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Describe the three theoretical frameworks that have been proposed to explain why there is a demand for audit and assurance service.

Chapter 1

- The three theories are agency theory, the information hypothesis and insurance hypothesis.
  - **Agency theory** → Where an owner hires a manager to run the business on their behalf, with potential conflicts arising.
    - Due to the remoteness of the owners from the entity, the complexity of items included in the financial report and competing incentives between the owners and managers:
      - The owners have an incentive to hire an auditor to assess the truth and fairness of the information contained in the financial report prepared by the managers
      - Managers also have an incentive to hire an auditor to demonstrate to their shareholders that they have prepared true and fair financial reports free of fraud and error
  - **Information hypothesis** → Financial report users require access to high-quality information to make a variety of decisions, such as determining whether to lend money to the entity, what rate of interest to charge the entity on the money lent, etc. Therefore, the greater the perceived quality of the information contained in the financial report, the more likely it is relied upon by the users of the information.
    - Due to the demand for reliable, high-quality information, various user groups including shareholders, banks and other lenders will demand that financial reports be audited to aid their decision making.
  - **Insurance hypothesis** → Investors take on a risk when buying shares – if an entity fails, investors could lose the money invested, hence, an audit for investors could insure against at least part of their loss should the company they invest in fail.
    - Investors will demand the financial reports be audited as a way of insuring against some of their loss should their investment fail.

What is the audit expectation gap? Give three examples of how this may be caused and outline two ways that this gap can be reduced

Chapter 1

- The audit expectation gap occurs when there is a difference between the expectations of assurance providers and financial report users. The gap occurs when user beliefs do not align with what an auditor has actually done.
- The gap is caused by unrealistic user expectations such as:
  - The auditor providing complete assurance
  - The auditor is guaranteeing the future viability of the entity
  - An unmodified audit opinion is an indicator of complete accuracy
  - The auditor will definitely find any fraud
  - The auditor has checked all transactions
- The audit expectation gap can be reduced by:
  - Auditors performing their duties appropriately, complying with auditing standards and meeting the minimum standards of performance that should be expected of all auditors
  - Peer reviews of auditors to ensure that auditing standards have been applied correctly
  - Education of the public