External audit

Audit framework and audit regulation

A statutory audit of financial statements is an example of an assurance engagement. In an assurance engagement, an auditor evaluates a subject matter (for example, financial statements) that is the responsibility of a third party (for example, company directors) so that they can provide a level of assurance about that subject matter. The purpose of a statutory audit is to increase the confidence of and reduce the risk to the users of financial statements.

A statutory audit is based on three important concepts:

- agency
- stewardship
- accountability.

Professional standards add to the quality of assurance engagements, including statutory audits. The conduct of statutory audits is governed by:

- company law
- auditing standards
- codes of professional ethics.

In this module, we will examine the concepts that underpin statutory audits. We will then consider the regulation of the statutory audit process.

Audit framework: agency, stewardship and accountability

An agency relationship exists when an agent (for example, company directors) is employed by a principal (for example, shareholders) to perform a task (for example, manage a company). Company directors are employed to run the company in the best interests of shareholders.

However, company directors have interests of their own (for example, pay rises). Conflicts of interest may arise between the agent and the principal. So: company directors are required to prepare financial statements to give an account of their actions in running the company. A statutory audit is carried out to enable an auditor to express an opinion on whether the financial statements give a 'true and fair view' of these actions.

Worked example 1

Take a look at this worked example.

Which of the following elements are required for a statutory audit assurance engagement? Identify the principal and the agent in these elements.

- Shareholders
- Company directors

- Financial statements
- Criteria for the preparation of financial statements, for example, company law, accounting standards.

Click to display/hide the solution.

Stewardship is the responsibility to take care of resources. In the context of a company, directors can be seen as stewards of company assets and other resources. Directors have a duty of care to shareholders to ensure that assets and resources are safeguarded and used in the best interests of shareholders.

Directors need to be held to account for this duty of care, and in respect of their other responsibilities. This concept of accountability means that directors are required to explain their actions. The financial statements and the audit thereof are an important part of this explanation.

Worked example 2

Which of the following is not a potential benefit of a statutory audit assurance engagement?

- Directors may be encouraged to ensure that assets and resources are safeguarded.
- Assurance may be given to investors that their assets have been used in their best interests.
- Fraud will be detected by auditors.
- Directors are required to explain their actions.

Click to display/hide the solution.

Audit regulation

Statutory audits should be carried out by people who are suitably qualified and whose work is of a satisfactory quality. Users of financial statements want assurance that the reliability of financial statements and the audit thereof does not vary from company to company.

The conduct of statutory audits is governed by:

- company law
- auditing standards
- codes of professional ethics.

Auditors have important responsibilities under the Companies Act 2006. Auditors must form an independent opinion on the truth and fairness of the financial statements, evaluate whether the financial statements have been prepared in accordance with the Companies Act 2006, and state in their audit report whether the information given in the directors’ report is consistent with the financial statements.

The International Auditing and Assurance Standards Board (IAASB) issues International Standards on Auditing (ISAs). Since 2005, all statutory audits of financial statements prepared under the laws of European Union (EU) must be conducted in accordance with ISAs.

ISAs do not override national regulations for statutory audits. States may set their own standards for statutory audits, or adopt and implement ISAs, possibly with modifications to meet national requirements. In the United Kingdom (UK), the Auditing Practices Board (APB) (the national standard setter for standards for statutory audits) decided to adopt and implement ISAs, with modifications.

Worked example 3

Describe how ISAs and national auditing standards influence each other.

Click to display/hide the solution.

The users of financial statements and other stakeholders must have trust in the services provided by auditors, such as statutory audit assurance engagements. This trust is supported by the existence of a professional code of ethics.

The International Ethics Standards Board for Accountants (IESBA) issues a code of ethics. The APB has used this code to develop UK code for professional ethics. The professional accounting bodies in the UK also have their own codes of professional ethics.

The IESBA code of ethics is based on five fundamental principles:

- Integrity: an auditor should be honest
- Objectivity: an auditor should not allow bias, conflict of interest or undue influence to affect professional judgement
- Professional competence: an auditor should maintain their professional knowledge and skill
- Confidentiality: an auditor should respect the confidentiality of client information
- Professional behaviour: an auditor should comply with relevant laws and regulations

Practice example

The worked examples show how to address a question on the audit framework. You can now have a go at putting together an answer yourself, in your own time, for the example below.

Your audit firm provides statutory audit assurance engagements for James Ltd and Daniel Ltd. You also prepare VAT returns for James Ltd. Your audit firm also provides statutory audit services for Daniel Ltd’s largest customer.

Identify the potential threats to objectivity that may be posed by these relationships. What steps might your audit firm take to address these threats?

Click to display/hide the solution.