1 What is Auditing?

LEARNING OBJECTIVES

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

- **explain the general nature 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 which arise from the external audit function for:**
  - **users of financial statements,**
  - **the auditee (i.e., the entity whose financial statements are audited),**
  - **society as a whole.**

The following fundamental principle of external auditing included in *The Auditors' Code*[1] is particularly relevant to this chapter: Providing value

[1] The fundamental principles of external auditing are reproduced on the inside of the front cover of this book.

1.1 INTRODUCTION

In general, United Kingdom (UK) legislation requires all but small companies, and virtually all public sector entities, to produce annually, audited financial statements. The audits of these financial statements frequently involve considerable time, effort and resources. As shown in Figure 1.1, in 2006, the audit fees of the 10 largest companies listed on the London Stock Exchange alone amounted to nearly £149 million.[2] From this it is evident that the statutory audits of UK corporate entities as a whole involve a substantial amount of the nation's resources. But, what is an audit? Why are they needed – and, indeed, are so important that they are required by law? Do they provide benefits which are commensurate with their cost?

We address these questions in this chapter. 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 consider the factors that make financial statement audits necessary and discuss their value for users of financial statements, for auditees (that is, the entities whose financial statements are audited), and for society as a whole.

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 2006[3]

Company	Audit fees	Non-audit fees paid to auditors: Audit related	Non-audit fees paid to auditors: Other	Auditor
	£million	£million	£million	
Royal Dutch Shell plc*	26.4	2.5	1.0	PricewaterhouseCoopers
BP plc*	23.4	7.6	43.2	Ernst & Young
HSBC Holdings plc*	22.7	20.8	4.2	KPMG
GlaxoSmithKline plc	7.7	4.4	3.8	PricewaterhouseCoopers
Vodafone Group plc	4.0	1.0	3.0	Deloitte & Touche
Royal Bank of Scotland Group plc	11.6	5.9	5.5	Deloitte & Touche
Barclays Bank plc	28.0	5.0	11.0	PricewaterhouseCoopers
HBOS plc	6.9	1.4	3.0	KPMG
AstraZeneca plc*	4.6	2.1	1.1	KPMG
Anglo American plc*	13.4	3.8	2.4	Deloitte & Touche
Total	**£148.7**	**£54.5**	**£78.2**	

*Figures stated in annual reports in $US. Converted at the closing rate on 31 December 2005: $US1.967 = £1

Source: Relevant companies' annual reports

[2] The 10 largest companies by market capitalisation on 31 December 2006.

[3] The fees shown include worldwide audit and non-audit fees paid by the relevant company (or group).

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 subsequently in Greece, Rome and elsewhere, citizens (or sometimes slaves) entrusted with the collection and disbursement of public funds were required to present themselves publicly, before a responsible official (an auditor), to give an oral account of their handling of those funds.

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 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 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 below.

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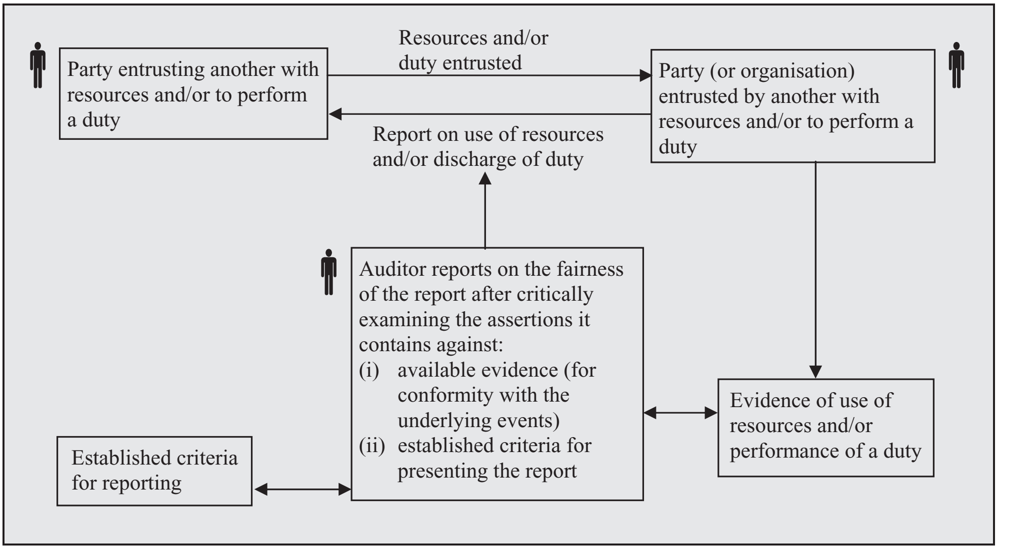
[4] Adapted from the definition provided by the Committee on Basic Auditing Concepts (1973, p. 8).

Figure 1.2: Major features of an audit



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.

1.3.1 Classification by primary audit objective

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

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

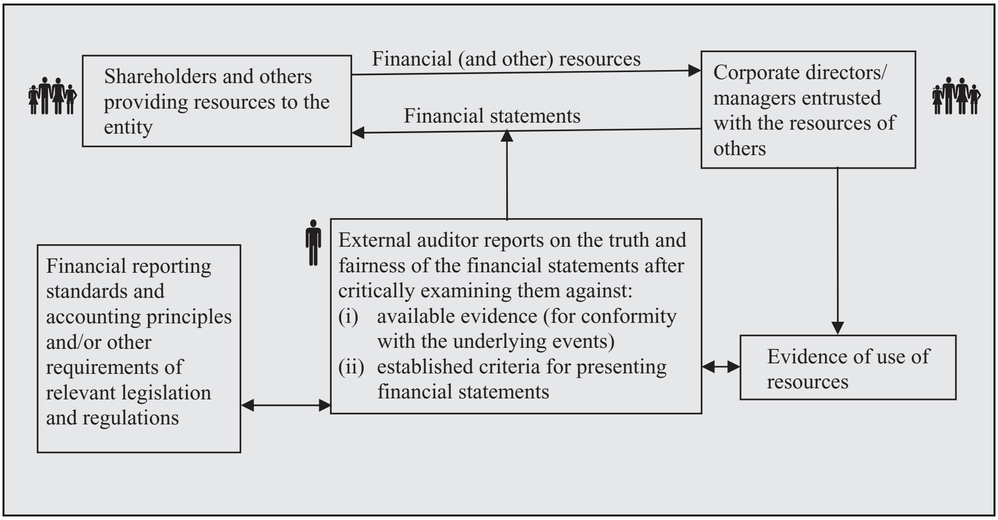
(i) Financial statement audits

A financial statement audit is an examination of an entity's financial statements, which have been prepared by the entity's management/directors[5] for shareholders and other interested parties outside the entity, and of the

[5] In the Preface to this book we note that the term 'managers' 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.

evidence supporting the information contained in those financial statements. It is conducted by a qualified, experienced professional,[6] 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, and comply with relevant statutory and/or other regulatory requirements. The major features of a financial statement audit are presented in Figure 1.3.

Figure 1.3: Major features of a financial statement audit



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 financial position (or 'state of affairs') as at the last day of the financial year;
- a profit and loss account, showing a true and fair view of the company's profit or loss for the financial year.

Additionally, under CA 2006, s. 495, auditors are required to report on these financial statements.[7] Thus, *prima facie*, all companies must, by law, subject their financial statements to an external audit. However, companies which qualify as small [that is, whose turnover is no more than £5.6 million and

[6] The term 'an auditor' usually refers to an audit firm. Although one person in the firm (known under the Companies Act 2006, s. 504, as 'the senior statutory auditor') is responsible for the audit and signs the audit report the audit is usually conducted by an audit team. We explain this further in Chapter 7.

[7] The statutory and regulatory requirements applying to the audited financial statements of companies are discussed in detail in Chapter 5.

balance sheet total (total assets) is no more than £2.8 million, during the financial year] are generally exempt from a statutory audit (CA 2006, s. 477).[8]

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 require financial statement audits for specific purposes. For example, if one of these entities approaches a bank for a loan, the bank may require 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 set the procedures or regulations in place.

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 imports and

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[8] Even if a company qualifies as 'small', it is not exempt from an audit if, at any time during the financial year, it was:

- a public company (CA 2006, s. 384),
- a company entitled to carry on a regulated activity (such as banking and insurance market activities), or is an appointed representative, under the Financial Services and Marketing Act 2000 (CA 2006, s. 384),
- a parent or subsidiary company (unless the group qualifies as a small group: that is, the group's aggregate turnover in the financial year is not more than £5.6 million net, or £6.72 million gross, and its balance sheet total is not more than £2.8 million net, or £3.36 million gross (CA 2006, s. 479). ('Net' refers to any set-offs or other adjustments made to eliminate group transactions; 'gross' means without those set-offs or adjustments: CA 2006, s. 383), or
- if members holding not less than 10 per cent of the nominal value of the company's issued share capital, or a class thereof, request an audit (CA 2006, s. 476).

The directors of any company taking advantage of the audit exemption provisions are required to state on the company's balance sheet:

- the fact they have taken advantage of the audit exemption provisions;
- that the members of the company have not required an audit of the financial statements for the year in question; and
- that they acknowledge their responsibilities for complying with the provisions of CA 2006 with respect to accounting records and the preparation of financial statements (CA 2006, s. 475).

[9] Limited liability partnerships, but not ordinary partnerships, are legally required to have their annual financial statements audited. We explain this in relation to audit firms in Chapter 16.

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 efficiency of the entity, or narrow and designed, for example, to solve a specific problem such as excessive staff turnover.[12]

1.3.2 Classification by primary audit beneficiaries

Based on 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. Experts, 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, for instance, by HM Revenue & Customs are also examples of external audits.

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[10] Internal control is discussed in Chapter 10.

[11] An audit committee is a subgroup of the board of directors (or its equivalent).

[12] In public sector entities, broadly based operational audits (or value for money audits) are generally required as part of the statutory audit function. However, additional more specific operational audits may also be initiated by the entity's management and conducted along the lines of those undertaken in private sector entities.

(ii) Internal audits

In contrast to external audits, internal audits are performed for parties (usually management) internal to the entity.[13] They may be performed by employees of the entity itself or by personnel from an outside source (such as an accounting firm). However, in either case, the audit is conducted in accordance with management's requirements. These may be wide-ranging or narrowly focused, and they may be continuous (on-going) 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 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 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 examination and evaluation of evidence which is undertaken to ascertain whether statements 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.

1.4 AUDITING VS ACCOUNTING

This book is primarily concerned with the external financial statement audits of public companies and, unless indicated otherwise, when we refer to 'audit' or 'auditor', these terms 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 these data, provide the raw materials with which auditors work. In order to understand these systems, and the data they process, an 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

[13] Within companies, internal audits are usually initiated by senior executives or, if there is one, the audit committee. Those conducting the audit usually report their findings to the party which initiated the audit.

identifying, 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, and communicating conclusions based on this evidence, about the fairness with which the communication resulting from the accounting process (that is, the financial statements) reflects the underlying economic events.

1.5 WHY ARE EXTERNAL FINANCIAL STATEMENT AUDITS NEEDED?

1.5.1 The need to communicate financial information

Over the last 160 or so years, '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 very many thousands of employees. The growth of such organisations has been made possible by channelling financial resources from innumerable 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 aspects 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 the 'checking out' of management's reports:

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

The answers to these questions may be found in four main factors:

(i) a conflict of interests,
(ii) consequences of error,

(iii) remoteness, and

(iv) complexity.

We discuss each of these below.

(i) Conflict of interests

As noted earlier, a company's financial statements are prepared by its directors; 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 financial performance as accurately as possible but they perceive that the directors may bias their report so that it reflects favourably on their management of the company's 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 is a fair representation of the company's financial affairs.

(ii) Consequences of error

If users of a company's external 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) Remoteness

In general, as a consequence of legal, physical and economic factors, users of a company's external financial statements are not able to verify the reliability of the information contained in the financial statements for themselves. Even if, for example, they are major shareholders in a company, they have no legal right of access to the company's records. Further, they may be many miles distant from the company which prevents easy access to it, and/or they may not be able to afford the time and expense which would be involved in checking the information personally, should they have the legal right to do so.[14]

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[14] However, it should be noted that many financial institutions (including pension funds, insurance companies and unit and investment trusts), which are significant shareholders of major UK companies, visit companies in which they have, or are considering, investment and question their managements. These institutions have considerable influence over the investee companies, especially if, in the view of the relevant financial institution(s), they are under-performing.

As a result of legal, physical and economic factors preventing users of external financial statements from examining personally the information provided by a company's directors, an independent party is needed to assess the reliability of the information on their behalf.

(iv) Complexity

As companies have grown in size, the volume of their transactions has increased. Further, especially in recent years, economic transactions, and the accounting systems which capture and process them, as well as the 'rules' governing their measurement and disclosure, have become very complex. As a result of these changes, errors are more likely to creep into the financial statements. Additionally, with the increasing complexity of economic transactions, accounting systems and financial reports, users of external financial statements are less able to evaluate the quality of the information for themselves. Therefore, there is a growing need for the financial statements to be examined by an independent qualified auditor who has the necessary competence and expertise to understand the entity's business, its transactions and its accounting system.

1.6 BENEFITS DERIVED FROM EXTERNAL FINANCIAL STATEMENT AUDITS

In section 1.5 above, we noted that external financial statement audits are necessary because the ownership and management functions of companies have become increasingly separated, and because of factors such as a potential conflict of interest between preparers and users of financial statements and the inability of financial statement users to verify the information for themselves. In this section we consider the benefits derived from external financial statement audits by 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. (Auditing Practices Board, 2008, Appendix 2)

1.6.1 Financial statement users

The value of an external audit for financial statement users is 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/or 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.

(ii) *Detective control*: Even if employees in the auditee 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 qualifying the audit report (that is, the auditor states that all is not well, giving reasons for this conclusion). In this way, users of the financial statements are made aware that, in the auditor's opinion, the information provided is not reliable.

It is interesting to note that, while UK legislation is silent on the qualifications of those who may prepare a company's financial statements, the Companies Act 2006 (s. 1212) specifies that the auditor of these statements must be a member of a recognised supervisory body. To be a member of such a body, an individual (or firm) must be appropriately qualified and be subject to the rules and supervision of that body: the rules include those governing "the conduct of statutory audit work" (s. 1217).[15] Thus, although the preparer of the financial statements need not be a qualified accountant, as a consequence of the Companies Act provisions, the auditor must be a well qualified, competent and experienced professional. It therefore seems that Parliament looks to auditors to protect the interests of financial statement users by giving assurance that the financial statements are reliable or providing a warning that they are not.

1.6.2 Auditees

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

These factors place the auditor in an ideal position to observe where improvements can be made. (S)he is able to advise the auditee on matters such as

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[15] The required qualifications and supervision of auditors are discussed in Chapter 5.

strengthening internal control; the development of accounting or other management information systems; and tax, investment and financial planning. In addition (in cases where the issue arises for the auditee), the auditor is able to provide advice on matters 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:

> 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 alleged audit failures in the early 2000s at Enron, WorldCom and Xerox (amongst others) in the United States of America (USA), Parmalat in Italy, HIH in Australia and similar failures in other parts of the world, serious disquiet was expressed by politicians, regulators and the public about the extent of the provision by auditors of non-audit services to their audit clients. Indeed, by the early years of the 21st 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 very significant margin.[16] This led to concerns that the provision of such services to auditees had resulted in auditors compromising their independence; in order to avoid upsetting the entity's management and consequently losing lucrative non-audit work, auditors had not been sufficiently critical 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.[17]

1.6.3 Society as a whole

The benefits flowing from audits for society as a whole fall into two broad groups:

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[16] For example, in the USA in 2001, Enron paid Arthur Andersen \$25 (£17.9) million in audit fees and a further \$27 (£19.3) million in non-audit fees; and Disney paid PricewaterhouseCoopers \$8.7 (£6.2) million in audit fees and a staggering \$32 (£22.9) million for non-audit services. In the UK in the same year, BP paid Ernst & Young £16.7 million for audit, and an additional £41 million for non-audit, services; Vodafone paid Deloitte & Touche £3 million for its audit, and a further £22 million for non-audit, work; and Astra-Zeneca paid KPMG £2 million in audit, and another £5.6 million in non-audit, fees.

[17] 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) those relating to the smooth functioning of financial markets; and
(ii) those relating to securing the accountability of corporate managements.

(i) Smooth functioning of financial markets

The benefits – and importance – of 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)

Thus, in the USA – and similarly in the UK, as in most other countries – 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. Continued investment in financial markets rests on investors having confidence in the financial information on which they base their investment decisions. This confidence, in turn, is derived from their having confidence in the external audit function. Although not referred to by Turner, indirect investment includes investment by local authorities, and other public sector bodies, of funds (derived in the form of taxes of one type or another) provided by the vast majority of the public. Therefore, most members of society – directly or indirectly – benefit from external financial statement audits.

(ii) Securing the accountability of corporate managements

Over the last 160 or so years, as financial, human and other non-financial resources have been channelled by individuals and groups in society to companies, so these entities have been able to grow in size. As they have become larger, they have gained significant social, economic and political power. Today, large national and multinational companies dominate the lives, and control 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 tends to corrupt, and absolute power corrupts absolutely", society has set in place checks and balances designed to prevent possible abuse of power. As one of the checks designed to ensure that company managements do not abuse the power bestowed upon them through the provision of resources, they are held 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 financial statements which report on their use of resources;[18]
- to submit these financial statements to a critical examination by an independent expert (that is, to an audit).

Thus, auditors may be seen as an integral part of 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. Legally in the UK, a company's auditor is appointed by, and reports to, the shareholders. In reality, however, all stakeholders who provide resources to company managements (or who are otherwise affected by company managements' decisions) have an interest in the accountability process of which auditing is a part.

Therefore, in addition to protecting the interests of financial statement users by giving credibility to the financial statements, and providing ancillary services to auditee entities, by helping to ensure the smooth functioning of financial markets, and by functioning as an element of social control within the corporate accountability process, the external audit is 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 the subject of criticism – some of it justifiably scathing. Indeed, some critics go so far

[18] As we will see in Chapter 5, the audited information directors are required to provide in their company's annual report has increased quite markedly since the mid-1990s. This 'additional' information, like the financial statements, is designed to help secure the accountability of company managements.

as to argue that the 'Big' accounting firms[19] use their extensive power and knowledge to facilitate doubtful financial practices that help a few wealthy clients, who can afford to pay "exorbitant consultancy fees", 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 and Sikka, 2002, p. 50).

While few would adopt quite such an extreme view, many commentators have noted the failings of some auditors and the adverse impact of 'shoddy audits' on investors and society in general. Some have also noted the reluctance of audit firms and/or the profession to acknowledge that the fault might lie with them and to recognise the need to improve their practices. For example, in 1994 Shields noted:

> The Big Six firms[20] 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)

The adverse consequences of substandard auditing were also highlighted by Schuetze (former Chief Accountant of the SEC) when he testified to the US Senate Committee on Banking, Housing and Urban Affairs (chaired by Sarbanes) in 2002, following the collapse of Enron. He stated:

> The public's confidence in financial reports of and by Corporate America, and in the audits of those financial reports by the public accounting profession, has been shaken badly by the recent surprise collapse of Enron, by recent restatements of

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[19] 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' became 'the Big 5' – Arthur Andersen, Deloitte & Touche, Ernst & Young, KPMG and PricewaterhouseCoopers. With the demise of Arthur Andersen in 2002, 'the Big 5' became 'the Big 4' firms.

[20] Arthur Andersen, Ernst & Young, Coopers & Lybrand, Deloitte & Touche, KPMG and Price Waterhouse.

> financial statements by the likes of Enron, Waste Management, Sunbeam, Cendant, Livent, and MicroStrategy, and the SEC's assertion of fraud by Arthur Andersen in connection with its audits of Waste Management's financial statements in the 1990s . . . The public's confidence needs to be regained and restored . . . [otherwise] . . . investors will bid down the price of stocks and bonds issued by both US and foreign corporations; . . . This will reduce the market capitalization of corporations, which in turn will negatively affect capital formation, job creation and job maintenance, and ultimately our standard of living. (Schuetze, 2002, pp. 1–2)

Poor-quality auditing has also had adverse consequences for the culpable auditors. As we discuss in Chapter 15 when exploring the topic of auditors' legal liability, a significant number of auditors have faced court action and hefty financial penalties as a consequence of performing defective audits. For example, as Shields (1994) reports:

> [In the USA in 1994] Deloitte & Touche agreed to pay $312 million to settle $1.8 billion in lawsuits and other claims brought by US bank regulators. . . . In Ireland, Ernst & Whinney (now Ernst & Young) reached an out-of-court settlement for $118 million with AIB Group, Ireland's largest bank and administrator of the Insurance Corporation of Ireland . . . [and] KPMG was accused of faulty auditing which contributed to the $2.1 billion crash of Tricontinental, the merchant-banking arm of the State Bank of Victoria in Australia. The firm reached an out-of-court settlement for $106 million. . . . (pp. 1–2)

In other cases, the activity of audit firms has been curtailed as a consequence of poor auditing. For example, in the 1980s in the USA, the deficient auditing of many savings and loan (S&L) institutions[21] prompted "Government regulators [to bar] several Big Six accounting firms' partners from auditing banks and S&L's, [and] the courts ordered others to take professional training courses before engaging in additional audits of financial institutions" (Saeed, Lee and Ray, 1994, p. 1). Along similar lines, in August 2004, Ernst & Young in the USA was barred from:

> accepting new public audit clients for six months because of the firm's "blatant" disregard and "utter disdain" for rules that require accountants to be independent from the companies whose books they review. [It was also] ordered to return $1.7 million in audit fees it collected from PeopleSoft Inc. from 1994 to 1999 and to hire an outside consultant to overhaul independence policies that the judge called a "sham". (Johnson, 2004, p. 1)

Likewise, in May 2006, the Japanese Financial Services Agency ordered Chuo Aoyama, PricewaterhouseCoopers' Japanese affiliate, to:

> halt auditing services for two months. The regulator specifically cited Chuo Aoyama's audit of cosmetics company Kanebo Ltd, in which three of the [audit]

[21] In the USA in the 1980s, more than 1,000 S&L institutions failed unexpectedly – and many auditors were found to be guilty of substandard auditing. The total cost of what is known as 'the savings and loan crisis' is estimated to be about $150 billion, of which about $125 billion was directly borne by the US Government (Wikipedia, 2006).

> firms' partners allegedly assisted with accounting fraud and boosted earnings for the company by about $1.9 billion over the course of five years. (Answers.com, 2006, p. 4)

In other cases the adverse financial consequences of poor auditing have been so severe that the audit firm concerned has been unable to survive. Probably the most dramatic demise was that of Arthur Andersen in 2002, as a consequence of its misdeeds in relation to its energy giant client, Enron. However, in 1990, Laventhol & Horwath, then the seventh largest accounting firm in the USA, was forced into bankruptcy and, at the time, this sent shock waves throughout the accounting profession similar to those resulting from Andersen's collapse 12 years later. According to Richards (2002):

> In the years leading up to 1990, Laventhol was frequently hauled into court to settle allegations of sloppy work. At its end, the firm had 115 legal actions against it, [almost entirely related to failed savings and loan institutions], seeking a total of $362 million. (p. 1)

Although, as we have seen, some auditors have attracted criticism – and penalties – 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 conducted during the last quarter of the 20th century. His findings suggest that audit failure is infrequent although there is some indication of a decline in audit quality during the 1990s.

When considering the failings of auditors, it should be noted that the deficiencies relate, not to the audit function *per se*, but to how that function is fulfilled by a few substandard auditors. In Chapter 16 we explore the steps the profession and regulators have taken, and/or proposed, 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 between external and internal audits. We have also 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 derived from these audits by financial statement users, auditees and society as a whole – and discussed some of the consequences of auditors failing to perform their audits with the rigour that the beneficiaries of the audit function have a right to expect.

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 words and phrases included in the definition of auditing given in this chapter:
   (i) systematic process,
   (ii) objectively gathering and evaluating evidence,
   (iii) assertions,
   (iv) degree of correspondence between assertions and established criteria,
   (v) communicating the results.

1.2 List the major elements 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.

1.4 Under the provisions of the Companies Act 2006 an auditor's report must be attached to a company's financial statements. Is this true for all companies? Explain.

1.5 Distinguish between:
   (i) auditing and accounting, and
   (ii) internal and external audits.

1.6 Explain briefly why external financial statement audits are needed.

1.7 The value of an audit for financial statement users lies, at least in part, 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 give credibility to audited financial statements.

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 services' to auditees.

1.9 Explain briefly the value of external financial statement audits for society as a whole.

1.10 Explain briefly how high-profile audit failures damage the reputation of the auditing profession.

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