5 Developments in Auditing and Assurance

Facts as facts do not always create a spirit of reality, because reality is a spirit.

– G.K. Chesterton

In view of the diversity of theories about accounting and the problematic nature of the conceptual frameworks, this chapter aims to examine the development of the external audit to see if it can help clarify the scope and nature of financial accounting.

The external audit has evolved in line with changes in the auditor's role, the auditing environment, and auditing technology. Today, '[t]he annual audit is one of the cornerstones of corporate governance' (*Cadbury Report*, 1992: 36). However, in the nineteenth century, the primary objective of the corporate audit was the detection of fraud. As the complexity of business developed so came the realization of the impossibility of such a proposition. Therefore, the role of the auditor has changed over time (e.g., Beck, 1973; Bird, 1970; Brown, 1962; Carmichael and Whittington, 1984; Flint, 1971; Lee, 1986), is still changing, and will probably continue to change (Panel on Audit Effectiveness, 2000). Audit approaches have been forced to change in order that a commercially viable service could be provided. Five 'generations' of audits are identified, culminating in the 'continuous audit'. The pressures for this latest generation of audit have arisen from developments in information technology (IT) and the perceived needs of the users of external financial data. This can be linked directly to the current emphasis on the provision of assurance services, which may be viewed as an extension of the statutory audit function.

EARLY AUDITS

Littleton (1933: 260) was of the view that early auditing 'was designed to verify the honesty of persons charged with fiscal, rather than managerial responsibilities'. He identified two types of early audits; firstly, public hearings of the results of governmental officials, and, secondly, the scrutiny of the charge-and-discharge accounts (as discussed in Chapter 3). 'Both types of

audit were designed to afford a check upon 'accountability' and nothing more. It was in effect a case of examining and testing an account of stewardship' (Littleton, 1933: 264). In the nineteenth century, the role of the auditor may have been directly linked to management's stewardship function (Flint, 1971) – with stewardship being regarded in the narrow sense of honesty and integrity. However, Littleton (1933: 264–5) considered that, as a consequence of commercial developments, this had changed:

> *With the advent of business, there came, instead of 'accountability', the accounting problems attendant upon the ownership of property and the calculation of profits or losses. Auditing, no longer an auditory process of checking another's stewardship, now began to lay increasing emphasis upon the visual scrutiny of written records and the testing of entries by documentary evidence.*

It was this that would lay the foundations for the basis of today's audits. The Joint-Stock Companies Act of 1844 introduced the requirement for an annual audit for companies formed under it. This Act did not confer the protection of limited liability on the shareholders. Therefore, this lack of limited liability for the owners of the business, together with the requirement of an audit, could lead one to conclude that the audit was intended to protect the stockholders from unscrupulous managers. However, it is the opinion of Lee (1969: 14) that:

> *the main objective of company auditing was exactly the same as that of company accounting – to portray a picture of solvency for the benefit of creditors who might otherwise lose confidence, panic and cause the downfall of the particular company owing them money. . . . It was thought, at least in the 1840s and 1850s, that such measures served to protect the shareholder best.*

The enactment of the Company Clauses Act 1845 (Section CII) required auditors to have at least one share in the company. The next major change came ten years later with the enactment of the Limited Liability Act 1855. It appears that the audit on its own was not enough to encourage wealthy investors to become members in unlimited joint-stock companies.

> *If there were no provision for limited liability, every firm (in a private enterprise economy) must have just one owner, or it must have a small*

> *group of owners. It would have to be a small group of owners when each was liable for the debts of the firm, if it ever came to be wound up, to the full extent of his wealth, his personal wealth. So it would be most unwise to invest in a firm, as part-owner, unless one was prepared to keep in close touch with its affairs, so as to see that one was not ruined by the mistakes it made. (Hicks, 1982: 11)*

The consequence of unlimited liability had been that the capital of an unlimited joint-stock company was still restricted to what could be raised by a small group of individuals. This defect in the 1844 Act was, therefore, rectified by the Limited Liability Act 1855. In the following year, there was a further liberalization of the law, for the Joint-Stock Companies Act 1856 abandoned the statutory requirement for a compulsory audit. There appears to be no clear consensus on why the audit was made optional. The introduction of limited liability status for companies registered under the Limited Liability Act 1855 meant that shareholders had less to lose if their company went into liquidation, and so this is a possible reason for the relaxation of the law. Hein (1963: 509), however, quotes Robert Lowe, who was Vice-President of the Board of Trade in 1856, on the topic of limited liability companies, as saying that, 'having given them a pattern, the State leaves them to manage their own affairs and has no desire to force on these little republics any particular constitution'. On the change in legislation, Lee (1969: 16) concluded that '[t]he reason for this move is not apparent from writings on the subject but presumably was because of a general feeling by legislators of the day that the audit was not beneficial enough to necessitate a compulsory provision – in other words, the "solvency" of the company could be established from the balance sheet without the need for an audit of that document'.

Another innovation contained in the Joint-Stock Companies Act 1856 was the provision that the auditor of a company did not have to be a member of it. The same article, Article 76, also forbade directors to take up the post of auditor, along with anyone else who might have a business interest in the company. The implications of this article are twofold. Firstly, it was a break from the original concept of shareholders that were not involved in the day-to-day running of the company checking on those that were, and, secondly, it was the introduction of the concept of independence. All in all, it was opening the way for the employment of professional accountants as auditors.

The Companies Act 1900 reintroduced the statutory requirement for a compulsory audit of all limited companies. This was basically how the legal position remained until the enactment on the Companies Act 1948. During the intervening period, the role of lending credibility to the accounts emerged as the auditor's primary objective (Lee, 1986).

THE DETECTION OF FRAUD AS AN AUDIT OBJECTIVE

During the nineteenth century and the early part of the twentieth century fraud detection was seen as an important part of the audit. Although the Joint-Stock Companies Acts remained silent on the subject of fraud, the Punishment of Frauds Act 1857 strengthened the law against fraud, making it an offence for a director or officer of a company to alter falsely a company's accounting records in order to defraud a creditor or shareholder. The judgement in Nichol's Case (1859) stated that it was part of an auditor's duty to discover fraudulent misrepresentations. Thus, the detection of fraud was laid down as being one of the top priorities of an audit and generally remained so well into the 1920s (Lee, 1986). The Victorian view on the detection of fraud can be seen from a contemporary comment: 'The object of an audit is a two fold one, the detection of fraud where it has been committed, and its prevention by imposing such safeguards, and devising such means as will make it extremely difficult of accomplishment, even if the inclination is in that direction' (Bourne, 1887: 330).

The decline in the importance of fraud as an audit objective started towards the end of the nineteenth century. This is reflected in the judgement in the *Kingston Cotton Mill Case* (1896). Auditors did not have to approach their work with the foregone conclusion that something was wrong, however, once something untoward was discovered, the auditor should investigate it to ensure that the error or defalcation was not so material as to affect the view given by the accounts. This case gave rise to the famous saying, 'an auditor is a watchdog but not a bloodhound'. In *Irish Woollen Co. Ltd.* v *Tyson and Others* (1900), it was held that an auditor is liable for any damages sustained by a company by reason of falsification which might have been discovered by the exercise of reasonable care and skill in the performance of the audit. So, instead of having to detect all frauds, it was becoming clear that it was the auditors' duty to exercise reasonable care and skill in the conduct of their work.

THE CONCEPTUAL BASIS OF AUDITING

The AAA's Committee on Basic Auditing Concepts (1973: 9–11) identified four conditions which it considered created the demand for an independent audit of accounting data. These can be summarized as follows:

1 *The potential or actual conflict of interest*. This conflict may exist between the user of the information and the preparer.
2 *Consequence*. The user may require the information for decision-making purposes; therefore, the user needs to be confident of the quality of the accounting information.

3 *Complexity*. The processes of producing the accounting information are so complex that the user has to rely on someone else to examine its quality.
4 *Remoteness*. Even if the user had the ability to reach a conclusion on the quality of the accounting information, it is unlikely that the user would have access.

This committee considered that '[t]hese four conditions (conflict of interest, consequence, complexity, and remoteness) interact in such a way that as they increase in their intensity they make it both increasingly important that an informed, independent conclusion be reached by the user as to the quality of the accounting information being received and increasingly difficult for the user of the information to reach such a determination without outside assistance' (AAA, 1973: 10).

In 1993, Pratt and Van Peursem considered that '[a]uditing has developed in a very practical way over the last 3,000 years, but it is only in the last 30 years that much consideration has been given to the discipline's underlying theoretical foundations'. This could be seen to have started in 1961 with Mautz and Sharaf's attempt to formulate a theory of auditing. They intended to try to bring together 'the bits of theory now in the literature' (p. 4), the objective being that such a framework would ensure that problems facing the auditor would be dealt with in a rational and consistent manner. Altogether, eight tentative postulates of auditing were formulated by Mautz and Sharaf:

> 1 *Financial statements and financial data are verifiable.*
> 2 *There is no necessary conflict of interest between the auditor and the management of the enterprise under audit.*
> 3 *The financial statements and other information submitted for verification are free from collusive and other unusual irregularities.*
> 4 *The existence of a satisfactory system of internal control eliminates the probability of irregularities.*
> 5 *Consistent application of generally accepted principles of accounting results in the fair presentation of financial position and the results of operations.*
> 6 *In the absence of clear evidence to the contrary, what has held true in the past for the enterprise under examination will hold true in the future.*
> 7 *When examining financial data for the purpose of expressing an independent opinion thereon, the auditor acts exclusively in the capacity of an auditor.*
> 8 *The professional status of the independent auditor imposes commensurate professional obligations. (Mautz and Sharaf, 1961: 42)*

Lee (1972) developed Mautz and Sharaf's work by categorizing auditing postulates into three divisions, to form 'justifying', 'behavioural' and 'functional' postulates. Sherer and Kent (1983: 19) described this categorization as 'a rational and comprehensive basis upon which to base an examination of auditing theory'. The justifying postulates set out the reasons for the existence of the external audit function. Gwilliam (1987: 45) describes these justifying postulates as 'the most significant extension of the postulate approach'. This was because Mautz and Sharaf were more concerned with whether an audit was in fact feasible, and not with whether it was necessary.

Lee's justifying postulates (1972: 53–6) can be summarized as follows:

1 Without a formal audit, the accounting information contained in a company's financial statements lacks credibility to be used confidently by external users.
2 The most important requirement of the external audit is to increase the credibility of the financial statements.
3 The best way to enhance the credibility of the financial statements is by means of the external audit.
4 It is assumed that the credibility of the financial statements can be established by the external audit process.
5 Users of the financial statements are not able to satisfy themselves as to the credibility of the accounting information in the financial statements.

The behavioural postulates support the assumption that the external auditor can enhance the credibility of the financial statements. Therefore, the assumptions (Lee, 1972: 56–60) are that:

1 The audit is not impeded by unnecessary conflicts of interest between the external auditor and company management.
2 The work of the external auditor is not impeded by any unreasonable legal restrictions.
3 The auditor is independent both mentally and physically.
4 The auditor has sufficient skill and experience to carry out the duties required.
5 The auditor is accountable for the quality of the work performed and the opinion expressed thereon.

The functional postulates relate to the actual work performed by the auditor (Lee, 1972: 60–3):

1 It is assumed that there is sufficient reliable evidence available to enable the external auditor to carry out an audit within a reasonable time and at a reasonable cost.

2 The accounting information in the financial statements, largely due to the existence of internal controls, is free of major fraud and error.
3 There exists generally accepted and recognized accounting concepts and bases which, when used consistently, result in a true and fair presentation of the accounting information in the financial statements.

Flint (1988: 9) considered there was 'a place for theory to explain the responsibility of the audit function and the basis of its evolution, and to assist in resolving the unanswered questions which have been posed – not a theory built up on a piecemeal basis from a series of solutions to particular questions, but a set of comprehensive propositions making up an overall theory from which the solutions to all these questions can be derived'. Flint's basic postulates view the audit in its wider setting and can be summarized as follows:

1 A relationship of accountability exists.
2 An audit is required because the subject matter is too remote, too complex or too important.
3 The distinguishing characteristics of audit are independence, and freedom from investigatory and reporting constraints.
4 The subject matter for audit 'is susceptible to verification by evidence' (p. 31).
5 The standards for accountability can be set and actual performance can be compared by known criteria – 'the process of measurement and comparison requires special skill and the exercise of judgement' (p.32).
6 'The meaning, significance and intention of financial and other statements and data which are audited are sufficiently clear that the credibility which is given thereto as a result of audit can be clearly expressed and communicated' (p. 38).
7 'An audit produces an economic or social benefit' (p. 39).

Flint (1988) viewed audit as 'a social control mechanism for securing accountability': 'The onus is on auditors and audit policy-makers constantly to seek to find out what is the societal need and expectation for independent audit and to endeavour to fulfil that need within the limits of practical and economic constraints, remembering at all times that the function is a dynamic, not a static one' (p. 17).

Although the Companies Acts set out the responsibilities of the auditor, they do not specify, in any great detail, how they are to be accomplished. The first UK auditing pronouncement (*General Principles of Auditing*) was issued in 1961. This was the first of the *Statements of Auditing*, which were replaced by the *Auditing Standards and Guidelines* during the 1980s. Following the

recommendations of the Dearing Report (1988), the Auditing Practices Board (APB) was established in 1991, and it introduced the *Statements of Auditing Standards* (*SAS*s). The *SAS*s contain the basic principles and essential procedures with which auditors are required to comply. The objective of an audit of financial statements was defined by *SAS 100* as being 'to enable auditors to give an opinion on those financial statements taken as a whole and thereby to provide reasonable assurance that the financial statements give a true and fair view (where relevant) and have been prepared in accordance with relevant accounting or other requirements' (para. 1). It then sets out the auditor's responsibilities in relation to the conduct of an audit. They are required to:

> *(a) carry out procedures designed to obtain sufficient appropriate audit evidence, in accordance with Auditing Standards contained in SASs, to determine with reasonable confidence whether the financial statements are free from material misstatement;*
> *(b) evaluate the overall presentation of the financial statements, in order to ascertain whether they have been prepared in accordance with relevant legislation and accounting standards; and*
> *(c) issue a report containing a clear expression of their opinion on the financial statements. (para. 2)*

SAS 210 goes on to state that '[a]uditors should have or obtain a knowledge of the business of the entity to be audited which is sufficient to enable them to identify and understand the events, transactions and practices that may have a significant effect on the financial statements or the audit thereof' (para. 2). This can be derived from knowledge of the industry in which a client operates and the related legislation. Knowledge of a specific client can be obtained through past experiences with them, recent discussions with management and visits to the site(s) of the client's operations. The findings then need to be related back to what is known about the industry. This knowledge can then be used to assist in the assessment of risk.

SAS 300 requires the auditor to 'use professional judgment to assess the components of audit risk and to design audit procedures to ensure it is reduced to an acceptably low level'. It defines audit risk as being composed of three components: inherent risk, control risk and detection risk. In developing an audit approach, an auditor must assess the likelihood of inherent risk ('the susceptibility of an account balance or class of transactions to material misstatement, either individually or when aggregated with misstatements in

other balances or classes, irrespective of related internal controls' [para. 4]). Therefore, inherent risk would include the integrity of the directors and management (and pressures on them), and the nature of the business and the industry in which it operates. Lower down the organizational structure, inherent risk would include the quality of the accounting system, the complexity of transactions, adjustments involving a high degree of estimation and unusual transactions.

A control risk is the risk that a material error or misstatement may go undetected by an accounting or internal control system (note that 'inherent risk and control risk are highly interrelated' [para. 32] because in situations where high inherent risk is likely to exist, management often counters this by its accounting and internal control systems), whereas detection risk is the risk that auditors' substantive procedures will not detect a material misstatement. *SAS 300* defines the internal control system as 'the control environment and control procedures' (para. 8) – thus highlighting the distinction between the two. The control environment is the overall philosophy and operating style of the directors and management in relation to their company's internal controls, while control procedures relate to specific policies and procedures. Therefore, the internal control system 'includes all the policies and procedures (internal controls) adopted by the directors and management of an entity to assist in achieving their objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to internal policies, the safeguarding of assets, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information' (para. 8).

'Auditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion' (*SAS 400*, para. 2). Audit evidence is gathered by carrying out tests of control or substantive procedures. The reliability of audit evidence is stated to be influenced by its source (*SAS 400*, para. 16):

- *audit evidence from external sources . . . is more reliable than that obtained from the entity's records,*
- *audit evidence obtained from the entity's records is more reliable when the related accounting and internal control system operates effectively,*
- *evidence obtained directly by auditors is more reliable than that obtained by or from the entity,*
- *evidence in the form of documents and written representations is more reliable than oral representations, and*
- *original documents are more reliable than photocopies, telexes or facsimiles.*

In relation to fraud, the current position is as follows: 'Auditors plan, perform and evaluate their audit work in order to have a reasonable expectation of detecting material misstatements in the financial statements arising from fraud or error' (*SAS 110*, para. 18).

DEVELOPMENTS IN AUDIT APPROACHES: FROM AUDIT EFFICIENCY TO AUDIT EFFECTIVENESS?

In relation to the external audit, perhaps the only constant thing is change. In the 1980s, audit efficiency was probably the major driving force behind audit developments (Burton and Fairfield, 1982). Accountancy firms were quite open about this, and Turley and Cooper (1991: 23), following their interviews with senior auditors, were able to conclude that '[t]he most important criterion for making the choice of [audit] strategy is the notion of efficiency'. However, there have been concerns about audit effectiveness (e.g. *Cadbury Report*, 1992: 36) and while there is no doubt that auditors are still very much concerned with efficiency, there is now evidence (Davis, 1996) that things have changed. Given the litigious atmosphere in which the auditors have to operate, they are starting to reassess the objective of the audit and, consequently, how this should be accomplished. So, rather than simply concentrating on how to do their work more efficiently (that is, the same level of confidence at lower cost), they are now starting to question what, as auditors, they are trying to achieve and thus, what sort of work this requires (what is required to achieve their objectives; that is, effectiveness). Therefore, there appears to have been a move by some firms to reconsider the overall effectiveness of their audit approaches in the light of a re-evaluation of the risks (both audit and commercial) that they face (Pincus et al. [1999] examined audit effectiveness in comparison with audit efficiency, but, essentially, this was just in relation to the auditor's responsibility for fraud detection). The nature of the changes implemented by some firms is such that the developments could almost be classified as an example of 'process re-engineering'. This is likely to have a dramatic impact on what people consider auditing is all about, and could indicate a need for the reassessment of the external auditor's function.

> *The benefits of more effective audits include improving the reliability of financial statements, enhancing the credibility of and investors' confidence in those financial statements, improving management decision making, lowering entities' cost of capital, and increasing the effectiveness of capital markets in allocating resources. (Panel on Audit Effectiveness, 2000: 8)*

Davis (1996: 6) considered that the first-generation audit could be described as 'verifying transactions in the books'. In relation to the audits of large companies, the first generation of audits probably ended during the late 1960s; however, the attempted verification of transactions probably continued in relation to the audit of very small companies until the abolition of their statutory audit requirement in 1994. Davis described the second-generation audit as 'relying on systems'. This approach involved the auditor's ascertaining and documenting the accounting system, with particular regard to information flows and the identification of internal controls. It required the evaluation of the usefulness to the auditor of these controls, and then compliance tests were required if the auditor wished to rely on them. If this work showed that the controls were effective, this would enable a reduction in the level of detailed substantive testing (although, in the early days this was not always the case, and thus there was a concern about overauditing). Though the early 1970s were the high point of the systems-based approach to auditing, this was never really appropriate for the audit of small companies due to the lack of controls that would be required to give audit assurance to external auditors.

The early 1980s saw a readjustment in auditors' approaches. The assessment of these systems was an expensive process, and so auditors began to cut back their systems work and make greater use of analytical procedures. Linked with this, was the development during the mid-1980s of risk-based auditing (Turley and Cooper, 1991), which Davis has termed 'the third-generation audit'. The significance of the application of the concept of risk to the audit approach 'is that its concern is not with the choice of a particular strategy for collecting evidence per se, but rather with providing a criterion for making that choice and determining the overall direction of audit work' (Turley and Cooper, 1991: 15).

Though risk-based auditing may have dominated auditors' approaches during the first half of the 1990s, by 1996 Davis considered that the fourth-generation audit had arrived. This he termed 'the investigatory audit', but it has also been called 'the business risk approach' (Bell et al., 1997; KPMG, 1999; Lemon et al., 2000; Winograd et al., 2000):

> *It means audit people making judgements about audited people. With integrated business and accounting systems, most system failures in larger companies are now detected long before the audit. Things go wrong from human abuse of the systems and of trust. The motives are usually personal protection in seeking to conceal poor profits, or personal gain through theft. The whites of the eyes test is worth hundreds of words in an audit programme. (Davis, 1996: 6)*

'[D]uring the 1990s, several of the major international accounting firms have developed their methodologies on the basis of business risk analysis, and this has led to claims that a new generation of audit approaches, conceptually different from previous approaches, has arrived' (Lemon et al., 2000: 1). Lemon et al. report that business risk audit approaches 'emphasize a "top-down" approach to the audit, starting from the business and its processes and working through to the financial statements, rather than in the opposite direction, where the business is essentially defined by the financial statements' (p. 11). With the business risk approach, 'emphasis is placed on understanding the risks the entity is subject to, in its environment, operations, and control processes' (p. 15).

The business risk approach appears to be moving the auditor's focus even further away from the detail of the entries in the accounting system and on to the people who manage the business. This is almost a recognition that external auditing could be regarded as the audit of motivations (this will be discussed further in the next chapter). Though the Accounting Standards Board (ASB) has made great efforts to limit management's discretion regarding the preparation and presentation of its financial statements, it must be recognized that the production of any set of financial statements requires the employment of judgement. Therefore, the honesty and motivations of management are important; however, there is a debate as to how much audit emphasis should be placed on these things rather than on the detail of the accounting records, and the risk-based approaches have been criticized (Hatherly, 1998).

In view of the limited amount of information about auditors' approaches to their audits, this chapter reports the results of eighteen interviews (including one pilot interview) which were conducted (in late 1995 and early 1996) with senior audit partners and managers. Consequently, the findings probably tend to reflect audit developments in larger firms and on larger audits, but they do illustrate issues which are of concern to auditors.

Most of the firms had moved towards a risk-based audit approach in the late 1980s; since then, there have been a number of developments, though most of these may be described as 'incremental' – building on what was already there. One person considered that over the previous decade, the increased emphasis on risk has been 'out of all proportion' to how it was used originally. A number of the larger firms do appear to have made significant alterations to their audit approaches. These approaches now place much greater emphasis on high-level risk (or business risk). This is the risk to the auditors themselves; that is, it is not just audit risk (the risk of a wrong opinion), but also commercial risk (the adverse consequences of an audit failure). This has led to a reassessment of the fundamentals of the audit: 'Do we need to do all this work? What are the risks?' Therefore, there is evidence that audit effectiveness is being questioned. Effectiveness could be defined as

an assessment of whether the auditor's approach is achieving its objective (as opposed to efficiency, which relates inputs to outputs). Therefore, 'audit effectiveness' leads to the auditor questioning whether something really needs to be done in order for an audit opinion to be formulated, whereas it could be argued that 'audit efficiency' (in the literal sense of the phrase) is about whether an existing procedure can be done in a more cost-effective manner. Consequently, some auditors are placing considerably greater emphasis on high-level risk, concentrating much more on the individuals who comprise the management team. There has been a greater emphasis on the understanding of management's control of business risk and its overall control of the information systems. This has involved examining management's attitude to controls and the strength of its control environment (that is, controls over the detection of errors and controls aimed at preventing fraud and manipulation). A couple of the interviewees stated that it was now their firms' policies to resign or refuse reappointment as auditors if they had doubts about the integrity of any of their clients.

A number of interviewees (speaking about other firms' approaches) were concerned about this emphasis and reliance on high-level risks and controls. One person stated that as part of the risk assessment, his firm would look at management, but he perceived a problem: 'I don't think we have enough information about the individual people.' Another person concluded that: 'The Big 6 [as it was then] can risk away with impunity.' Therefore, it can be seen that a debate exists regarding how much assurance auditors should be seeking from their assessment of the levels of risk. *SAS 400* requires that '[a]uditors should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion' (para. 2), and as one person stated: 'It all comes back to judgement at the end of the day.'

Central to the conduct of an audit is the development of a strategy aimed at achieving the audit objective, followed up by a specific plan to implement the strategy. Auditors are required to 'obtain an understanding of the accounting and internal control systems sufficient to plan the audit and develop an effective audit approach' (*SAS 300*, para. 3). It is a requirement of *SAS 200* that auditors plan and document their work. Thus, the overall plan should describe the expected scope and conduct of the audit. All those interviewed considered that the time spent on these parts of the audit had increased, some admitting to a significant increase. The planning stage was seen as an opportunity for auditors to consolidate their knowledge of the client; it 'enables the identification of problem areas at the start of the audit, and not at the end'. However, other factors appear to have been the JMU (Joint Monitoring Unit) visits as well as the *SAS* on planning.

Auditors' approaches now tend to emphasize the overview of the control flows, and 'the top level controls are more and more important'. The auditors

are now interested in 'how managers manage the business', or, as another person described it, 'a top-down' approach to controls – 'historically, people worked up from the bottom (e.g. transactions controls and compliance)'. As a consequence, there has been 'far less compliance testing by low level junior staff'. It was considered that the auditing disasters of the early 1990s had illustrated the threats posed by things going wrong at the top of an organization. Another reason given for this switch from concentrating on the low-level, detailed controls was the changes in the nature of clients' systems. One person stated that auditors 'hardly ever find controls work picking up errors'. The greater use of IT by clients was cited as being particularly important in this respect. Until the 1970s, most systems were clerically based, whereas now IT predominates; consequently, the auditor needs to obtain a different type of evidence. Management's use of IT means that auditors are now encountering much fewer clerical errors – 'there has been a drastic reduction in the number of errors found'. Therefore, auditors tend to consider that the client's use of standard software packages has contributed to a reduction in control risk. Obviously, they need to consider the individual environments and the potential for any unauthorized adjustments to the systems, but, generally, it was considered that 'the vast majority of companies do not have people with the necessary expertise'. This person stated that 'fraud in a computerised environment is not extensive – big frauds do not happen as a result of a manipulation of software'; as a consequence, this interviewee considered that 'computerised systems were less risky than manual systems'. It appears that auditors are most concerned when management make alterations to its systems – one person stated that 'change equals risk'. A few types of audits are of necessity systems-based (as in the financial sector), but, in general, one can now report the 'death' of the old systems-based audit (that is, the second-generation audit). One person considered that the move away from systems work was 'a shame because of a loss of quality in what we can provide'; consequently, the auditor's comments were not as helpful to management.

It was suggested that the systems audit can often be done by internal audit, and then the external auditors can review this work. The existence of an internal audit function does depend very much on the nature and size of the company being audited. It still tends to be the largest companies which make extensive use of them. As a result of the *Cadbury Report*, more companies have reassessed their use of the internal audit function. One development has been the outsourcing of this function – some companies have started to use external agencies, rather than set up their own departments. Though external auditors try to make as much use as possible of the internal auditor's work, its value to them is often limited. This is because of the varied nature of the internal auditor's work. It is just as likely to relate to operational issues (such as economy, efficiency and effectiveness) as to the operation of the financial

controls which are of most interest to the external auditors. Where possible, more use was being made of internal audit departments. A number of auditors made favourable comments regarding the quality of the people in such departments and the clarification of their reporting lines. Generally, the auditors' views of internal audit departments appeared to be much more positive than in the mid-1980s. However, one person made it clear that he did not want to comment on the usefulness of the few internal audit departments that he had encountered!

In general, auditors have continued to make greater use of analytical review. *SAS 410* defines analytical procedures as the analysis of relationships:

> *(a) between items of financial data, or between items of financial and non-financial data, deriving from the same period; or*
> *(b) between comparable financial information deriving from different periods or different entities. (para. 3)*

Analytical review is now an extremely important part of the audit. As one person stated, 'the whole thing is about reducing [detailed] substantive testing – justifiably'. Another person stated: 'If you want reduced costs but the same coverage, analytical review was the answer.' Analytical review was regarded as 'very important . . . and very powerful'. The main perceived advantages were that it enabled the reduction in other types of work, it was relatively cheap to perform, it should force the auditor to think about the implications of the results, and it focused the auditor on problem areas. Although analytical review is mandatory at the planning and review stages of an audit (*SAS 410*), one person considered that it was 'nonsense in relation to the beginning of the audit – if analytical review is an attempt to predict an account balance'. The intention of using it at the start of the audit was to identify unusual variations and subsequently direct audit attention to them; however, this person was concerned that at the commencement of an audit it was often very difficult to attempt to make a prediction of what the relationship should be.

Another person was concerned about the lack of management accounting information available to auditors in some businesses. This person considered that the limited use of management accounting was 'one of the most disappointing things about British business'. Thus, there was a concern that the data necessary for an analytical review may not be available. Other drawbacks were stated as being the difficulty of interpreting the results and determining when something was unusual. One interviewee considered that analytical review was 'strong regarding completeness . . . [but] there is a question as to how effective it is'. Another person considered that 'in many

cases the quality of analytical review leaves much to be desired . . . the quality has improved and it needed to!' The general view was that analytical review was now of a better quality and performed more thoughtfully than in the past. It was considered that auditors were now better trained in its use. However, one view was that 'it was a constant struggle to use more analytical review', and that 'slow progress' was being made, because 'it was difficult to get people to relate it intelligently to the audit'. Other reservations about the usefulness of analytical review, have come from the Panel on Audit Effectiveness:

> *The entities with the most sophisticated frauds often were concerned about concealing them from the auditors and particularly about making the numbers and relationships among them 'look right' to the auditors when they performed their analytical procedures. A favorite technique for accomplishing this was to 'play around' with the numbers, often through the use of non-standard entries, until they 'looked right'. (Panel on Audit Effectiveness, 2000: 85)*

Therefore, there are concerns regarding the effectiveness of analytical review, and there is a question over the amount of assurance that it gives.

Perhaps the key thing to come out of the interviews is how greatly the detailed substantive testing of transactions appears to have declined. The early 1980s saw a swing away from reliance on internal controls and towards more substantive testing (analytical review and testing of transactions). This was because audit partners required a heavy level of detailed substantive testing in order for them to feel comfortable about forming the audit opinion. An examination of audit manuals in the mid-1980s found that a number of firms then considered that substantive tests of detail were the most reliable source of evidence. At least one firm considered that direct substantive testing of transactions and balances could provide high, easily measurable levels of assurance, and in many cases the bulk of their evidence was derived from this source. Thus, it can be seen that detailed substantive testing used to be a fundamental type of audit procedure.

However, there was a perception at the time that overauditing was taking place. The rise of analytical auditing procedures during the 1980s resulted in a justification for reductions in detailed substantive testing. The implementation of risk-analysis approaches continued to move auditors even further away from detailed substantive testing. This trend has continued. The interviews made it clear that during the 1990s less and less audit assurance was being sought from detailed substantive testing. All firms were developing their audit approaches so as to be able to justify reductions in detailed substantive

testing – 'we have moved a long way from gaining assurance from detailed substantive assurance'. Another person described the trend as 'a waning of heavy substantive tests'. The risk-evaluation approach adopted by some of the larger firms has had the impact of eliminating a number of areas of work. The justification was that if a company had good internal controls and there was a good analytical review, the auditor 'may not do any tests of detail in many cases'.

Clients' use of IT was also considered to have contributed to the decline in detailed substantive testing. Reliance on this has enabled auditors to concentrate on analysing what is produced – to the extent that 'the need to check transactions is much reduced – if not eliminated'. In view of these comments, it is interesting to note that '[t]he advent of the computerized systems has increased the improper manipulation of input or transaction data, application programs, data files, and computer operations. Embedded fraud is often hard to detect' (Vanasco, 1998: 62). Despite this, the effect of the developments in the audit approaches is such that, in some large firms, one can almost pronounce the demise of detailed substantive testing, as, increasingly, 'sampling is a test of last resort'.

The changes identified here are profound, and it can be concluded that the nature of some audits (particularly those of large companies) has been completely revolutionized. In the light of this development, one wonders whether the 'basis of opinion' paragraph in the current unqualified audit opinion really reflects the work that underpins the formulation of the auditor's view. This paragraph states: 'An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements' (APB, 1993, *SAS 600*, Example 2). Given the swing away from testing, and the additional emphasis being given to the assessment of risk and high-level controls, it may now be appropriate to reconsider this wording.

Not everyone is in agreement with the extent to which some of these developments have been taken. One person considered that 'transactions are key. If you ignore transactions you are getting away from your responsibilities. This is taking risk too far, which is what we are not prepared to do.' It is clear that each firm has had to formulate its own view in deriving an audit strategy to obtain sufficient appropriate audit evidence, and it is clear that there is a debate within the profession regarding the nature and extent of the audit evidence required by the auditor.

The decrease in the reliance on detailed substantive testing also has implications in relation to statistical sampling. The 1970s saw the growth in statistical sampling and statistical approaches to auditing – recent developments mean that these have now been almost eliminated. Even with the reductions in sample sizes which occurred in the 1980s, firms would claim that there was an underlying statistical basis for their samples. Now, with most firms, there is little pretence at the statistical approach to auditing. One

person whose firm did use 'an essentially statistical method' considered that they 'tend to find statistical theory more helpful in planning sample sizes and choosing the sample, rather than in the evaluation process . . . [as] you do need judgement for this'. Even this person considered that 'statistical evaluation was not that useful at the end of the day'. The main advantages of a statistical approach were seen as 'ensuring comparability across the firm', and that it 'makes some people think about what they should be thinking about when selecting a sample'. Another person stated: 'If we resort to sampling it is only on a statistical basis.' However, this 'was relatively infrequently used. Often enough confidence comes from the controls and analytical review.' When samples were conducted, most interviewees considered that efforts were made to ensure that they were representative of the whole population – though this did not necessarily mean that they were selected on a statistical basis. In general, there appears to have been a swing away from quantitative approaches to auditing. Without a statistical basis, it would now be very difficult for auditors to try to specify any sort of confidence levels to underpin their opinions – this may reflect the essentially judgemental nature of the external audit, and, in one person's view, that 'auditing is an art form'. Another reason for abandoning a claim to a statistical approach could be the current litigious atmosphere. After all, if, under scrutiny, a 'statistical' approach was found to be faulty, this would obviously damage an auditor's defence.

With tighter and tighter reporting deadlines (especially with major companies), the auditors have had to rethink the timing of their work. Market pressures mean that directors want to report their results as soon after their year end as possible. In order to cope with this, auditors have tended to adopt a 'hard-close' approach. Therefore, if a company has a 31 December year end, the auditors essentially carry out their detailed audit work on the figures at the end of November and then roll forward the accounting data to the end of December. This enables results to be published earlier than otherwise would be possible. In this situation, timeliness appears to be taking priority over 'precision'.

Overall, it can be seen that a number of fundamental changes have been identified as having occurred in recent years. Underlying all this has been a growing sense of crisis. The ever-present pressures on auditors have meant, in the words of one interviewee, that 'developments have been accelerated by market forces, driving auditors into more and more desperate ways of increasing efficiency'. Another person expressed his unease as follows: 'My biggest concern is whether an audit, as currently designed, is appropriate. . . . The big problem with audit is, unlike other services, it is not for the benefit of the directors. . . . Therefore, a cost benefit analysis can never be done properly.' This comment was reinforced by another person who posed the question: 'Does the independent audit have a future?'

ASSURANCE SERVICES

In view of these concerns, auditors have been trying to 'add value' to the external audit (Steen, 1989). Initially, it seemed that auditors were trying to give themselves a competitive edge by trying to distinguish their services from those of the other firms. Examples of 'adding value' include benchmarking, keeping management informed about developments in their business sector, and advice on foreign currency management, treasury issues and stock management. Such developments did cause concern regarding auditor independence (Hatherly, 1989). Some auditors considered that this was simply a formalization of what had been happening in the past, but, strictly speaking, it was not part of the audit – it was part of the auditor–client relationship.

In a way, the emphasis on assurance services could be seen as an extension of this attempt to add value to the audit. Elliott (1994; 1995) advocated the recognition of customer needs and emphasized the decision usefulness of information. Whereas 'adding value' could be seen to be giving more to management, 'assurance services attempt to help decision makers (who might not be clients) arrive at optimum decisions' (Elliott Committee, 1997a: 7). The Elliott Committee defined assurance services as 'independent professional services that improve the quality of information, or its context, for decision makers' (p. 1). It contended: 'Assurance services help people make better decisions by improving information available to them' (p. 2). It would appear that the audit is trying to realign itself with the decision-usefulness approaches so espoused by the accounting standard-setters. The Elliott Committee identified the opportunity to provide assurance services in relation to:

- risk assessments (e.g. profiling an entity's business risk);
- business performance measurements (including both financial and non-financial); and
- information systems reliability – 'this service represents a major step in a migration path that will eventually lead to real-time assurance on on-line data base systems' (1997b: 3).

These services may seem very similar to the provision of the non-audit services that have given rise to the debate about the auditor's independence, but

> *CPAs [Certified Public Accountants] presently are involved in limited aspects of these three assurance services in conjunction with the performance of an audit. The new services represent extensions (though substantial extensions) of current activities. And the*

> *intersection of the three services represents a possibly new accountability domain into which today's financial reporting/auditing model might migrate. (Elliott Committee, 1997b: 2–3)*

Such an approach would require a customer focus (Elliott and Pallais, 1997a) and would also require the building of acceptance to such changes, the creation of measurement criteria, and the bringing of such products to the market place (Elliott and Pallais, 1997b). Kelly (1997: 10) reports an Ernst & Young partner talking of an 'assurance revolution', with auditors starting to look way beyond the statutory financial statements. These developments could eventually lead to the next generation of audit.

CONTINUOUS AUDIT – THE FIFTH-GENERATION AUDIT?

Traditionally, independent assurance was viewed as resulting from the conflict of interest between preparers and users, the consequence of information to users, the complexity of subject matter and audit process, and the remoteness of users from subject matter and the preparers (AAA, 1973: 11). The CICA (1999: 3) considered that '[t]hese conditions will continue to prevail in the digital economy, and will spur the growth of opportunities for independent auditors to provide assurance on new information needs'. As a result of the technological revolution, there is now talk of 'continuous audit' and 'continuous assurance'. The Elliott Committee (1997) discussed 'a set of real time financial and non-financial information accompanied by continuous assurance (to clients and possibly to the public)' (cited in ASB [US], 1997, Initiative A: 1).

> *Information technology is making the continuous performance of audit procedures more practical and cost effective than in the past. Performance of continuous audit procedures will permit auditors to obtain evidence to support more timely and eventually continuous assurance on information. (ASB [US], 1997, Initiative A: 1)*

'A continuous audit is a methodology that enables independent auditors to provide written assurance on a subject matter using a series of auditors' reports issued simultaneously with, or a short period of time after, the occurrence of events underlying the subject matter' (CICA, 1999: 5). The CICA continued, 'a continuous audit is defined by both the desire to release audited information at frequent intervals and by the short length of time between the

availability of the completed subject matter for audit and the release of related information with the auditors' report on it' (CICA, 1999: 10):

> *In some cases, management may want audited information to be released on a real-time basis. In these situations, there would be virtually no delay between the occurrence of events underlying the subject matter, the availability of the complete subject matter for audit, the performance of the audit and the release of the information and the auditors' report on it. (CICA, 1999: 11)*

In order for 'continuous audit' to be effective, the client would have to have a highly automated process that would require only the minimum of human intervention (CICA, 1999: 12) (that is, hard data rather than soft data, which is dependent on assumptions and judgements). 'Continuous audit' would also be dependent on the reliability of clients' systems and effective controls. Auditors may be able to monitor their clients' systems on a real-time basis with embedded audit modules (EAMs) – subroutines set up by the auditors. 'The EAMs work within an entity's application programs to perform audit procedures concurrently with normal application processing' (CICA, 1999: 54). Exception reports could then highlight unusual transactions, such as errors and anomalies. The CICA considered these developments to be a long-term goal.

The development of 'continuous audit' does raise a number of questions. Firstly, who should be responsible for continuous assurance? Is it the internal auditors or the external auditors? If the external auditors are trying to 'add value' to their audit, it is understandable that they would want to be involved with the 'continuous audit'. However, given the nature of the work, it would have seemed natural for the internal auditors to have adopted it as part of their work. Secondly, what sort of assurance can be given? 'The performance of more continuous audit procedures also is related to the trend toward testing effectiveness of processes rather than testing the results' (ASB [US], 1997, Initiative A: 1). Therefore, the auditors could monitor the working of the system on a real-time basis. Whether real-time figures per se would have much meaning is problematic; this issue is discussed further in Chapter 8. Thirdly, if the focus is very much on the contents of the real-time system, where does that leave the financial statements and all the effort and debate relating to the inclusion of current values and net present values?

CONCLUSION

The refocusing of auditors on assurance services could almost be classified as an audit revolution. The recognition of the limited usefulness of the financial

statements for decision making appears to have resulted in the auditors trying to extend the remit of their work. Whether this is to provide a service to the stakeholders in general or simply to protect their position is problematic: 'assurance services will help accountants adapt to the evolving practice environment and sustain their contribution to society on into the future' (Elliott, 1998: 7).

For the past twenty years, auditors have been seeking less and less audit evidence from detailed substantive testing. Better accounting systems and the greater use of IT by clients has meant that very few material transaction errors are being discovered by external auditors. Therefore, audit emphasis is increasingly being switched away from the detailed examination of the routine processing of transactions and on to the corporate control culture and the potential of risk. Due to the pressure that auditors face, it appears that they have been reassessing what the audit is trying to achieve, and this has resulted in an extensive questioning of how it should be done. Therefore, it is suggested that it may be possible to view developments in terms of a change from audit efficiency to audit effectiveness. There has been a resurgence in the emphasis on judgement – judgement regarding the assessment of risks and controls, judgement regarding the interpretation of analytical review, and judgement in relation to any (limited) testing. The focus, by some firms, on the high-level risks and controls, together with the justification of very limited amounts of detailed substantive testing based on their risk analyses and analytical reviews, has completely altered previous conceptions of the external audit. It is clear that external auditors are going through a period of immense uncertainty; as to the outcome of this, only time will tell.

DISCUSSION QUESTIONS

1 The need for the external audit of limited companies is often questioned. What would you say are the factors that currently bring about the need for the external audit?

2 Can an auditor ever be fully confident of having done enough work to support an unqualified audit opinion?

3 In recent years, external auditors have placed much more emphasis on 'high-level' risks. What do you consider constitutes 'high-level' risks and why are they important?

4 How do assurance services differ from the traditional concept of the external audit? Are these services really compatible with the role of the external auditor?

5 What do you see as the advantages and disadvantages of the advent of the 'continuous audit'?

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