**APPENDIX 1B**

**Alternative Theories of the Role of Auditing in Society**

**SOLUTIONS FOR REVIEW CHECKPOINTS**

1B-1 Yes, many people feel that the most important reason auditors are demanded is due to the conflict of interest between preparers of the financial statements and the 3rd party financial statement users. Most 3rd party users are more interested in intentional errors rather than unintentional errors because of these conflicts of interest. This also helps explain the importance of professional skepticism in judgments—it is needed to offset the potential bias and unethical reporting that results from the conflict of interest. No, assumes auditors do not place a high importance on detecting fraud. Such a stance contradicts auditor’s responsibility under CAS 240 and contradicts what the auditor says in the report!

1B-2 Information risk is the risk that user decisions may be based on incorrect information. More specifically, information risk is the risk that the financial statements fail to appropriately reflect the economic substance of a reporting entity’s business activities, and be misleading or unethical. Information risk applies to the numbers on the face of the financial statements as well as note disclosures. It needs to be reduced so that investor’s confidence will be increased to the point they will trust the financial reporting sufficiently to use in their decision making.

1B-3 The 3 theories that have evolved to explain how audits reduce information risk are as follows:

1. Insurance hypothesis: auditors are demanded so that they can be sued and act as insurers of the accuracy of the financial statements.

2. Information hypothesis: auditors are demanded by users to reduce information risk to users of financial statements.

3. Monitoring hypothesis: auditors are demanded by management to reduce information risk so that the managers can be compensated at higher levels because their audited performance as reflected in the financial statements will be more trustworthy.

Note that in all 3 theories, information risk will be reduced by the auditor.