1 What Is Auditing?

LEARNING OBJECTIVES

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

• explain the key features of the audit function;
• distinguish between financial statement audits, compliance audits and operational audits;
• distinguish between external and internal audits;
• describe how auditing differs from accounting;
• explain why financial statement audits are necessary;
• discuss the benefits of financial statement audits for
  – users of financial statements,
  – the auditee (the entity whose financial statements are audited),
  – society as a whole;
• explain why the benefits to be gained from financial statement audits are sometimes not obtained.

1.1 INTRODUCTION

In general, United Kingdom (UK) legislation requires all but small companies, and virtually all public sector entities, to produce audited financial statements annually. The audits of these financial statements require time, effort and resources. As shown in Figure 1.1, in 2012 the audit fees of the 10 largest companies listed on the London Stock Exchange alone amounted to £148.5 million.¹ From this it is evident that the audits of the financial statements of UK corporate entities as a whole consume a considerable amount of the nation’s resources. But, what is an audit? Why are they needed? Indeed, why are financial statement audits so important that they are required by law? Do they provide benefits which are commensurate with their cost?

In this chapter we address the questions posed above. More specifically, we examine the nature of the audit function and distinguish between financial statement audits, compliance audits and operational audits, and also between external and internal audits. We also consider the factors which make financial statement audits necessary and explain their value for financial statement

¹ The ten largest companies by market capitalisation on 31 March 2013. The financial year for Vodafone ended on 31 March 2012, for Diageo on 30 June 2012 and for all other companies on 31 December 2012.
Figure 1.1: Audit and non-audit fees paid to the auditors of the 10 largest (by market capitalisation) companies listed on the London Stock Exchange in March 2013

<table>
<thead>
<tr>
<th>Company</th>
<th>Audit fees</th>
<th>Non-audit fees paid to auditors</th>
<th>Auditor</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>£million</td>
<td>Audit related&lt;sup&gt;1&lt;/sup&gt; £million</td>
<td>Other services&lt;sup&gt;2&lt;/sup&gt; £million</td>
</tr>
<tr>
<td>Royal Dutch Shell plc*</td>
<td>29.5</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td>HSBC Holdings plc*</td>
<td>29.9</td>
<td>14.5</td>
<td>6.0</td>
</tr>
<tr>
<td>BP plc*</td>
<td>20.3</td>
<td>8.0</td>
<td>4.3</td>
</tr>
<tr>
<td>Vodafone Group plc</td>
<td>14.0</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>GlaxoSmithKline plc</td>
<td>14.6</td>
<td>3.3</td>
<td>5.9</td>
</tr>
<tr>
<td>British American Tobacco</td>
<td>10.5</td>
<td>1.0</td>
<td>4.1</td>
</tr>
<tr>
<td>SABMiller</td>
<td>7.4</td>
<td>11.1</td>
<td>22.8</td>
</tr>
<tr>
<td>Diageo</td>
<td>5.8</td>
<td>1.6</td>
<td>4.0</td>
</tr>
<tr>
<td>BG Group*</td>
<td>4.0</td>
<td>0.0</td>
<td>0.2</td>
</tr>
<tr>
<td>Rio Tinto plc*</td>
<td>12.4</td>
<td>3.3</td>
<td>48.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>£148.5</strong></td>
<td><strong>£44.4</strong></td>
<td><strong>£96.9</strong></td>
</tr>
</tbody>
</table>

*Figures in these annual reports are in $US. Converted at the rate on 31 December 2012: US$1 = £0.6165
<sup>1</sup> Examples of ‘audit related’ service are reviews of interim financial information, filings pursuant to legislation and reporting on internal controls
<sup>2</sup> Examples of ‘other services’ are tax compliance, internal audit and information technology services

Source: Relevant companies’ annual reports

users, auditees (that is, the entities whose financial statements are audited) and society as a whole. Before concluding the chapter we discuss why the benefits which should be provided by financial statement audits are sometimes not obtained.

1.2 WHAT IS AN AUDIT?

Anderson (1977) captured the essence of auditing when he stated:

The practice of auditing commenced on the day that one individual assumed stewardship over another’s property. In reporting on his stewardship, the accuracy and reliability of that information would have been subjected to some sort of critical review [i.e., an audit]. (p. 6)

The term ‘audit’ is derived from the Latin word meaning ‘a hearing’. Auditing originated over 2,000 years ago when, firstly in Egypt and later in Greece, Rome and elsewhere, citizens (or sometimes slaves) who were entrusted with the collection and disbursement of public funds were required to give an

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<sup>2</sup> The fees shown include the worldwide audit and non-audit services fees paid to the auditor by the relevant company (or group).
oral account of their handling of those funds, in public, to a responsible official (an auditor).³

In order to understand what an audit is, and how it is conducted in the modern context, we need a definition. A comprehensive definition of auditing with general application is as follows:

Auditing is a systematic process of objectively gathering and evaluating evidence relating to assertions about economic actions and events in which the individual or organisation making the assertions has been engaged, to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to users of the reports in which the assertions are made.⁴

This definition conveys that:
• auditing proceeds by means of an ordered series of steps (a systematic process);
• auditing primarily involves gathering and evaluating evidence;
• in pursuing this activity the auditor maintains an objective unbiased attitude of mind;
• the auditor critically examines assertions (statements implied to be true) made by an individual or organisation about economic activities in which they have been engaged;
• the auditor assesses how closely these assertions conform to the ‘set of rules’ which govern how the individual or organisation is to report to others about the economic activities and events that have occurred. This ‘set of rules’ comprises the established criteria which enable the auditor to evaluate whether the assertions fairly represent the underlying events;
• the auditor communicates the results of this evaluation in a written report. The report is available to all users of the document(s) in which the assertions are made.

The major features of an audit are presented diagrammatically in Figure 1.2.

1.3 TYPES OF AUDIT

Audits may be classified in various ways. They may, for instance, be classified according to:
• the primary objective of the audit, or
• the primary beneficiaries of the audit.

³ It should be remembered that, at the time, very few people could write or read, thus the account of public funds collected and disbursed needed to be given orally and in public.

⁴ Adapted from the definition provided by the Committee on Basic Auditing Concepts (1973, p. 8).
1.3.1 Classification by primary audit objective

Based on the primary audit objective, three main categories of audits may be recognised:

(i) financial statement audits,
(ii) compliance audits, and
(iii) operational audits.

(i) Financial statement audits

A financial statement audit is an examination of an entity’s financial statements, which have been prepared by its management/directors for shareholders and other interested parties outside the entity, and of the evidence supporting the information contained in those financial statements. It is conducted by a qualified, experienced professional who is independent of the entity, for the purpose of expressing an opinion on whether or not the financial statements provide a true and fair view of the entity’s financial performance and financial position.

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5 In the Preface to this book we note that the term ‘management’ is defined to mean a company’s executive directors, non-executive directors and non-director executives (that is, all executives and directors). Under the Companies Act 2006 (s. 394), a company’s directors are responsible for the preparation of its annual financial statements.

6 The term ‘an auditor’ usually refers to an audit firm. Although one person in the firm (referred to in the Companies Act 2006, s. 504, as ‘the senior statutory auditor’) is responsible for an individual audit engagement (the audit of a client’s financial statements for a single year) and signs the audit report, the audit is usually conducted by an audit team. We explain this further in Chapter 7.
What is auditing?

An and comply with relevant legal and/or other regulatory requirements. The major features of a financial statement audit are presented in Figure 1.3.

The Companies Act (CA) 2006 (ss. 396, 404) requires the directors of all companies to prepare annually financial statements which include:

- a balance sheet showing a true and fair view of the company’s ‘state of affairs’ (or financial position) as at the last day of the financial year; and
- a profit and loss statement showing a true and fair view of the company’s profit or loss for the financial year.

CA 2006, s. 495, also requires auditors to report on these financial statements. Thus, prima facie, all companies must, by law, have their financial statements audited. However, companies which are not public companies and which qualify as small [that is, companies which meet two of the following three criteria: turnover of no more than £6.5 million, balance sheet total (total assets) of no more than £3.26 million and no more than 50 employees during the financial year] are generally exempt from a statutory audit (CA 2006, s. 477).

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7 Accounting standards also require all but small companies to provide a cash flow statement showing the company’s cash flows during the financial year. It should also be noted that International Financial Reporting Standards use the terms ‘statement of financial position’ and ‘income statement’ in place of ‘balance sheet’ and ‘profit and loss statement’, respectively.

8 Until October 2012, non-public companies could qualify for exemption from an audit if they met the turnover and total assets criteria. In October 2012, ‘no more than 50 employees’ was added as a criterion, and non-public companies could be exempted from having an audit if they met any two of the three criteria. The statutory and regulatory requirements applying to the audits of companies’ financial statements are explained in Chapter 5, section 5.2.1.
Companies taking advantage of the audit exemption, and also partnerships and sole traders (which are not legally required to have their financial statements audited),\(^9\) may still have their financial statements audited for specific purposes. For example, if one of these entities approaches a bank for a loan, the bank is likely to require the entity to provide audited financial statements as a basis for deciding whether or not to grant the loan. Further, it is usual for clubs and societies to include in their constitution a requirement for their annual financial statements to be audited.

(ii) **Compliance audits**

The purpose of a compliance audit is to determine whether an individual or entity (the auditee) has acted (or is acting) in accordance with procedures or regulations established by an authority, such as the entity’s management or a regulatory body. The audits are conducted by competent, experienced professionals (internal or external to the auditee) who are appointed by, and report to, the authority which initiated the audit (usually the authority which established the procedures or regulations).

Examples of compliance audits include audits conducted by HM Revenue & Customs which are designed to ascertain whether individuals or organisations have complied with tax legislation or legislation governing duties or taxes levied on imports and exports. They also include audits conducted within companies or other entities to ascertain whether the entity’s employees are complying with the system of internal control established by management.\(^{10}\)

(iii) **Operational audits**

An operational audit involves a systematic examination and evaluation of an entity’s operations which is conducted with a view to improving the efficiency and/or effectiveness of the entity. Such audits are usually initiated by the entity’s management or, sometimes, if there is one, by its audit committee.\(^{11}\) They are conducted by competent, experienced professionals (internal or external to the organisation) who report their findings to the party which initiated the audit. An operational audit may apply to the organisation as a whole or to an identified segment thereof such as a subsidiary, division or department. The objectives of the audit may be broad, for example, to improve the overall

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9 Limited liability partnerships, but not ordinary partnerships, are legally required to have their annual financial statements audited unless they meet two of the following criteria to qualify as ‘small’: turnover of no more than £6.5 million, balance sheet total of no more than £3.26 million, and no more than 50 employees. We explain this in relation to audit firms in Chapter 16, section 16.5.3.

10 Internal control is discussed in Chapter 10.

11 An audit committee is a subcommittee of the board of directors (or its equivalent).
efficiency of the entity, or narrow and designed, for example, to solve a specific problem such as excessive staff turnover.\textsuperscript{12}

1.3.2 Classification by primary audit beneficiaries

Based on the primary audit beneficiaries (that is, those for whom the audit is conducted), audits may be classified as:

(i) external audits, or
(ii) internal audits.

(i) External audits

An external audit is an audit performed for parties external to the auditee and it is these parties to whom the auditor reports the audit findings or conclusions. Competent, experienced professionals, independent of the auditee and its personnel, conduct these audits in accordance with requirements which are defined by, or on behalf of, the parties for whose benefit the audit is conducted. Probably the best-known and most frequently performed external audits are the statutory audits of the financial statements of companies and public sector entities (that is, financial statement audits). However, compliance audits conducted by HM Revenue & Customs are also examples of external audits.

(ii) Internal audits

In contrast to external audits, internal audits are performed for a party (usually management or, if it has one, the entity’s audit committee) internal to the entity. They may be performed by employees of the entity (internal auditors) or by personnel from an outside source (such as an accounting firm or, for example, environmental or other specialists). In either case, the audit is conducted in accordance with the requirements of the party which initiated the audit and it is this party to whom the auditor reports his/her audit findings. Internal audits may be wide-ranging or narrowly-focused, and they may be continuous (ongoing) or one-off in nature. They may, for example, be as broad as investigating the appropriateness of, and level of compliance with, the organisation’s system of internal control, or as narrow as examining the entity’s policies and procedures for ensuring compliance with health and safety or environmental regulations.

1.3.3 Common characteristics of audits

It should be noted that, although different categories and types of audit may be recognised, all audits possess the same general characteristics. Whether they

\textsuperscript{12} In public sector entities, broadly-based operational audits (value for money audits) are generally required as part of the statutory audit (that is, the audit required by law). However, additional more specific operational audits may also be initiated by the entity’s management and conducted along the lines of those undertaken in companies.
are financial statement, compliance or operational audits, and whether they are conducted for parties external or internal to the entity, they all involve:

- the systematic collection and evaluation of evidence which is undertaken to ascertain whether assertions by individuals or organisations fairly represent the underlying facts and comply with established criteria; and
- communication of the results of the examination, usually in a written report, to the party by whom, or on whose behalf, the auditor was appointed to conduct the audit.

1.4 AUDITING vs ACCOUNTING

This book is primarily concerned with the external financial statement audits of companies which issue shares and/or debt instruments to the public and, unless we indicate otherwise, the terms ‘audit’ and ‘auditor’ should be understood in that context. However, before focusing attention on these audits we need to distinguish between auditing and accounting.

Accounting data, and the accounting systems which capture and process the data, provide the raw materials with which financial statement auditors work. In order to understand these systems, and the data they process, a financial statement auditor must first be a qualified accountant. However, the processes involved in auditing and accounting are rather different. Accounting is primarily a creative process which involves identifying, collecting, organising, summarising and communicating information about economic events. Auditing, on the other hand, is primarily an evaluative process. It involves gathering and evaluating audit evidence from which conclusions may be drawn about the fairness with which the communication resulting from the accounting process (that is, the financial statements) reflects the underlying economic events and communicating those conclusions to the users of the financial statements.

1.5 WHY ARE EXTERNAL FINANCIAL STATEMENT AUDITS NEEDED?

1.5.1 The need to communicate financial information

Since the Industrial Revolution (the late eighteenth century), ‘large’ business organisations have changed from being owner-operated entities with a small number of employees, many of whom were family members, to vast multinational companies staffed by many thousands of employees. The growth of such organisations has been made possible by the channelling of financial resources from numerous investors, through financial markets and credit-granting institutions, to the growing companies.
As companies have grown in size, their management has passed from shareholder-owners to small groups of professional managers. Thus, company growth has been accompanied by the increasing separation of ownership interests and management functions. As a consequence, a need has arisen for company managers to report to the entity’s owners, and other providers of funds such as banks and other lenders, on the financial outcomes of their activities. Those receiving these reports (external financial statements) need assurance that they are reliable. Therefore, they wish to have the information in the reports ‘checked out’ or audited.

1.5.2 The need to have the communication examined

Three questions arise in relation to ‘checking out’ the reports provided by management to the entity’s owners and other interested parties external to the entity:

1. Why might the information in the reports not be reliable?
2. Why is it important to receivers of the reports that the information is reliable?
3. Why do receivers of the reports not audit the information for themselves?

The answers to these questions lie in four main factors:

(i) conflict of interests,
(ii) consequences of error,
(iii) practicality and remoteness, and
(iv) complexity.

We discuss each of these factors below.

(i) Conflict of interests

We noted earlier that a company’s directors are legally responsible for preparing its financial statements; these directors are essentially reporting on their own performance. Users of the financial statements want the statements to portray the company’s financial position and performance as accurately as possible but they perceive it is in the directors’ personal interests to bias their report so that it reflects favourably on their management of the company’s financial affairs. Thus, there is a potential conflict of interest between the preparers and users of the financial statements. The audit plays a vital role in helping to ensure that directors provide, and users are confident in receiving, information which fairly reflects the company’s financial affairs.\(^\text{13}\)

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\(^{13}\) Some commentators apply agency theory to explain the existence of financial statement audits. They view the company’s owners (shareholders) as ‘the principal’ and its directors as ‘the agent’. In brief, agency theorists maintain that the agent is aware that the principal will perceive the agent has an incentive and opportunity (for example, by taking unauthorised perquisites) to act in his/her personal interests rather than in...
(ii) Consequences of error

If users of a company’s financial statements base decisions (such as whether to invest in, buy from, supply to, or accept employment with the company) on unreliable information, they may suffer serious financial loss as a result. Therefore, before basing decisions on financial statement information, they wish to be assured that the information is reliable and ‘safe’ to act upon.

(iii) Practicality and remoteness

In general, as a consequence of practical, legal, physical and economic factors, users of a company’s external financial statements are not able to verify the reliability of information in the financial statements for themselves. In the modern environment, it is common for public companies to have hundreds of thousands of shareholders and it is clearly not practical for such a large number of shareholders to verify the financial statements for themselves. Further, even if a person is a major shareholder in a company, that person has no legal right of access to the company’s records (such access is limited to the company’s directors and other authorised personnel within the entity). Additionally, shareholders may live many miles away from the company whose financial statements they would like to examine, and/or they may not be able to afford the time and expense which would be involved in travelling to the company and checking the information personally, should they have the legal right to do so.\(^\text{14}\) Thus, as a result of practical, legal, physical and economic factors, which prevent users of financial statements from personally examining the information provided by a company’s directors in its financial statements, an independent party is needed to assess the reliability of the information on their behalf.

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\(^{14}\) However, it should be noted that the senior executives of many financial institutions (including pension funds, insurance companies, and unit and investment trusts) which have significant shareholdings in major UK companies visit companies in which the institution has, or is considering, investment and question their directors/senior executives. These institutions have considerable influence over the investee companies especially if, in the view of the relevant financial institution(s), they are under-performing.
**iv) Complexity**

As companies grow in size, the number of their transactions increases. Further, especially in recent years, economic transactions, the accounting systems which capture and process them, and the ‘rules’ governing their measurement and disclosure (that is, financial reporting standards) have become very complex. As a result, errors are more likely to occur in financial statements. Additionally, with the increasing complexity of economic transactions, accounting systems and financial reporting standards, users of companies’ financial statements are less able to evaluate the quality of the information for themselves. The financial statements need to be examined by an independent qualified auditor who has the necessary competence and expertise to understand the entity’s business, its transactions, its accounting system and the ‘rules’ which govern external financial reporting.

### 1.6 BENEFITS DERIVED FROM EXTERNAL FINANCIAL STATEMENT AUDITS

In section 1.5 we explained why external financial statement audits are necessary. We now consider the benefits these audits provide for financial statement users, auditees and society as a whole. These benefits are reflected in the fundamental principle of external auditing – *Providing value*:

> Auditors add to the reliability and quality of financial reporting [to external parties]; they [also] provide to directors and officers [of the auditee] constructive observations arising from the audit process; and thereby contribute to the effective operation of business, capital markets and the public sector. (Financial Reporting Council, 2013, Appendix 2)

#### 1.6.1 Financial statement users

The value of an external audit for financial statement users lies in the credibility it gives to the financial information provided by the reporting entity. This credibility arises from three forms of control which an audit provides:

(i) **Preventive control:** Employees involved in the capture and processing of accounting data and in the preparation of the entity’s financial statements, who know their work will be subject to the scrutiny of an auditor, are likely to work more carefully than they would in the absence of an audit. It is probable that the extra care taken by employees prevents at least some errors from occurring in the financial statements.

(ii) **Detective control:** Even if employees in the reporting entity process the accounting data and prepare the financial statements carefully, errors may still occur. The auditor may detect these errors during the audit
and draw them to management’s attention. They may then be corrected prior to publication of the financial statements.

(iii) **Reporting control**: If the auditor detects material errors in the financial statements and refers them to management, but management refuses to correct them, the auditor draws attention to the errors by modifying the audit report (that is, the auditor states that all is not well with the financial statements, giving reasons for this conclusion). In this way, users of the financial statements are made aware that, in the auditor’s opinion, at least some of the information provided is not reliable.

It is interesting to note that the UK’s Companies Act 2006 is silent on the qualifications of those who may prepare a company’s financial statements but it specifies (in section 1212) that the auditor of these statements must be a member of a Recognised Supervisory Body (RSB). To become a member, an individual (or firm) must be appropriately qualified and be subject to the rules of the RSB – including those governing “the conduct of statutory audit work” (s. 1217). Thus, although the preparer of the financial statements need not be a qualified accountant, the auditor must be a well-qualified, competent and experienced professional. It seems that Parliament looks to auditors to protect the interests of financial statement users by providing assurance that the financial statements are reliable or giving a warning that they are not.

### 1.6.2 Auditees

During the course of a financial statement audit, the auditor becomes very familiar with the reporting entity, its business, its accounting system and all aspects of its financial affairs. Added to this, the auditor is a qualified and experienced professional who comes to the auditee as an independent objective outsider, divorced from the day-to-day operation of the entity.

These factors place the auditor in an ideal position to observe where improvements can be made. The auditor is able to advise the auditee on, for example, strengthening its internal controls, the development of its accounting and/or other management information systems, and on tax, investment and financial planning matters. In addition, the auditor is able to provide advice on issues (in cases where they arise for the auditee) such as how to proceed with a share float, business acquisition or divestment, or liquidation. The provision of these ‘additional services’ by the auditor is very valuable for the auditee. Indeed, as Anderson (1977) pointed out:

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15 The required qualifications and supervision of auditors are discussed in Chapter 5, section 5.3.1.
In many cases, it is the presence of these collateral services which makes the audit an economical package from management’s point of view. The professional auditor must always be alert for opportunities to be of service to his or her client while at the same time discharging conscientiously his or her responsibilities to the users of the audited financial statements. (p. 6)

Notwithstanding the value of these advisory services for the auditee, largely as a result of investigations following audit failures\(^\text{16}\) in the early 2000s at Enron, WorldCom and Xerox (amongst others) in the United States of America (USA), Equitable Life in the UK, Parmalat in Italy, HIH in Australia, and similar failures elsewhere, serious disquiet was expressed by politicians, regulators and investors about the extent of non-audit services provided by auditors to their audit clients. Indeed, at the turn of the twenty-first century, fees paid by audit clients to their auditors for non-audit services had grown to such an extent that, in many instances, they exceeded the audit fee by a significant margin.\(^\text{17}\) This led to concerns that the provision of such services results in auditors compromising their independence; in order to avoid upsetting the entity’s management, and thus losing lucrative non-audit as well as audit work, auditors are not sufficiently sceptical or rigorous when performing their auditing duties. As a consequence, laws and regulations have been enacted in many parts of the world to prohibit or curtail the provision of non-audit services by auditors to their audit clients. Probably the most far-reaching and stringent restrictions have been enacted in the USA in the Sarbanes-Oxley Act of 2002.\(^\text{18}\)

1.6.3 Society as a whole

The benefits flowing from financial statement audits for society as a whole fall into two broad groups, namely those relating to:

(i) the smooth functioning of financial markets; and 
(ii) securing the accountability of corporate managements.

\(^{16}\) An audit failure occurs when the auditor expresses an unmodified (‘clean’) opinion on financial statements that are materially misstated.

\(^{17}\) For example, in 2001 in the USA, Enron paid Arthur Andersen $25 (£17.9) million in audit fees and a further $27 (£19.3) million in non-audit fees; similarly, Disney paid PricewaterhouseCoopers $8.7 (£6.2) million in audit fees and a staggering $32 (£22.9) million for non-audit services. In 2001 in the UK, BP paid Ernst & Young £16.7 million in audit fees and an additional £41 million for non-audit services; and Vodafone paid Deloitte & Touche £3 million in audit fees and a further £22 million for non-audit work.

\(^{18}\) Notwithstanding the sharp curtailment since the turn of the twenty-first century in the non-audit services that UK auditors can offer their audit clients, it may be seen from Figure 1.1 that the fees paid to PricewaterhouseCoopers by both Rio Tinto and SABMiller for non-audit services exceeded the fees they paid for audit services. The dangers to auditors’ independence of providing non-audit services to audit clients, and measures taken in recent years to reduce those dangers, are discussed in Chapter 4.
(i) Smooth functioning of financial markets

The benefits – and importance – of financial statement audits in helping to ensure the smooth functioning of financial markets was aptly conveyed by Turner (2001) when he was Chief Accountant of the Securities and Exchange Commission (SEC) in the USA. He stated:

The enduring confidence of the investing public in the integrity of our capital markets is vital. In America today, approximately one out of every two adults has invested their savings in the securities markets, either [directly] through the purchase of individual stocks or [indirectly through investment] in a mutual fund or . . . pension plan. . . . These investments have provided trillions of dollars in capital for companies in the United States and around the globe. That capital is providing the fuel for our economic engine, funding for the growth of new businesses, and providing . . . job opportunities for tens of millions of workers. But . . . the willingness of investors to continue to invest their money in the markets cannot be taken for granted. . . . Public trust begins, and ends, with the integrity of the numbers the public uses to form the basis for making their investment decisions. . . . Accordingly, investors in the U.S. capital markets have depended for over a hundred years on an independent third party, an external auditor, to examine the books and financial reports prepared by management. (pp. 1–2)

Along similar lines, the UK’s House of Lords’ Select Committee on Economic Affairs19 stated:

. . . investors, regulators and commentators regard rigorous and reliable external audit as an essential underpinning of business and the capital markets which finance it, in Britain and elsewhere. . . . Audit and accountancy are absolutely fundamental to the integrity of our capital markets. . . . (House of Lords, 2011, Abstract, para 2)

It is evident that continued investment in capital markets is essential to the well-being of the economy – and to the financial well-being of those who invest directly or indirectly in those markets. However, continued investment rests on investors having confidence in the financial information on which they base their investment decisions – and hence in the external audit function. Although not referred to by Turner, indirect investment includes investment by the Government, local authorities and other public sector bodies of funds provided by the vast majority of the public in the form of taxes of one type or another. Therefore, most members of society – directly or indirectly – benefit from external financial statement audits.

(ii) Securing the accountability of corporate managements

Since the late eighteenth century, as financial and non-financial resources have been channelled by individuals and groups in society to companies, so these

19 The House of Lords’ Select Committee conducted an eight-month inquiry into the part played by auditors in the 2007–9 financial crisis (House of Lords, 2011).
entities have been able to grow. As they have become larger, they have gained significant social, economic and political power. Today, large national and multinational companies dominate the lives, and affect the well-being, of whole communities and have a major impact on society in general. However, in a democratic society, power is not absolute. Mindful of Lord Acton’s dictum that “power corrupts and absolute power corrupts absolutely”, society has established checks and balances designed to prevent possible abuse of power. One of the checks designed to ensure that company managements do not abuse the power bestowed upon them through the provision of resources is holding them accountable for the responsible use of the resources entrusted to them. This accountability is secured primarily by requiring company directors:

- to provide publicly available annual reports (which include financial statements) that report, among other things, on their use of resources and the outcomes thereof; and
- to submit the financial statements (and some other information in their annual reports) to a critical examination by an independent expert (that is, to an audit).

Thus, auditors are a key element in the process of securing the accountability of company managements who control and use the financial and non-financial resources of various groups in society such as shareholders, debtholders, creditors, employees, suppliers, customers and the general public. In the UK, a company’s auditor is legally appointed by, and reports to, the shareholders. However, all those who provide resources to company managements, or who are otherwise affected by company managements’ decisions or actions, have an interest in the accountability process of which auditing is a part.

Therefore, in addition to benefitting financial statement users and auditees, by helping to ensure the smooth functioning of financial markets and by functioning as an element of social control within the corporate accountability process, external audits are also of value to society as a whole.

1.6.4 Failure to secure the potential benefits of the audit function

While the external audit function can – and does – provide important benefits for financial statement users, auditees and society as a whole, the manner in which auditors have performed their function has, on occasion, been subject to criticism – and, in some cases, the criticism has been justifiably scathing. Indeed,

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20 As we will see in Chapter 5, the audited information companies are required to provide in their annual reports has increased markedly during the past couple of decades.
some critics go so far as to argue that the ‘Big’ accounting firms\(^\text{21}\) use their extensive power and knowledge to facilitate doubtful financial practices which help a few wealthy clients, who can afford to pay “exorbitant consultancy fees” (Mitchell & Sikka, 2002, p. 50), to exploit the capital system for their own benefit. They assert that these firms are at the centre of a web of conspiracies to “operate cartels, launder money, facilitate tax avoidance/evasion, [engage in] bribery and obstruct enquiries into frauds and deliver shoddy audits” (Mitchell & Sikka, 2002, p. 50).

While few would adopt such an extreme view, many observers have commented on the failings of auditors; others have noted the reluctance of audit firms and/or the profession to acknowledge that they might be at fault and to recognise the need for improvement. For example, in 1994 Shields noted:

> The Big Six firms have been key players in a recent spate of audit failures around the world which are beginning to undermine the internal system of accountability on which the business world relies. But instead of focusing on improving their practices and regaining the public’s trust, the Big Six have launched a full-scale campaign to reduce their liability for failed audits. (Shields, 1994, p. 1)

A decade later, Sarup (2004) observed:

> [T]he audit profession . . . is increasingly under attack as the profession attracts, fairly or unfairly, some of the blame for the recent corporate failures and the consequent losses to the investing public, the thousands of innocent employees and suppliers, and a multitude of other stakeholders. At Enron . . . the profession tried, unsuccessfully, to rationalize the patently failed audit. . . . [T]he circumstances of the multibillion-dollar fraud at WorldCom are hard to even attempt to rationalize. . . . People are asking, given [the] basic nature [of the fraud] and its magnitude, how could it have been missed. The alleged frauds at Tyco International, Adelphia Communications, HealthSouth Corp, and Dutch retailing giant Ahold NV all beg the same questions: What were the auditors doing? Is the audit approach fundamentally flawed? (pp. 1–2)

Similar questions have been raised in relation to auditors’ failure to alert investors (and others) to the undue risks investment banks around the globe were increasingly accepting during the first half of the 2000s – risks that resulted in the 2008 financial crisis. The House of Lords’ Select Committee which enquired into the part auditors played in the crisis noted:

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\(^{21}\) During the 1980s there were ‘the Big 8’ global accounting firms – Arthur Andersen, Arthur Young, Coopers & Lybrand, Deloitte Haskins & Sells, Ernst & Whinney, Peat Marwick, Price Waterhouse and Touche Ross. During the 1990s, ‘the Big 8’ first became ‘the Big 6’ – Arthur Andersen, Coopers & Lybrand, Deloitte & Touche, Ernst & Young, KPMG and Price Waterhouse – then, with the merger of Coopers & Lybrand and Price Waterhouse, they were reduced to ‘the Big 5’. With the demise of Arthur Andersen in 2002, ‘the Big 5’ became ‘the Big 4’ accounting firms.
The Big Four [accountancy firms] expressed the general view that in auditing banks before and during the crisis they had carried out their duties properly. . . . We [the Committee] do not accept the defence that bank auditors did all that was required of them . . . that defence appears disconcertingly complacent. It may be that the Big Four carried out their duties properly in the strict legal sense, but we have to conclude that, in the wider sense, they did not do so. (House of Lords, 2011, para 142)

As we will see when we discuss audit quality in Chapter 16, in general, audit failures result from two key causes – auditors’ not being sufficiently independent of their audit clients and not applying the required level of competence. As a consequence of one or both of these underlying causes, auditors may not adhere to auditing and/or ethical standards, employ an appropriate level of scepticism and/or exercise due professional skill and care appropriate to the circumstances. Whatever the reason for an audit failure, when it occurs, the auditee, financial statement users and society as a whole are deprived of the benefits they should have gained as an outcome of the audit. Further, as we explain in Chapter 16, the culpable auditors also suffer. A significant number who have performed defective audits have faced court action and hefty financial penalties; others have had their audit activities curtailed and, in a few extreme cases, the adverse consequences of poor quality auditing have been so severe that the audit firm concerned has been unable to survive (as was the case with Arthur Andersen in 2002).

Notwithstanding that some auditors have attracted criticism – and sanctions – as a result of shoddy audit work, and the reputation of, and the public’s confidence in, the auditing profession has suffered as a consequence, it should be remembered that:

Commentary in the media tends to focus on the few, high profile audit failures, rather than the huge number of successful audits. . . . The overwhelming majority of audits conducted by the major accounting firms are highly professional, effective and valuable. (Accountancy Age, 2005, p. 1)

This conclusion is supported by the findings of Francis (2004) who reviewed empirical research which investigated audit quality during the last quarter of the twentieth century. His findings suggest that, although there is some indication of a decline in audit quality during the 1990s, audit failure is infrequent.

When considering the failings of auditors, it should be noted that the deficiencies relate, not to the audit function \textit{per se}, but to how that function is fulfilled by sub-standard auditors. In Chapter 16 we explore the steps the profession and regulators have taken to ensure that auditors perform their audits to the highest standard thus enabling the audit function to deliver its potential
benefits to the users of audited financial statements, auditees and society as a whole.

1.7 SUMMARY

In this chapter we have considered the nature of the audit function and distinguished between financial statement audits, compliance audits and operational audits, and also between external and internal audits. Additionally, we have noted the difference between accounting and auditing and discussed why external financial statement audits are needed. In the final section of the chapter we have examined some of the benefits provided by these audits for financial statement users, auditees and society as a whole – and explained why these benefits may not always be obtained.

In the next chapter we trace the development of auditing noting, in particular, how auditing has responded over time to changes in its socio-economic environment.

SELF-REVIEW QUESTIONS

1.1 Explain briefly the following phrases included in the definition of auditing given in this chapter:
   (i) systematic process
   (ii) objectively gathering and evaluating evidence
   (iii) assertions about economic actions and events
   (iv) the degree of correspondence between the assertions and established criteria.

1.2 List the major elements (or features) which are present in all audits.

1.3 Explain briefly the key differences between the following types of audits:
   (i) financial statement audits
   (ii) compliance audits
   (iii) operational audits.
   For each type of audit you need to mention who appoints the auditor, the purpose of the audit and to whom the auditor reports his/her audit findings.

1.4 Distinguish between:
   (i) auditing and accounting;
   (ii) internal and external audits.
1.5 Explain briefly why external financial statement audits are needed.

1.6 Explain briefly why the users of a company’s financial statement cannot examine those financial statements (and the supporting evidence) for themselves to determine whether or not the financial statements can be relied on.

1.7 The value of an audit for financial statement users lies primarily in the credibility it gives to the financial statements which are prepared by management. Explain briefly the three types of control which help an audit to make audited financial statements credible.

1.8 Explain briefly the benefits which an external financial statement audit provides for an auditee. Also explain any dangers which may result from auditors providing additional (non-audit) services to auditees.

1.9 Explain briefly the value of external financial statement audits for society as a whole. (Your answer should identify two sources of benefits an audit can provide.)

1.10 Explain briefly why the beneficiaries of a financial statement audit (financial statement users, the auditee and society as a whole) may not obtain the benefits the audit should provide.

REFERENCES


**ADDITIONAL READING**


WHAT IS AUDITING?


