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AUDITING THEORY & PRACTICE

AUSTRALASIAN EDITION

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Auditing Theory and Practice

1st Australasian Edition

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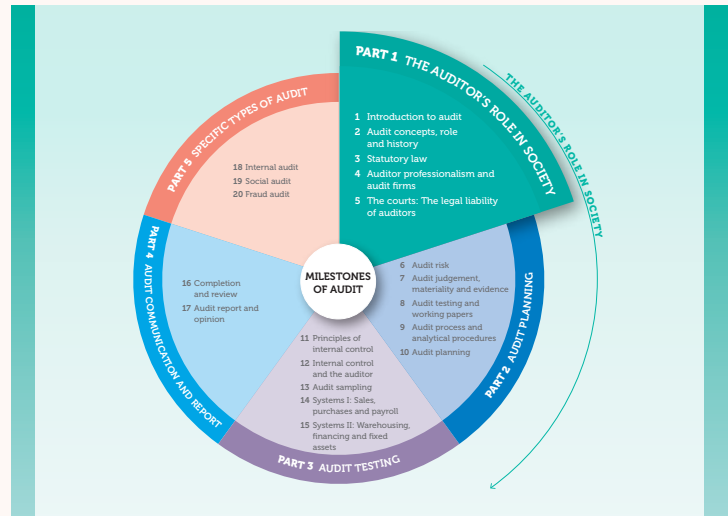
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Guide to the text

As you read this text you will find a number of features in every chapter to enhance your study of auditing and help you understand how the theory is applied in the real world.

PART-OPENING FEATURES

Understand how key concepts are connected across all chapters in the part by viewing the **Concept map**.



Part openers introduce each of the chapters within the part and give an overview of how they relate to each other.

The auditor's role in society

- Chapter 1** Introduction to audit
- Chapter 2** Audit concepts, role and history
- Chapter 3** Statutory law
- Chapter 4** Auditor professionalism and audit firms
- Chapter 5** The courts: The legal liability of auditors

Part 1 of the textbook focuses on the auditor's role in society and comprises five chapters. Chapter 1 introduces the auditing profession. The purpose of this chapter is to explain the role and activities of the auditor, audit firm and audit practices. Chapter 2 focuses on audit concepts, roles, and the history of the audit profession. The chapter also explains the purpose and elements of a conceptual framework for audit. Statutory law related to the work of auditors and its application in Australia and New Zealand is covered in Chapter 3. The chapter sets out the regulations in Australia and New Zealand. Chapter 4 discusses audit professionalism and audit firms, and includes the codes of ethics for assurance services and quality control. The role of courts and the legal liability of auditors, and how reasonable skill and care is interpreted in common law, is covered in Chapter 5.

PART 1

CHAPTER-OPENING FEATURES

Identify the key concepts you will engage with through the **Learning objectives** at the start of each chapter.

Refer to the **Introduction** for a contextualised summary of the chapter.

CHAPTER 12

12

Internal control and the auditor

Learning objectives

After studying the material in this chapter, you should be able to:

- describe an appropriate strategy to evaluate a client's control system for audit
- prepare and evaluate documentation methods such as system flowcharts and data flow diagrams using the procedures introduced
- select and describe tests of controls in response to the auditor's evaluation of the client's internal control system.

Introduction

This chapter is about internal controls and when audit tests should be performed on them. Auditing standards define the frame of interest.

For [these] purposes ... the system of internal control consists of five interrelated components: (i) Control environment; (ii) Entity's risk assessment process; (iii) Entity's process to monitor the system of internal control; (iv) Information system and communication; and (v) Control activities. (ISA 315, para 12m; ISA NZ 315, para 12m)

Here, we consider how to incorporate control-testing decisions into the audit strategy and plan (see Figure 12.1). We introduce fundamental controls and consider whether tests of the client's controls allow the auditor to reduce the nature, timing or extent of substantive testing.

This chapter introduces two documentation methods that we ask you to learn to use. Overall, the chapter introduces procedures to understand and evaluate that portion of the client's system of concern to the financial statement auditor.

FEATURES WITHIN CHAPTERS

Analyse practical applications of concepts through **Auditing in practice** boxes.

Auditing in practice

Environmental audits

The 'market' – shareholders, corporate boards, lenders, advisers – may be unwilling to pay for environmental audits because, in the absence of laws that require it to do so, there is little market incentive to purchase such assurance services.

Challenge the theory you have learnt by considering the **Professional scepticism** boxes, perhaps in a group discussion.

Professional scepticism

Professional scepticism is expected of auditors under professional ethical standards and codes pertaining to assurance services.

Check your understanding of the content by answering the **Concept questions** as you progress through the chapter.

CONCEPT QUESTION 1

Define what an 'assurance provider' does and provides.

FEATURES WITHIN CHAPTERS

Short extracts from the AUASB and NZAuASB are covered by **Auditing standards**.

Sufficiency of evidence

Sufficiency (of audit evidence) means the measure of the quantity of audit evidence. The quantity of the audit evidence needed is affected by the auditor's assessment of the risks of material misstatement and also by the quality of such audit evidence. (ASA 500, para 5(f); ISA NZ 500, para 5(f))

END-OF-CHAPTER FEATURES

At the end of each chapter you will find several tools to help you to review, practise and extend your knowledge of the key learning objectives.

Review your understanding of the key chapter topics with the **Summary**.

Extend your understanding with **Case/resources link** relevant to each chapter.

Test your knowledge and consolidate your learning through the **Review questions** and **Exercises**.

Study tools

Summary

In this chapter, audit tests were considered, and the types of tests and purposes for them were explained. Differences between walk-through procedures, tests of controls and substantive tests were explained and exemplified. Test techniques that enable efficiencies include sampling, dual testing and directional testing were introduced.

Working paper purposes, ownership and protocols were discussed, although each audit firm will vary as to the detail. Working paper hierarchies and examples were also illustrated. This chapter also introduced IT technology tools used by the auditor, such as automated working papers, audit software routines and AI expert systems to improve audit quality. If used wisely, audit technology can enhance audit efficiency and effectiveness.

Case/resources link

CAATs for Classrooms

Accompanying this book is a series of data, integrated worksheets and exercises that are designed to support your learning and give you exposure to hands-on audit decision-making dilemmas faced by auditors in the planning elements of the audit process. Acquire the relevant material for this chapter from your instructor.

Review questions

- 8.1 Define 'testing'. How does this apply to audits?
- 8.2 What is the difference between the 'sufficiency' and 'nature' of audit evidence?
- 8.3 What is the difference between 'tracing' and 'vouching'?
- 8.4 What is a characteristic of 'confirmations' as to evidence quality?
- 8.5 What is the difference between the 'extent' and 'timing' of audit testing?
- 8.6 When would it be possible to rely on tests conducted only midway through the year?
- 8.7 What are the premises, implied or otherwise, that professionals test in an audit?
- 8.8 Define 'walk-through procedures'.

Exercises

- 6.1 **RISK:** You must apply your knowledge of risk in relation to a company you have audited previously, when it had strong systems and no problems, but which currently faces challenges because its low-tech market has disappeared and sales have declined. Identify what you believe to be the areas of greatest risk and explain why:

a overall risk	c control risk
b inherent risk	d detection risk
- 6.2 **RISK MODEL:** Four types of risk are used in the ARM. If you could choose to add 'sampling risk', 'non-sampling risk' or 'technology risk' for a next-stage ARM, what might you add to the model and why?
- 6.3 **RISK MODEL:** Your audit client is a metal parts manufacturer of significant interest to the community. They fill a unique local market niche but have been hurt by the effects of a falling dollar on raw materials imports. Gross profit margins have held steady.

Required:

 - a Determine whether the following risks are 'high' or 'low', and why:
 - I APR
 - II IR
 - III OAR
 - b What does this mean for STR?
 - c What are the implications?

Guide to the online resources

FOR THE INSTRUCTOR

Cengage is pleased to provide you with a selection of resources that will help you prepare your lectures and assessments. These teaching tools are accessible via cengage.com.au/instructors for Australia or cengage.co.nz/instructors for New Zealand.

MINDTAP

Premium online teaching and learning tools are available on the *MindTap* platform – the personalised eLearning solution.

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The *Cengage Mobile App* puts your course directly into students' hands with course materials available on their smartphone or tablet. Students can read on the go, complete practice quizzes or participate in interactive real-time activities.

MindTap for Pratt's Auditing Theory and Practice is full of innovative resources to support critical thinking, and help your students move from memorisation to mastery! Includes:

- Pratt's Auditing Theory and Practice eBook
- What do you think? Polling activities
- Concept checks
- Discussion cases with student guide
- CAATs for Classrooms
- Case study: Delos Ltd.

MindTap is a premium purchasable eLearning tool. Contact your Cengage learning consultant to find out how *MindTap* can transform your course.



SOLUTIONS MANUAL

The Solutions Manual provides detailed answers to all review questions and every exercise in the text.

COGNERO® TEST BANK

A bank of questions has been developed in conjunction with the text for creating quizzes, tests and exams for your students. Create multiple test versions in an instant and deliver tests from your LMS, your classroom, or wherever you want using Cognero. Cognero test generator is a flexible online system that allows you to import, edit, and manipulate content from the text's test bank or elsewhere, including your own favourite test questions.

POWERPOINT™ PRESENTATIONS

Use the chapter-by-chapter **PowerPoint slides** to enhance your lecture presentations and handouts by reinforcing the key principles of your subject.

ARTWORK FROM THE TEXT

Add the **digital files** of graphs and flow charts into your learning management system, use them in student handouts, or copy them into your lecture presentations.

DELOS CASE STUDY

The **Delos case** is a comprehensive case study designed to give the learner a full audit practice-like experience from planning to completion.

CAATS FOR CLASSROOMS

CAATs for Classrooms – an Excel subroutine and exercise program for instructors.

FOR THE STUDENT

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PREFACE

Welcome to *Auditing Theory and Practice*, Australasian edition. Our book is derived from *Auditing: Theory and Practice*, first published in The United Kingdom by Longman in 1982. It has been continuously in print since then and was first published in New Zealand in 1990. From the outset, the emphasis of the book has been on readability and the why and how of auditing, beyond the recitation of what is to be done.

This Australasian edition is inspired by the ongoing need for a text to reflect Australia's and New Zealand's unique professional and regulatory environments. Furthermore, we believe there is a real need to keep up with changes brought about by updates related to auditing standards and growth in 'other' assurance services, and the expansion of e-business. The explosion in information technology – while providing unmatched global business opportunities – also challenges the integrity of information, necessitating the need for knowledgeable audit professionals.

In this Australasian edition we have expanded some elements, in particular:

- Concept questions throughout to help you check your understanding
- An emphasis on risk, audit judgement and professional scepticism throughout
- Review questions at the end of each chapter
- Exercises for students, also found at the end of each chapter
- Figures, diagrams and examples.

We have also updated and incorporated the most current Standards, requirements, regulations, oversight and professional practices throughout all chapters of the text. We have tightened the content to ensure that it covers, with minimal repetition, the range of topics and material required to understand the theory and practice of auditing. While building on our previous editions, we also take the opportunity to make the material relevant to today's professional and tertiary practices.

To enhance both the accessibility to students and our ability to make changes in accordance with a changing environment, this edition is also available digitally.

Our best thanks go to the Cengage team for their work on presentation to emphasise concepts, and enhance readability and learning.

We have combined a few chapters and expanded support material. We bring other assurance services to the fore, reflect IT changes and highlight recent events.

We have retained our focus on theory and practice in the text and believe that the conceptual framework continues to explain rationales for, and the nature of, audit and assurance. We believe it provides students with the foundational knowledge they need for audit decision-making. Our goal is to help future audit professionals become technically skilled, socially aware and ethically professional members of the business community.

Names used in examples and exercises are fictitious unless specified otherwise, and any resemblance to actual persons or businesses is unintended and coincidental.

ABOUT THE AUTHORS

Dr Michael J. Pratt, D.Com, FCA, was a Professor and Dean at Waikato Management School, University of Waikato, from 1990 to 2008. Before that, he was a Professor of Accounting and Finance at Massey University. Michael holds a doctorate in Finance and has extensive academic, professional, educational, consultancy, governance and leadership experience. He is the author of numerous academic, educational and professional publications in performance improvement, sustainability, strategy, leadership, auditing and accounting.

Dr Karen A. Van Peurse, FCA (CA ANZ), CPA (USA, ret), PhD was a Professor of Accounting at Victoria University of Wellington (2011–2020) and the University of Waikato (2004–2011). Her experience includes over a decade in private accounting firms and industry, followed by a career in teaching, research leadership and graduate supervision. Karen has published numerous academic and professional publications in auditing and professional practice, performance measurement, public sector, education, financial accounting and tax. She is currently a Research Fellow at Victoria University of Wellington.

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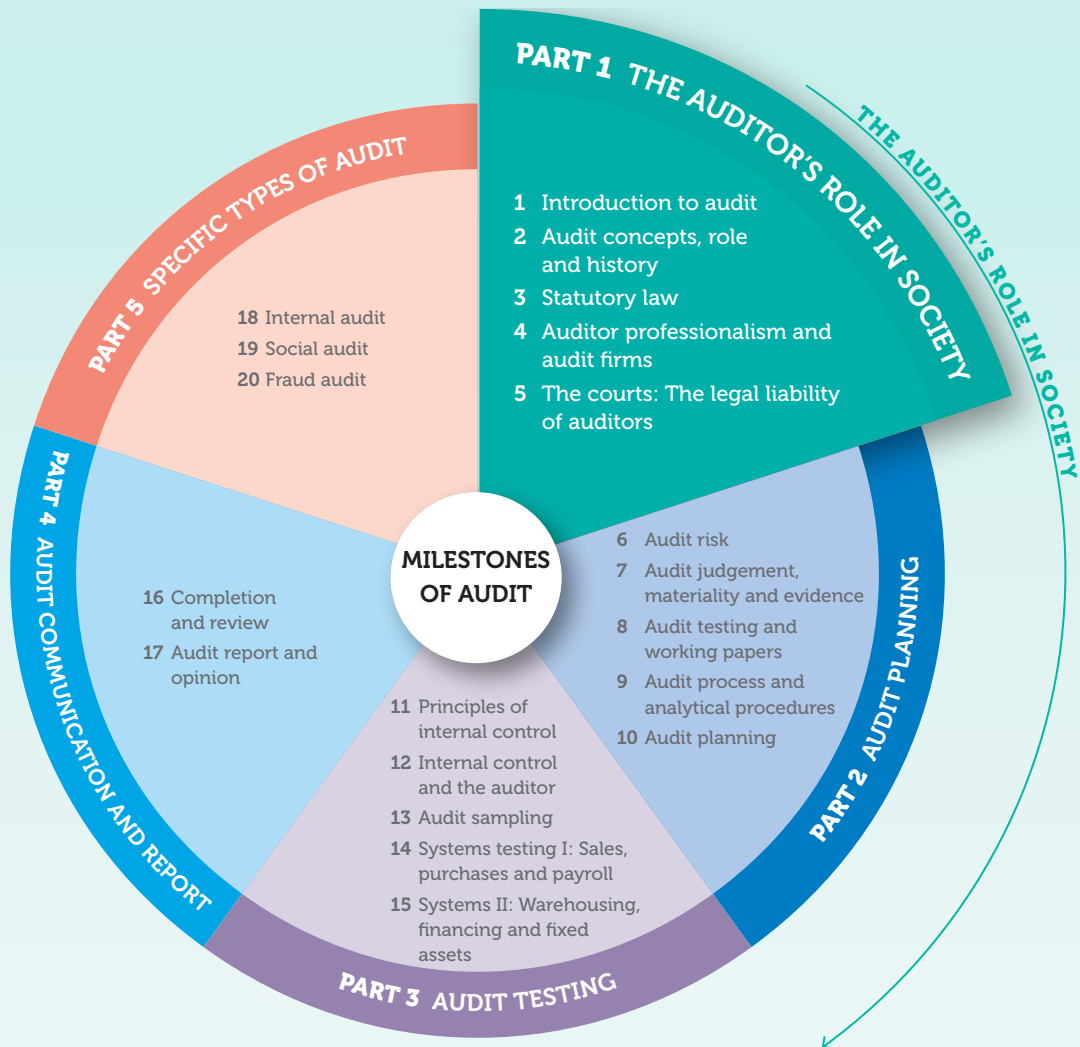
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The auditor's role in society

Chapter 1 Introduction to audit

Chapter 2 Audit concepts, role and history

Chapter 3 Statutory law

Chapter 4 Auditor professionalism and audit firms

Chapter 5 The courts: The legal liability of auditors

Part 1 of the textbook focuses on the auditor's role in society and comprises five chapters. Chapter 1 introduces the auditing profession. The purpose of this chapter is to explain the role and activities of the auditor, audit firm and audit practices. Chapter 2 focuses on audit concepts, roles, and the history of the audit profession. The chapter also explains the purpose and elements of a conceptual framework for audit. Statutory law related to the work of auditors and its application in Australia and New Zealand is covered in Chapter 3. The chapter sets out the regulations in Australia and New Zealand. Chapter 4 discusses audit professionalism and audit firms, and includes the codes of ethics for assurance services and quality control. The role of courts and the legal liability of auditors, and how reasonable skill and care is interpreted in common law, is covered in Chapter 5.

PART 1

Introduction to audit

Learning Objectives

After studying the material in this chapter, you should be able to:

- describe the nature of audit engagement
- understand the concept of audit
- identify the conditions that call for audit
- understand audit practice in Australia and New Zealand
- describe Australian and New Zealand auditing standards.

Introduction

If you were to ask the average person in the street about the purpose of an auditor's work, you would probably be told that it is to prevent fraud. Were you to press the person further, you might be offered a description of a rather drab individual submerged in a sea of journals and ledgers, surfacing only from time to time to produce sets of figures that are not important and are difficult to understand.

Such is the image of the auditor that has been widespread in the past. However, it is inaccurate and unfair. It is inaccurate because the auditor's primary responsibility is not to produce information, and their interest extends far beyond books of account. It is unfair because auditing is a highly skilled professional task without which the modern economy could not function.

So, what does the auditor do? Through usage, the word *audit* has come to denote the independent checking and validation of information. That information is prepared by and/or claimed to be 'true' by the preparer (client). Understanding the auditor's role and how the auditor carries out this validation through the audit process is the purpose of this text. The auditor provides **assurance** to the users of financial statements.¹

assurance

'Refers to the expression of a conclusion by an assurance practitioner that is intended to increase the confidence that users can place in a given subject matter.' (CPA Australia, 2019, p. 5)

Professional engagements

Professionals in audit and accounting engage in many revenue-earning activities. They may prepare accounting records, provide tax advice, conduct fraud investigations, or provide business advisory services. They may review forecasts or conduct statutory financial statement audits. Where providing

¹ *User* is the term applied to those with direct financial interest in the audited organisation, while *client* refers to the audited organisation or its owners. The term *accountee*, which you will encounter in the next section, embraces a wider group within society who may rely on, and have the right to rely on, the audit assurance.

an opinion on a matter prepared or asserted by others, the audit professional is carrying out a different kind of function and, in such cases, is known as an **assurance practitioner**.

Assurance engagements are thus a particular type of professional service (see **Figure 1.1**). They are sometimes referred to as *reporting engagements* because the assurance practitioner will issue a report on the findings of their investigation.



Figure 1.1 Types of professional engagements

In this text, because of its importance to society and the economy, we concentrate on one type of assurance engagement: the financial statement audit (see **Figure 1.1**). Other engagements are discussed in Part 5: Specific types of audit.

Although professions can profit from providing many different types of services, there is always the risk that clients and auditors have misunderstandings about the engagement. There can be confusion around the duty of care owed or the level of assurance offered. Some professional engagements provide a reasonably high (audit) level of assurance, but many court cases suggest how such confusion can occur. To cite a few examples from Australia and New Zealand:

- Slater and Gordon recently launched an investor class action against Freedom Foods Group and its auditor Deloitte in the Supreme Court of Victoria. The class action alleges that Deloitte failed in its duties in signing off on Freedom Foods accounts each financial year between 2014 and the first half of 2020.
- In the case of *Cam & Bear Pty Ltd v. McGoldrick* [2018] NSWCA 110, the NSW Court of Appeal found that, by failing to provide warnings about the recoverability of assets, the auditor of a self-managed superannuation fund (SMSF) was responsible for 90 per cent of this SMSF's loss.
- In 2017, Fuji Xerox NZ added audit firm EY (formerly Ernst & Young) as a defendant in its case against three former executives over an accounting scandal that saw Fuji Xerox NZ and Fuji Xerox Australia overstate revenues by about A\$450 million.
- Deloitte was held to a duty of care to ensure that securities regulations over minimum public subscriptions were met in a non-audit advisory engagement (*Deloitte v. Christchurch Pavilion Ptnshp* [1999])
- The New Zealand Audit Office failed to 'undertake the further obligations set out in its letter of engagement', in addition to the audit, in *Dairy Containers Ltd v. NZI Bank and Others* (1994).

It therefore becomes important to communicate the particular service being provided, so that misunderstandings can be avoided. Distinctions between engagement types are thus categorised in terms of the level of assurance, their scope, and the nature of their users/accountees (see **Table 1.1**).

.....
assurance practitioner
 An individual, company or other organisation, whether in public practice, industry or commerce, or the public sector, conducting assurance engagements or related services engagements. (AUASB, 2017)

.....
assurance engagement
 '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.' (AUASB, 2014)

Table 1.1 Concepts defining professional engagements: Financial statement example

Scope	Users	Level of assurance		
		Reasonable (audit)	Limited (review)	No assurance
Financial statements over a specified period	Shareholders, lenders, investors, others	Financial statement audit	Review of financial statement	Compiling financial statements: Compilation

Level of assurance

The greater the effort (and cost) that goes into gathering evidence – assuming that the effort is efficient – the greater is the assurance it can provide.

The highest level of assurance possible in a reporting engagement is that provided for an audit. While audit engagements will vary from one to another in scope, all audits should express the same level of assurance acquired through the extensive analysis of reliable evidence. Although there is no guarantee that the information is as claimed, even after the audit is completed, reasonable confidence can be placed in it. This is called **reasonable assurance**. An audit opinion requires an examination of a recording of, or claims about, events that have occurred in the past.

The assurance practitioner does not always provide their highest (audit) level of assurance; they can also conduct an engagement in which the assurance is limited. This is referred to as a **limited assurance engagement**.

Other professional engagements, such as compiling financial statements, do not provide assurance (see **Figure 1.1**). No assurance can be provided if the professional is not sufficiently independent to add confidence. Nonetheless, the audit professional, as a member of their profession, is expected to conduct all engagements with care, competence and integrity.

Scope

The scope of an engagement is simply what the engagement includes and what it does not include. For example, the scope of the Australian and New Zealand statutory financial audit includes an assessment of specific financial statements over a fiscal year ending on a particular date. Knowing the scope is important in order to understand the responsibility surrounding that engagement. That is, everyone should agree on what is being done and what is to be reported upon!

This seemingly obvious idea should be taken seriously since there are now numerous court cases in which either the user did not understand or the auditor did not follow through on the expectations of their engagement.

Common engagements include but are not limited to the following:

- the financial statement audit, the scope of which is set out in law (in particular, those statutes referred to in Chapter 3)
- audits of compliance with the law, such as may occur if the auditor is called on to evaluate compliance
- economy, efficiency and effectiveness (EEE) audits, in which the scope has to do with how well management is running the organisation
- reporting on prospective financial statements or forecasts, but not directly on past events – these usually, though not always, also call for a lower level of assurance.

reasonable assurance

The highest level of assurance possible, obtained through an audit engagement where the professional acquires sufficient appropriate evidence to reduce the risk of misstatement to a low level. (ISA NZ 200, para 5)

limited assurance engagement

'An assurance engagement where the assurance practitioner's objective is a reduction in assurance engagement risk to a level that is acceptable in the circumstances of the assurance engagement, but where that risk is greater than that for a reasonable assurance engagement, as the basis for a negative form of expression of the assurance practitioner's conclusion. A limited assurance engagement is commonly referred to as a review.' (IAASB, 2008)

Users of audit report

Another characteristic that distinguishes one engagement from another has to do with who relies on the professional's opinion. For example, management may be the primary beneficiary of a professionally reviewed sales forecast, while the shareholders or regulators may be users of financial audit reports. Knowing the potential user or **accountee** is important to professionals because it helps them plan and target their evidence-collection procedures towards areas that are of greater importance to those users.

CONCEPT QUESTION 1

Define what an 'assurance provider' does and provides.

accountee

The person or entity to whom information is owed.

Concept of audit

A comprehensive definition of an **audit** has been provided by the American Accounting Association (AAA) Committee on Basic Auditing Concepts:

As was noted earlier, an audit provides *reasonable assurance* that the information – in our case, financial statements – is free from material misstatement. According to the International Federation of Accountants (IFAC), a misstatement is considered material if the information is sufficiently incorrect to influence the economic decisions of users of the financial statements. That is, and by definition, an audit provides the highest level of assurance. To achieve this goal, the auditor will gather evidence from documents and records, observing, communicating with managers, and reviewing data and other procedures. This provides confidence that, following investigation, the information is free from material misstatements (IFAC, 2005, Glossary, p. 143).

It is an expensive endeavour to provide 'assurance'. The process of carrying out an audit is time-consuming and requires expertise, planning and care.

audit/auditing

'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.' (AAA, 1973)

What is a financial statement audit?

A financial statement audit is a specific type of assurance-granting engagement. Where required under Australian and New Zealand law, the auditor must come to an opinion as to whether an organisation's financial statements comply with generally accepted accounting principles (GAAP) (see **Figure 1.2**).

The financial statement can be distinguished from other engagements in terms of the scope (financial statements for a specific period), the intended users (shareholders and selected others) and the level of assurance (reasonable). Financial statement audits offer reasonable confidence to those relying on those statements that the information represents a known standard of accounting. Most government organisations, publicly listed companies and entities of public interest must have an annual financial statement audit under law.

Coming to a view on financial statements, even with evidence in hand, is not easy. Determining the valuation of derivatives, for example, involves the estimation of future events; determining the existence of a **going concern** means trying to forecast what may occur in the future; coming to an opinion about contingent liabilities is challenging. As a result, the auditor cannot provide absolute assurance!

CONCEPT QUESTION 2

How would you describe a financial statement audit in terms of its scope, users and level of assurance.

going concern

An entity that has the ability to pay its debts as they fall due and that is solvent (assets exceed liabilities).

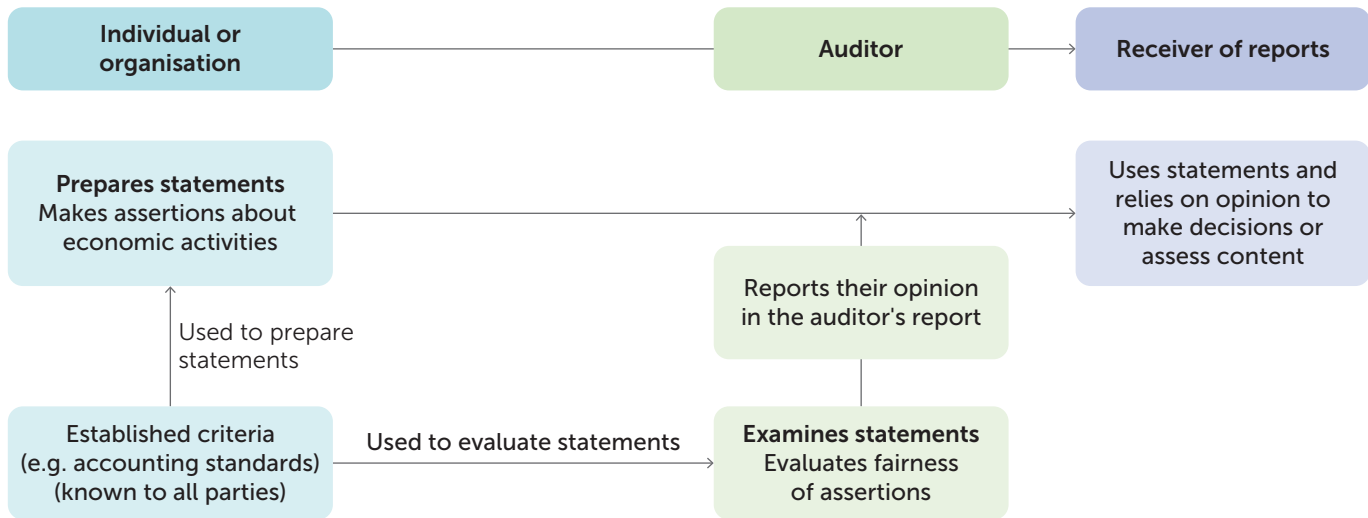


Figure 1.2 Statutory financial statement audit: Process and participants

Theoretical explanations

There are as many different reasons and calls for an audit and other assurance services as there are numbers of users. However, most can be understood in terms of theories explaining the interests of users and accountees. These are informed by:

- neoclassical economics and market assumptions
- social accountability and public theories
- critical theory in terms of its critique of professions (see [Table 1.2](#)).

Table 1.2 Theories explaining calls for audit

Issue	Neoclassical	Social accountability	Critical
Assumes	<ul style="list-style-type: none"> • Information is timely, available • Individuals motivated by economic benefit • Managers act in company (or self-) interest 	<ul style="list-style-type: none"> • Imperfect knowledge • Society, stakeholders owed assurance • Law represents societal rights • Market players are not the only stakeholders 	<ul style="list-style-type: none"> • Powerful position held by select few • Power used to further position, status
Explains or predicts	<ul style="list-style-type: none"> • Market demand for audit • Profession's desire to please the market 	<ul style="list-style-type: none"> • Call for social audits • Third-party liability • Statutory audits 	<ul style="list-style-type: none"> • Self-serving actions that enhance monopoly rights or reduce risk
Views on regulation	<ul style="list-style-type: none"> • Useful only to ensure unfettered market 	<ul style="list-style-type: none"> • Important to protect society because assurance is a public good 	<ul style="list-style-type: none"> • May be used to retain privileged positions
Role of auditor	<ul style="list-style-type: none"> • Insurer • Reduces transaction or agency costs 	<ul style="list-style-type: none"> • Protect society from managers (stewards) • Policeman, watchdog, bloodhound for public 	<ul style="list-style-type: none"> • Can create a false or misleading sense of authenticity or fairness

Neoclassical economics

The concepts of neoclassical economics (which informs market theory) are based on economic assumptions grounded in the teachings of Adam Smith. They include assumptions that:

- organisations are profit-maximising
- individual property rights are paramount
- individuals are economically rational
- managers work towards the betterment of their organisation
- perfect knowledge is available to information users
- markets are self-regulating
- market forces tend towards equilibrium – see, for example, Chambers (1966) for a summary of the relationship between economics and accounting.

Proponents of neoclassical economics claim that, for products or services to exist, there must be both demand and supply. Therefore, if audit ‘services’ – the opinion – are a benefit to market players (such as shareholders), then those players will demand an independent audit through market mechanisms. If the audit is not seen to be particularly useful to market players, they will opt out and the ‘supply’ will either diminish or the auditor will adjust rents (prices) to make its ‘product’ more desirable. An implication is that the choice of whether or not to have an audit comes from those who directly benefit from it and who have the resources to pay for it. This interplay can be represented in a typical supply-and-demand curve (see **Figure 1.3**).

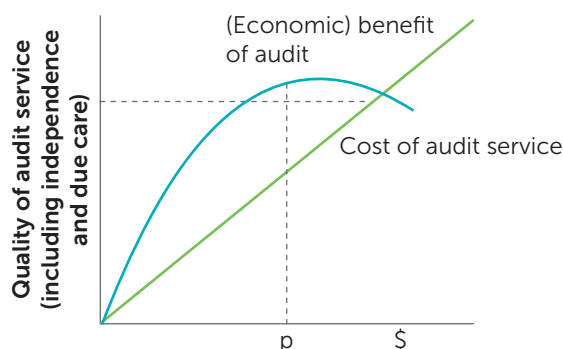


Figure 1.3 Supply and demand for audit services

In **Figure 1.3**, where the lines cross on ‘p’ is where you find the point at which the greatest economic benefit is achieved by users at the least cost of an audit. Rational purchasers of audit services will only pay for an audit if the perceived benefits exceed the cost of the audit. The ‘market’ will adjust accordingly if a less-expensive service (such as ‘review’ or ‘compilation’) is available that will satisfy the users’ needs for verification.

Auditing in practice

Environmental audits

The ‘market’ – shareholders, corporate boards, lenders, advisers – may be unwilling to pay for environmental audits because, in the absence of laws that require it to do so, there is little market incentive to purchase such assurance services.