

List of Figures	xix
Preface	xxii
Acknowledgements	xxv
About the Author	xxviii
1 An Introduction to Auditing and Assurance	1
2 Demand for and Supply of External Audit Services	28
3 Auditing, Organization and Governance	66
4 The Audit Committee, Internal and External Auditing	92
5 International Auditing and Assurance Services	126
6 Auditing in the European Context	159
7 Auditor Independence and Professional Ethics: International Issues	184
8 Audit Risk, Materiality and Business Risk Management	215
9 Audit Sampling Techniques	242
10 Evidence and Decision Making in Auditing	279
11 Internal Control over Financial Reporting and IT Environment	301
12 Audit Reporting	336
13 Information Technology and Auditing	387
14 Continuous Auditing and Continuous Reporting	416
15 Quality Control and Oversight Systems in Auditing: International Issues	442
16 Auditor Liability in a Changing Environment	471
17 The Independent Auditor, Stock Markets and Lending Decisions	496
18 Corporate Fraud, Corporate Scandals and External Auditing	532
19 Auditing: Looking Ahead	577
Glossary	609
Index	634

Contents

List of Figures	xix
Preface	xxii
Acknowledgements	xxv
About the Author	xxviii

1 An Introduction to Auditing and Assurance **1**

Learning objectives	1
Introduction	2
Questions about the critical role of auditors	2
The nature and objectives of auditing	4
Recent changes in the audit environment	5
A theoretical approach to auditing	7
Debating the historical perspective of auditing concepts	8
The demand for assurance services: an economic explanation	14
Attestation services	18
Concluding remarks	23
Bibliography and references	23
Notes	24
Review questions	26
Discussion questions	26

2 Demand for and Supply of External Audit Services **28**

Learning objectives	28
Introduction	29
Debating audit expectations	30
Demand and supply of audit	33
Parties demanding financial statement information	33
The problem of 'information asymmetry'	37
The economics of information	39
Supply of financial statement information (mandatory and voluntary disclosures)	39
Factors affecting corporate financial disclosure	41
External auditors and supply and demand of financial information	44
Demand for auditing	45

Conditions creating demand for auditing	46
Theoretical explanations of the demand for audit services	49
Concluding remarks	60
Bibliography and references	60
Notes	62
Review questions	64
Discussion questions	64

3 Auditing, Organization and Governance **66**

Learning objectives	66
Introduction	67
Auditing and organizations	67
The economics of corporate governance	72
The governance malaise	75
Essential elements of corporate governance	76
Corporate governance and corporate reporting	81
External auditing and corporate governance as a multidisciplinary field	84
Concluding remarks	87
Bibliography and references	88
Notes	89
Review questions	90
Discussion questions	90

4 The Audit Committee, Internal and External Auditing **92**

Learning objectives	92
Introduction	93
Overview of governance mechanisms	93
An overview of audit committee and its place in corporate governance structure	94
Basic functions of the audit committee	95
Evolution of the role of the audit committee	96
Audit committee independence	97
Economic determinants of audit committee independence	97
Oversight role of the audit committee in corporate financial reporting	101
The relationship between the audit committee and internal auditing	105
Oversight role of the audit committee in financial risks and internal control	108
The audit committee and independent auditors	112
Audit committee and compliance with laws and codes of conduct	113
Concluding remarks	114
Bibliography and references	115
Notes	116
Review questions	118
Discussion questions	118
Appendices	120

5 International Auditing and Assurance Services**126**

Learning objectives	126
Introduction	127
Generally accepted auditing standards (GAAS) in the US	127
The IFAC and the international harmonization of auditing standards	129
International Standards on Auditing (ISAs)	131
The International Auditing Practices Committee and ISAs	132
Role, composition and objectives of the IAASB	132
The framework of International Standards on Auditing	138
General principles of an audit	139
The International Standard on Assurance Engagements (ISAE 3000)	140
Principles and essential procedures for assurance engagements	145
Harmonization of accounting standards	151
Concluding remarks	154
Bibliography and references	155
Notes	156
Review questions	157
Discussion questions	157

6 Auditing in the European Context**159**

Learning objectives	159
Introduction	160
European directives in statutory auditing	160
Eighth European Directive (1984) and approved new Eighth Company Law on statutory audits (2005)	161
Features of the approved directive on audits of company accounts	162
Other European Commission actions in statutory auditing	166
Summary of the European Commission priorities in auditing	169
European Commission's strategy with regard to US regulations	177
European Federation of Accountants (FEE)	178
Concluding remarks	178
Bibliography and references	179
Notes	180
Review questions	182
Discussion questions	182

7 Auditor Independence and Professional Ethics: International Issues**184**

Learning objectives	184
Introduction	185
The fundamental ethical principles of the audit profession	185

Auditor independence in question	190
The economics of auditor independence	195
Definitions of threats and risks to auditor independence	201
Auditor independence in the European context	202
The position of US regulators on auditor independence	206
Concluding remarks	209
Bibliography and references	210
Notes	212
Review questions	213
Discussion questions	214

8 Audit Risk, Materiality and Business Risk Management 215

Learning objectives	215
Introduction	216
Different types of audit risk	216
The audit risk model (ARM) at the planning stage	221
The external auditor's risk assessment procedures	228
The auditor and materiality assessment	228
Selecting appropriate controls in audit risk assessment	230
Risk assessment and the auditor's understanding of the company	231
The auditor's concerns about significant risks	232
Business risk	233
Concluding remarks	236
Bibliography and references	237
Notes	238
Review questions	239
Discussion questions	240
Appendix	241

9 Audit Sampling Techniques 242

Learning objectives	242
Introduction	243
Uncertainty and audit sampling	243
Evidence and sampling	244
Sampling risk	244
Non-sampling risk	246
Statistical and non-statistical sampling	247
Comparison of statistical and non-statistical sampling approaches	249
General discussions on audit sampling	249
Audit sampling techniques	259
Steps involved in statistical sampling	267
Concluding remarks	275
Bibliography and references	276

Notes	276
Review questions	277
Discussion questions	277

10 Evidence and Decision Making in Auditing **279**

Learning objectives	279
Introduction	280
The concept of audit evidence	280
Some reflections on audit evidence	283
The use of assertions in obtaining audit evidence	284
Audit procedures for obtaining evidence	285
Auditing as a decision-making process	290
Bounded rationality and heuristics in auditing	294
Concluding remarks	298
Bibliography and references	299
Notes	299
Review questions	300
Discussion questions	300

11 Internal Control over Financial Reporting and IT Environment **301**

Learning objectives	301
Introduction	302
The need for control	302
Internal control definition	303
Internal control framework	303
Relationship of objectives and internal control components	309
'Tone at the top' or 'control environment'	309
The auditor's understanding of control environment	310
Limitations on internal control effectiveness	313
The auditor's understanding of external environment	314
Essential terms used in reporting on internal control	315
Assessing the reliability of internal control	316
Management's and auditor's reports on internal control	316
The 'top-down approach' to audit of internal control	319
Enterprise Risk Management (ERM)	320
Effectiveness of internal control in an IT environment	323
Developments in the audit of internal control within the IT environment	323
Features of the COSO report in the area of IT	324
The US Sarbanes-Oxley Act and IT controls	326
The IFAC on IT and audits of internal control	329
Concluding remarks	331
Bibliography and references	332

Notes	333
Review questions	334
Discussion questions	334

12 Audit Reporting

336

Learning objectives	336
Introduction	337
Reporting standards	337
Types of audit reports	339
The standard audit report	341
Forming the opinion on the financial statements	343
Departures from standard audit report	344
Qualified reports	349
'Adverse opinion' qualified audit report	359
Disclaimer of opinion	360
Other reporting responsibilities of the external auditor	362
Auditor's report in European countries	368
Concluding remarks	368
Bibliography and references	369
Notes	370
Review questions	371
Discussion questions	372
Problems	373
Cases	374
Appendix (auditors' reports in the European countries)	382

13 Information Technology and Auditing

387

Learning objectives	387
Introduction	388
An overview of the IT environment	388
Challenges facing auditors in an IT environment	389
Auditing and electronic commerce and electronic business	390
Reliability of accounting information and IT risks	392
Audit risk in an e-commerce environment	396
Information technology risk management	399
Planning the audit in a computer environment	400
Auditor's concerns regarding risk assessment in an IT environment	400
Computer-assisted audit techniques (CAATs)	402
Concluding remarks	412
Bibliography and references	412
Notes	413
Review questions	414
Discussion questions	414

14 Continuous Auditing and Continuous Reporting **416**

Learning objectives	416
Introduction	417
An assessment of IT in organizations	417
IT controls and the auditor	420
COBIT framework	420
Information technology advances and assurance services	423
Continuous reporting	424
An overview of XBRL	425
An overview of continuous audit: assurance in a real-time economy	429
Continuous assurance	433
Continuous monitoring	434
Similarities and differences between continuous monitoring and continuous auditing	435
Concluding remarks	437
Bibliography and references	437
Notes	438
Review questions	439
Discussion questions	439
Appendix	441

15 Quality Control and Oversight Systems in Auditing: International Issues **442**

Learning objectives	442
Introduction	443
An overview of quality control in auditing at international level	443
Setting standards in auditing	446
Ethical standards	446
Public oversight of the auditing profession	447
Self-regulation	447
Monitoring, disciplinary schemes and sanctions	448
The position of the IFAC on quality control	448
Audit quality control in the European Union	456
Audit quality control in the United Kingdom	458
Audit quality control in the United States	460
Concluding remarks	465
Bibliography and references	466
Notes	467
Review questions	469
Discussion questions	469

16 Auditor Liability in a Changing Environment**471**

Learning objectives	471
Introduction	472
Company accounts: who is liable?	472
Economic analysis of auditor's liability	473
The increasing litigation risk against auditors	474
Changes in the legal environment	475
Types of audit professional liability	476
The German experience of capping auditor liability	481
Mandatory insurance for corporate directors	482
Efforts to modify unlimited auditor liability system	483
Threatened litigation in assurance services	483
Common law and statutory law	484
Auditor liability in the US	485
The European approach towards auditors' liability	486
The UK profession's plea for auditor liability reforms	489
Concluding remarks	491
Bibliography and references	492
Notes	493
Review questions	494
Discussion questions	494

17 The Independent Auditor, Stock Markets and Lending Decisions**496**

Learning objectives	496
Introduction	497
The auditor's role in corporate financial reporting	498
The critical role of auditors and the changing audit environment	498
Auditors and the capital market	499
An overview of market efficiency	500
Demand for capital market research in accounting and auditing	503
Event studies in accounting and auditing	503
The relationship between audit opinion and stock price	506
Problems of research design	511
Contributions to research on audit reports in the 1980s	513
Complementary studies in the 1990s	516
Lending decisions, accounting information and the independent auditor	518
Future research directions	522
Concluding remarks	524
Bibliography and references	524
Notes	528
Review questions	530
Discussion questions	530

18 Corporate Fraud, Corporate Scandals and External Auditing

532

Learning objectives	532
Introduction	533
Fraud and error in financial statements	533
The importance of the concept of fraud in corporate reporting and auditing	535
Auditor's responsibilities for detecting material misstatement due to fraud	542
Audit procedure to identify the risks of material misstatement due to fraud	543
Red flags of fraud: 'warning signals'	547
Temptation to manage earnings	550
The audit profession and corporate financial failures	555
Enron	556
The WorldCom collapse	560
Evidence from the audit failure at Lincoln Savings and Loan	562
The Parmalat scandal	563
Bank of Credit and Commerce International	565
The Royal Ahold case	568
Concluding remarks	570
Bibliography and references	571
Notes	573
Review questions	575
Discussion questions	575

19 Auditing: Looking Ahead

577

Learning objectives	577
Introduction	578
How the audit profession got to where it is today	578
The bubble economy: does it do more harm than good?	580
Audit concentration	581
Implications of firms moving into consulting services	582
Challenges facing the audit profession	584
Regulators' reaction to audit concentration	589
Regulation and monitoring: can the auditing profession regulate itself?	591
Audit education for the twenty-first century	592
Research in auditing as an imperative	594
Auditors facing a world of change	594
The revolving door: auditor tenure and audit quality	596
Economics of audit pricing: a challenge for the audit market and regulators	597
The litigation crisis	599
Globalization of markets and harmonization of standards	599
Where do we go from here?	600
Concluding remarks	604
Bibliography and references	604

CONTENTS

Notes	606
Review questions	607
Discussion questions	607
Glossary	609
Index	634

List of Figures

2.1	Auditor Function as a Value-Added Factor in Corporate Financial Reporting	30
2.2	Parties Demanding Financial Statement Information	34
2.3	Supply of Financial Statement Information	40
2.4	Financial and Information Flows in a Capital Market Economy	42
2.5	Auditors' Role in Supply and Demand of Financial Information	45
2.6	Conflicts of Interest Between Shareholders and Managers	56
2.7	Role of External Auditor in Monitoring Information	58
3.1	Shareholder, Manager and Auditor Relationships Within an Organization	68
3.2	Major Contributions to the Evolution of the Theory of the Firm	75
3.3	Essential Elements of Corporate Governance	77
3.4	Financial Reporting Process	83
3.5	The Relationship Between External Auditor and Company	85
4.1	Governance Mechanisms	94
4.2	The Three-Legged Stool of Financial Reporting	102
4.3	Current and Emerging Issues Facing Audit Committees	110
5.1	International Standards on Auditing, Assurance and Related Services	134
5.2	Differences Between Reasonable Assurance Engagements and Limited Assurance Engagements	144
5.3	International Reporting Standards (IFRS) and International Accounting Standards (IAS)	153
6.1	Measures Proposed in the EU Directive on Statutory Auditors and Audit Firms	163
6.2	Specific Measures of the EU Directive (2005) Applicable to Statutory Auditors and Audit Firms of Publicly Listed Companies	164
6.3	Measures Included in the EU Directive (2005) to Reinforce Public Oversight of the Audit Profession	165
6.4	Ten-Point Action Plan on Statutory Audit	167
7.1	Prohibited Non-Audit Services	200
8.1	Overview of the Audit Process	218
8.2	Example of the Audit Risk Model	224
8.3	Example of the Inverse Relationship Between Detection Risk and Inherent and Control Risks	225
8.4	Event Sequence	226

LIST OF FIGURES

8.5	Event Sequence with Prevention by Controls	226
8.6	Interrelationship of the Components of Audit Risk	227
8.7	Identifying and Assessing Risk from a Risk Management Approach	234
8.8	Risks Affecting a Company's Business	236
9.1	Types of Sampling Risk for Tests of Controls	245
9.2	Types of Sampling Risk for Substantive Tests of Details	246
9.3	Factors Influencing Sample Size for Tests of Control	252
9.4	Factors Influencing Sample Size for Substantive Procedures	253
9.5	Differences Between Attribute and Variable Sampling	259
9.6	Reliability Factors for Overstatements	265
9.7	Expansion Factors for Expected Misstatement: PPS Sampling	266
9.8	Sample Size Table for Attribute Sampling (10% Risk of Overreliance)	270
9.9	Sample Size Table for Attribute Sampling (5% Risk of Overreliance)	271
9.10	Statistical Sample Evaluation Table (10% Risk of Overreliance)	272
9.11	Statistical Sample Evaluation Table (5% Risk of Overreliance)	273
11.1	Internal Control Components	305
11.2	The Evolution of Risk Management	322
12.1	Hierarchy of Types of Audit Reports on Company's Financial Statements	340
12.2	Example of Auditor's Standard Report on Financial Statements	342
12.3	Example of Qualified Report: Disagreement on Accounting Policies (Inappropriate Accounting Method)	349
12.4	Qualified Report: Disagreement on Accounting Policies (Inadequate Disclosure)	351
12.5	Example of the Auditor's Unqualified Report When the Note Disclosure on Going Concern Assumption <i>Is</i> Adequate	356
12.6	Example of the Auditor's Qualified Report When the Note Disclosure on Going Concern Assumption <i>Is Not</i> Adequate	357
12.7	Example of the Auditor's Adverse Opinion When the Note Disclosure on Going Concern Assumption <i>Is Not</i> Adequate	357
12.8	Example of Auditor's Adverse Opinion Report	361
12.9	Example of Auditor's Report with a Disclaimer of Opinion Because of a Scope Limitation	363
12.10	Review Report on Interim Financial Statements	366
12.11	Sample audit reports in France, Germany, and the UK	376
12.12	US Unqualified Report	380
12.13	Results of FEE Study on Non-Compliance of Auditor's Report in European Countries with ISA Requirements: Summary of Differences to ISA 700	383
13.1	IFAC Risk Management Approach in an E-Business Environment	399
13.2	Advantages and Disadvantages of CAATs	403
14.1	Common Elements of Organizations	418
14.2	Traditional Auditing and Continuous Processes	431
14.3	Continuous Assurance	434

15.1	Framework for Quality Control in Auditing	444
15.2	Relationship Between High Quality Audits and Auditing Standards	446
17.1	Summary of the Studies Regarding the Relationship Between Audit Reports and Financial Markets	507
18.1	The Enron Case by the Numbers	557
19.1	Breakdown of Gross Fees According to Accounting and Auditing, Tax and Management Consulting (Percentage of Gross Fees)	583
19.2	Comparison of Historical and Future Assurance Services	601