SOX of 2002

- Prompted by the corporate scandals involving Enron, WorldCom, and others, the Sarbanes-Oxley Act was passed to restore investor confidence in financial markets.

Australia's FRC

- The FRC monitors developments in international accounting standards, provides strategic direction to the Australian Accounting Standards Board (AASB), and oversees its priorities and business plan.

UK's Review Board

- In the United Kingdom, the Review Board, funded by the Accountancy Foundation Limited, is responsible for ensuring that the regulatory system fully serves the public interest.
- Its oversight extends to the Ethics Standards Board, the Auditing Practices Board, and the Investigation and Discipline Board. The Review Board also oversees the investigation, training, and qualifications related to professional accountants.

Big Four vs Non-Big Four

- Audit firms can broadly be classified into two groups: the Big Four and Non-Big Four firms. The Big Four (Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers) resulted from several major mergers in the 1980s and operate through a global network.
- Though these firms are structured as national partnerships, they maintain international coordination through shared methodologies and resources, enhancing their ability to conduct multinational audits efficiently.

Big Four vs Non-Big Four

- The Big Four audit firms operate through an extensive global network and account for a significant share of international audit engagements.
- Although the member firms of the Big Four networks often function as separate national partnerships, they participate in international coordination to ensure consistency.

Big Four vs Non-Big Four

- It is often argued that the Big Four audit firms deliver superior audit quality compared to their smaller counterparts.
- The basis for this assumption lies in several factors: firstly, the Big Four have superior resources, including advanced auditing technologies, which give them an edge in conducting thorough audits.
- Secondly, the revenue from any single client constitutes a smaller percentage of the overall fee income for these large firms, making them less dependent on individual clients. This lesser dependence is seen as a factor that potentially enhances their objectivity and independence.

Big Four vs Non-Big Four

- Additionally, audit independence is often thought to vary depending on client size.
- Similarly, companies facing financial distress are believed to receive more intensive audits compared to their well-performing peers.

Market Evaluation

- In evaluating auditors in the marketplace, clients consider both technical and functional elements of audit quality.
- Technical audit quality refers to how effectively an audit meets expectations concerning the detection and reporting of errors, irregularities, or fraud in financial statements.
- On the other hand, functional audit quality concerns the manner in which the audit is executed and how well the process aligns with the expectations of stakeholders.

Audit Tenure

- The length of an auditor's relationship with a client, known as audit tenure, can influence audit quality in complex ways. Generally, audit engagements during the first year are considered less comprehensive, as auditors need time to understand the nuances of the client's business and identify all potential risks.
- However, prolonged tenure (particularly beyond ten to fifteen years) may lead to a decline in the quality of skepticism. Overly close relationships with management may result in a less critical approach, ultimately undermining audit effectiveness.

Audit Fees

- Audit fees are influenced by multiple factors, which represent the other side of the coin compared to audit quality.
- Key determinants of audit fees include the size and complexity of the client, where larger companies or those with geographically dispersed operations tend to incur higher audit costs due to increased audit scope.
- Another important factor is the size of the audit firm itself.
- If a company also engages the auditor for other advisory services, this may result in bundled fee arrangements.
- Finally, the type of fee contract can also affect the overall cost of the audit engagement.

Stakeholders & Legal Liability

- A broad range of stakeholders depends on audited financial statements, each with its own interest in the audit process. These stakeholders include the company itself, current and potential investors, lenders such as banks, suppliers, employees, and even government agencies.
- The legal liability of auditors towards each of these groups differs depending on jurisdiction, as liability may be shaped by common law, statutory law, criminal law, or professional standards.
- Under common law, auditors may face liability in two primary categories: liability to clients and liability to third parties.

Statutory Liability

- Various countries have statutory laws that outline the civil liabilities of auditors, especially regarding securities transactions.
- Auditors bear the burden of proving that they conducted a reasonable investigation, or that losses were due to factors unrelated to their audit work. Failure to prove this generally results in the auditor being liable for damages.
- Moreover, auditors can also face criminal liability if they knowingly engage in deceitful practices, such as providing false financial statements.

Disciplinary Actions

- Most countries have established disciplinary mechanisms to maintain standards within the audit profession. Such disciplinary courts often include representatives from both the auditing and legal professions, as well as, in some cases, members of the general public.
- Following a formal hearing where arguments from both the plaintiff and the defendant are considered, the disciplinary court can impose sanctions ranging from fines and reprimands to suspensions and even permanent bans from the profession.
- The outcomes of these disciplinary hearings are often made public, particularly if severe sanctions such as a suspension or lifetime ban are imposed.

Litigation Risks

- Over the past few decades, litigation risks have become a major concern for audit firms, particularly following several high-profile cases that resulted in substantial settlements.
- The financial burden of litigation poses a significant threat to the viability of the audit profession, leading to calls for various protective measures.

Audit Expectation Gap

- The debate surrounding the role of auditors has been ongoing for decades, often referred to as the "audit expectation gap." This gap arises from the discrepancy between what the public expects from auditors and what auditors actually do.
- This expectation gap continues to fuel public debates about the duties and responsibilities of auditors .

Users of Audit Services

- The users of audit services can be broadly categorized into two main groups: internal stakeholders, typically the board of directors (referred to as auditees), and external third parties.
- These external parties include shareholders, lenders, creditors, employees, customers, and other interested groups.

Users of Audit Services

- Specifically, these expectations often revolve around the following key responsibilities of auditors:
 - Assessing the fairness of the financial statements presented.
 - Evaluating whether the organization can continue as a going concern in the foreseeable future.
 - Reviewing the internal control framework of the company.
 - Investigating the potential occurrence of fraud.
 - Evaluating any occurrences of illegal acts.

Fairness in Financial Reporting

- The assessment of the fairness of financial statements is often seen as the cornerstone of an auditor's role. National and international auditing standards emphasize this as a core duty.
- Yet, an expectation gap exists, where the public often presumes that financial statements with an unqualified audit opinion are entirely error-free.

ISA 700

- International Standard on Auditing (ISA) 700 addresses the concept of fairness in financial reporting.
- It emphasizes that the reporting framework is built on International Financial Reporting Standards (IFRS), regulations set by recognized standard-setting bodies, and the general accounting practices prevalent within a country, with fairness considered in light of local laws.

ISA 570

- A significant challenge to the credibility of auditors arises when companies fail shortly after receiving an unqualified audit opinion.
- Under ISA 570, auditors are expected to evaluate an entity's ability to continue as a going concern, flagging any serious doubts through their reports.

Expectation Gap

- There is an evident gap between the expectations of certain stakeholders and the defined duties of auditors.
- For example, in situations where a company faces potential bankruptcy, auditors may still issue an unqualified opinion with appropriate explanatory paragraphs.

Internal Control Assessment

- The audit process recognizes the importance of assessing a company's internal control systems.
- According to ISA 400, auditors are required to understand internal controls to design an appropriate audit approach.

Internal Control Assessment

- The Sarbanes-Oxley Act's Section 404 specifies that each company's annual report must contain an "internal control report."
- This report must outline management's responsibility for establishing internal controls, provide an assessment of their effectiveness, and include attestation from external auditors.

Fraud Detection

- The issue of fraud remains at the core of the audit expectation gap. Many stakeholders expect auditors to detect and disclose all instances of fraud.
- Historically, fraud detection was a key focus of auditing, but over time, the scope of the audit shifted, leading to decreased emphasis on fraud detection.
- In the mid-20th century, the role of auditors evolved to prioritize providing opinions on financial statements rather than focusing on fraud detection.

Fraud Detection

- ISA 240 describes the current role of auditors in preventing and detecting fraud. The responsibility for fraud primarily rests with those responsible for governance and management.
- While performing audit procedures, auditors may identify potential indications of fraud or error. When such findings are material, auditors must escalate their concerns to management and determine the impact on the audit report.
- SAS 99, issued by the AICPA, requires auditors to consider where the company's financial statements may be susceptible to fraud during the planning phase.

Reporting Illegal Acts

- ISA 250 and national regulations restrict this responsibility to detecting illegal acts that have a material effect on financial statements.
- If illegal acts are identified, auditors are expected to communicate the implications for financial statements within the audit report and, depending on jurisdiction, may be required to inform relevant authorities.
- The majority of expectation gap studies indicate that stakeholders believe auditors should identify and report illegal acts that significantly affect financial statements.

COSO Report Objectives

- The COSO Report, developed by the Committee of Sponsoring Organizations of the Treadway Commission, aimed to:
 - Harmonize definitions related to internal control and its components.
 - Provide a framework for management to assess the quality of internal control systems.
 - Develop benchmarks for internal control to enable comparison with best practices.
 - Form a foundation for external reporting on internal control adequacy.

Cadbury Report

- The Cadbury Report, which was released in the United Kingdom by the Committee on the Financial Aspects of Corporate Governance, addresses the distinct roles and responsibilities of both executive and non-executive directors on corporate boards.
- This report introduced a pioneering framework for corporate governance, emphasizing accountability and transparency in managing public companies.
- It recommended that companies listed on the London Stock Exchange comply with a set of governance standards known as the "Code of Best Practice".
- The Code provided specific guidelines to improve board effectiveness, maintain transparency in decision-making, and protect shareholders' interests.

Cadbury Report

- According to the Combined Code, boards are mandated to explicitly declare their adherence to these governance principles in their published financial statements.
- The Combined Code further refined these expectations, extending the scope of internal control review beyond financial controls alone, to encompass all types of operational and compliance controls.

Turnbull Report

- The Turnbull Report, formally known as "Internal Control: Guidance for Directors on the Combined Code".
- This report was a significant milestone in providing practical guidance for companies listed on the London Stock Exchange, assisting them in effectively implementing internal control requirements as outlined in the Combined Code.
- The Turnbull Report established that a company's board of directors must set clear policies regarding internal control, and they must also seek ongoing assurance that these systems are functioning effectively.

Accounting Scandals

- The collapse of Enron and subsequent scandals involving high-profile corporations like WorldCom, Xerox, and Tyco triggered a public outcry and a strong legislative response in the United States.
- These scandals revealed widespread malpractices, such as inflated earnings and misrepresentation of financial information, which caused significant financial losses for investors and undermined confidence in corporate governance.

New Requirement

- The Sarbanes-Oxley Act imposed new responsibilities on audit firms and audit committees, ensuring greater independence and transparency.
- Under the Act, auditors were now required to report directly to the audit committee instead of company management, emphasizing an independent oversight role to prevent conflicts of interest.
- The lead audit partner, as well as the audit review partner, were subject to mandatory rotation every five years, aimed at maintaining independence and preventing the development of cozy relationships with the client.

New Requirement

- Additionally, a second partner was tasked with reviewing and approving the audit report to add another layer of scrutiny.
- The Act also defined eight types of non-audit services that were deemed unlawful for a public company's auditor to provide, as these could impair objectivity and independence.
- These prohibited services included bookkeeping, information systems design, appraisal services, actuarial services, internal audits, management and human resource functions, investment banking, and legal services related to audits.
- The Public Company Accounting Oversight Board (PCAOB), created under the Act, was authorized to regulate additional services if necessary to preserve the auditor's impartiality.

Conclusion

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Closing

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Reference (reading material):

- Principles of Auditing: an Introduction to International Standards on Auditing, 3rd Edition, Hayes, Wallage, and Gortemaker, Pearson Education Limited, 2014