Topic 1: Introduction to the Audit Function, Assurance Framework, Regulation of Audits and Auditors' Legal Liability

Information Asymmetry

Owners have no way of determining if financial statements are "true and fair".

- Managers might lie about company performance for personal gain (fraud); or
- Managers might misrepresent company performance because they do not know how well it is going (incompetence).

This is the problem of information asymmetry.

Agency Costs

Both parties lose from information asymmetry.

- Good managers cannot prove they are good (owners under reward good managers because they think good performance may not be real); and
- Owners cannot tell which companies are good investments.

These costs are called agency costs.

There is a net loss to society from agency costs. Both owners and managers benefit from reducing agency costs.

Assurance

Agency costs can be reduced by having an independent third party provide assurance as to whether the financial statements are true and fair.

The third party:

- Conducts procedures to determine the truth and fairness of the financial statements; and
- Issues an opinion on their truth and fairness to the shareholders.

Assurance Engagement

An assurance engagement is an engagement in which an assurance practitioner aims to obtain sufficient appropriate evidence in order to express a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the measurement or evaluation of an underlying subject matter against criteria – Framework for Assurance Engagements para 10.

Key Elements of Assurance Engagements

An assurance engagement involves:

- A three party relationship involving a practitioner, a responsible party and intended users;
- An appropriate subject matter;
- Suitable criteria;

- Sufficient appropriate evidence; and
- A written assurance report in a form appropriate to a reasonable assurance engagement or a limited assurance engagement – Framework for Assurance Engagements para 26.

Absolute Assurance

Absolute assurance can never be provided because of:

- The nature of accounting i.e. valuation issues, accounting policy choice and judgements, and contingent items; and
- Time and cost of evidence collection and evaluation.

Reasonable Assurance

Reasonable assurance is a high but not absolute level of assurance.

The conclusion is expressed in a positive form i.e. the financial statements are true and fair.

An audit engagement provides a reasonable level of assurance.

The opinion is expressed in an audit report.

Limited Assurance

Limited assurance is a lower level of assurance than reasonable assurance. The actual level of assurance depends upon the nature of the procedures that are carried out.

The conclusion is expressed in a negative form i.e. nothing has come to our attention to suggest that the financial statements are not true and fair.

A review engagement provides a limited level of assurance.

Financial Statement Audits

The auditor is appointed by shareholders at the AGM. Most of the time they accept the recommendation of the board of directors.

The auditor expresses their audit opinion to the shareholders via an auditor's report, included in the annual report.

The auditor's sole responsibility is to express an opinion on the financial statements.

The auditor has no right to change any aspect of the financial statements. The preparation of the financial statements is the responsibility of the directors and the auditor's report does not absolve them of this.

The auditor needs to determine if the financial statements:

- Comply with accounting standards; and
- Present a "true and fair view".

Material errors arise from three sources:

- Legitimate errors;