The evolution of auditing: An analysis of the historical development

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Abstract: This paper aims to analyze the development of auditing. It is found that auditing has evolved through a number of stages. In the mid 1800s to early 1900s, the audit practice was considered as “traditional conformance role of auditing”. However, for the past 30 years, the auditor has been playing an “enhancing role”. Today, auditors are expected not only to enhance the credibility of the financial statement, but also to provide value-added services. Nevertheless, following extensive reform in various countries as a result of the collapse of big corporations, it is expected that the role of auditors will converge. It is evident that the paradigm about auditing has shifted over the years and it is likely to continue shifting in the future.

Key words: history of auditing; historical development; audit objectives; audit expectation gap

1. Introduction

The word “audit” comes from the Latin word audire, meaning “to hear”. According to Flint (1988), audit is a social phenomenon which serves no purpose or value except of its practical usefulness and its existence is wholly utilitarian. Flint (1988) further explains, the audit function has evolved in response to a perceived need of individuals or groups in society who seek information or reassurance about the conduct or performance of others in which they have an acknowledged and legitimate interest. Flint (1998) argues that audit exists because interested individuals or groups are unable for one or more reasons to obtain for themselves the information or reassurance they require. Hence, an audit function can be observed as a means of social control because it serves as a mechanism to monitor conduct and performance, and to secure or enforce accountability. Mackenzie (as cited in Normanton, 1996, p. vii) in the foreword to *The Accountability and Audit of Governments* made the following remark: “Without audit, no control; and if there is no control, where is the seat of power?” All in all, an audit function plays a critical role in maintaining the welfare and stability of the society.

Many auditors (e.g. Mascarenhas & Turley, 1990; Abdel-Qader, 2002; Porter, et al., 2005) concur with Flint (1988) that the aim of an audit has always been a dynamic rather than a static one. Brown (1962) asserts that the objective and techniques of auditing have changed during the four hundred years of recognizable existence of auditing to suit the changing needs and expectations of society. It can be observed that the changes in needs and expectations of society are highly influenced by the factors contextual to the economic, political and sociological environment at a particular point of time. Therefore, the review of the historical development of auditing enables one to understand, analyze and interpret the evolution of auditing due to the change in expectations of the society.

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2. Purpose of the paper

This paper aims to analyze the development of auditing over the years, with particular reference to the nature and objectives of auditing, the responsibilities of auditors and the audit techniques used. The reasons for such an analysis are two-fold. Firstly it enables readers to gain an understanding of the audit development over the years. Secondly, it provides the evidences on auditing as a discipline that modifies its role over the years to meet the changing needs and expectations of society.

3. The evolution of auditing practices

To facilitate the examination of the historical development of auditing, this review will be divided into the following five chronological periods: (i) Prior to 1840; (ii) 1840s-1920s; (iii) 1920s-1960s; (iv) 1960s-1990s; and (v) 1990s–present.

3.1 Prior to 1840

Generally, the early historical development of auditing is not well documented (Lee, 1994). Auditing in the form of ancient checking activities was found in the ancient civilizations of China (Lee, 1986), Egypt and Greece (Boyd, 1905). The ancient checking activities found in Greece (around 350 B.C.) appear to be closest to the present-day auditing. The existence of such activities can be proven by Aristotle’s quotation (as cited in McMickle, 1978, pp. 11-12) as follows:

> Ten [logistae]….and ten [euthuni]….are chosen by lot. Every single public officer must account to them. They have sole control over those subject to [examination]…. they place their findings before the courts.
>
> Anyone against whom they prove embezzlement is convicted and fined by the court ten times the sum discovered stolen. Anyone whom the court on [their]….evidence convicts of corruption, is also fined ten times the amount of bribe. If he is found guilty of administrative error, they assess the sum involved, and he is fined that amount provided in this case that he pays it within nine months; otherwise the fine is doubled.

Similar kinds of checking activities were also found in the ancient Exchequer of England. When the Exchequer was established in England during the reign of Henry 1(1100-1135), special audit officers were appointed to make sure that the state revenue and expenditure transactions were properly accounted for (Gul, et al., 1994, p. 1). The person who was responsible for the examinations of accounts was known as the “auditor”. The aim of such examination was to prevent fraudulent actions (Abdel-Qader, 2002).

Likewise, the existence of checking activities was found in the Italian City States. The merchants of Florence, Geneo and Venice used auditors to help them to verify the riches brought by captains of sailing-ships returning from the Old World and bound for the European Continent. Again, auditing in this period was concerned about detection of fraud. The audit found in the City of Pisa in 1394 was somehow similar to those found in the Italian City State. It was meant to test the accounts of government officials to determine whether or not defalcation had taken place (Brown, 1962).

According to Porter, et al (2005), auditing had little commercial application prior to the industrial revolution. This is because industries during this period were mainly concerned with cottages and small mills which were individually owned and managed. Hence, there was no need for the business managers to report to owners on their management of resources. As a result, there is little use of auditing.

In a nutshell, in the period pre-1840, the auditing at the time was restricted to performing detailed verification of every transaction. The concept of testing or sampling was not part of the auditing procedure. The existence of internal control is also unknown. Fitzpatrick (1939) commented that the audit objective in the early period was primarily designed to verify the honesty of persons charged with fiscal responsibilities.

3.2 1840s-1920s

The practice of auditing did not become firmly established until the advent of the industrial revolution during the period 1840s-1920s in the UK (Gill & Cosserat, 1996, p. 9; Ricchiute, 1989, p. 9). According to Brown (1962), the large-scale operations that resulted from the industrial revolutions drove the corporate form of enterprise to the foreground. Large factories and machine-based production were established (Abdel-Qader, 2002). As a result, a vast amount of capital is needed to facilitate this huge amount of capital expenditure.

The emergence of a "middle class" during the industrial revolution period provided the funds for the establishment of large industrial and commercial undertakings. However, the share market during this period was unregulated and highly speculative. As a consequence, the rate of financial failure was high and liability was not limited. Innocent investors were liable for the debts of the business. In view of this environment, it was apparent that the growing number of small investors was in dire need of protection (Porter, et al, 2005). Hence, the time was ripe for the profession of auditing to emerge (Brown, 1962).

In response to the socio-developments in the UK during this period, the Joint Stock Companies Act was passed in 1844. The Joint Stock Companies Act stipulated that "Directors shall cause the Books of the Company to be balanced, and a full and fair Balance Sheet to be made up". In addition, the Act provided the appointment of auditors to check the accounts of the company. However, the annual presentation of the balance sheet to the shareholders and the requirement of a statutory audit were only made compulsory in 1900 under the Companies Act 1862 (UK) (Leung, et al., 2007).

According to Porter, et al (2005) the accountant particularly in the early years of this period, was normally the company manager and his duties were to ensure proper use of the funds entrusted to him. The auditors during this period were merely shareholders chosen by their fellow members. Brown (1962) claimed that the auditors during this period were required to perform complete checking of transactions and the preparation of correct accounts and financial statements. Little attention was paid to internal control of the company.

Porter, et al (2005) commented that the duties of auditors during this period were influenced by the decisions of the courts. For example, the verdicts from the case of London and General Bank (1985) and Kingston Cotton Mill (1896) reinforced that the audit objective was detection of fraud and errors. These cases in turn established the general standard of work expected of auditors. Likewise, as noted in the auditing book of Lawrence R Dicksee (1892 cited in Leung, et al, 2004, p. 7): A Practical Manual for Auditors, the objectives of auditing were: (i) the detection of fraud; (ii) the detection of technical errors, and (iii) the detection of errors of principles. It can be concluded that the role of auditors during the period of 1840s-1920s was mainly on fraud detection and the proper portrayal of the company's solvency (or insolvency) in the balance sheet.

3.3 1920s-1960s

The growth of the US economy in the 1920s-1960s had caused a shift of auditing development from the UK to the USA. In the years of recovery following the 1929 Wall Street Crash and ensuing depression, investment in business entities grew rapidly. Meanwhile, the advancement of the securities markets and credit-granting institutions had also facilitated the development of the capital market in this period. As companies grew in size, the separation of the ownership and management functions became more evident. Hence to ensure that funds continued to flow from investors to companies, and the financial markets function smoothly, there is a need to convince the participants in the financial markets that the company's financial statement provided a true and fair portrayal of the relevant company's financial position and performance (Porter, 2005).

In view of the economic condition, the audit function was mainly to provide credibility to the financial statements prepared by company managers for their shareholders. Consensus were generally achieved that the primary objective of an audit function is adding credibility to the financial statement rather than on the detection of fraud and errors. Such a change in audit objective is evidenced in successive edition of Montgomery's Auditing text issued during this period which stated "An incidental, but nevertheless important, objective of an audit is detection of fraud." (1934, p. 26). "Primary responsibility…for the control and discovery of irregularities necessarily lies with management." (1940, p. 13). Hence, it can be witnessed that the shift of the focus of an audit function from preventing and detecting fraud and error towards assessing the truth and fairness of the companies' financial statements began at this period.

The concept of materiality (Queenan, 1946) and sampling techniques (Brown, 1962) were used in auditing during this period. The development of material concept and sampling technique was due to the voluminous transactions involved in the conduct of business by large corporations operating in widespread locations. It is no longer practical for auditors to verify all the transactions. Consequently, sampling and the development of judgment of materiality were essential. The use of sampling technique during this period can be proven from the following statement of Short (1940, p. 226) "… it is not necessary to make a detailed examination of every entry, footing, and posting during the period in order to get the substance of the value which resulted from an audit".

Corresponding to the use of sampling techniques, auditors need to rely on internal control of the company to facilitate the use of such research approach. The reliance on internal control during this period can be witnessed from the following statement found in page 240 of Accountants Digest in March 1936:

> The first step to take when planning an audit by test methods consists of a thorough investigation of the system on which the books are kept…It is not the auditor's sole duty to see that the internal check is carried out but to ascertain how much it can be relied upon to supplement his investigation.

The fundamental principles of auditing during this period were influenced by some major auditing cases such as the case of McKesson and Robbins (1938). The verdict of this case had resulted in the emphasis of physical observation of assets such as cash and stock, and the use of external evidence. In addition, the Royal Mail case highlighted the need of audit for the profit and loss statements. However, the audit of profit and loss account was only made mandatory with the enactment of Securities and Exchange Commission Act 1934 in the USA and Companies Act 1948 in the UK.

In short, the social-economic condition in the period had highly influenced the development of auditing. As highlighted by Porter, et al (2005) the major characteristics of the audit approach during this period, among others, included: (i) reliance on internal control of the company and sampling techniques were used; (ii) audit evidence was gathered through both internal and external source; (iii) emphasis on the truth and fairness of financial statements; (iv) gradually shifted to the audit of Profit and Loss Statement but Balance Sheet remained important; and (v) physical observation of external and other evidence outside the "book of account".

3.4 1960s to 1990s

The world economy continued to grow in the 1960s-1990s. This period marked an important development in technological advancement and the size and complexity of the companies. Auditors in the 1970s played an important role in enhancing the credibility of financial information and furthering the operations of an effective capital market (Porter, et al., 2005). Similar description on the auditors' role was found in *The New York Times* on

6 April 1975 (Leung, et al., 2004, p. 10) that the duties of auditors, among others, were to affirm the truthfulness of financial statements and to ensure that financial statements were fairly presented. Hence, the role of auditors with regard to the audit of financial statement generally remained the same as per the pervious period.

Despite the overall audit objectives remaining similar, Davies (1996) opines that auditing had undergone some critical developments in this period. In the earlier part of this period, a change in audit approach can be observed from “verifying transaction in the books” to “relying on system”. Such a change was due to the increase in the number of transactions which resulted from the continued growth in size and complexity companies where it is unlike for auditors to play the role of verifying transactions. As a result, auditors in this period had placed much higher reliance on companies’ internal control in their audit procedures. Furthermore, auditors were required to ascertain and document the accounting system with particular consideration to information flows and identification of internal controls. When internal control of the company was effective, auditors reduced the level of detailed substance testing.

In the early 1980 there was a readjustment in auditors’ approaches where the assessment of internal control systems was found to be an expensive process and so auditors began to cut back their systems work and make greater use of analytical procedures (Salehi, 2007). An extension of this was the development during the mid-1980s of risk-based auditing (Turley & Cooper, 1991). Risk-based auditing is an audit approach where an auditor will focus on those areas which are more likely to contain errors. To adopt the use of risk-based auditing, auditors are required to gain a thorough understanding of their audit clients in term of the organization, key personnel, policies, and their industries (Porter, et al., 2005) Hence, the use of risk-based auditing had placed strong emphasis on examining audit evidence derived from a wide variety of sources, i.e. both internal and external information for the audit client.

According to Porter, et al (2005), most of the companies in this period had introduced computer systems to process their financial and other data, and to perform, monitor and control many of their operational and administrative processes. Similarly, auditors placed heavy reliance on the advanced computing auditing tool to facilitate their audit procedures. In addition to the auditing of financial statement, auditors at the same time were providing advisory services to the audit clients. Leung, et al (2004, p. 24) made the following comments in connection with the role of auditors in providing such services:

> There was a surge of one-stop shows such as multidisciplinary practices and the development of holistic audit strategies which provided an extensive range of non-audit services performed for audit client. Accounting and auditing during this period has became an industry with strong competition among firms, a blurring of relationship with clients, an apparent failure to exercise due diligence by some.

Porter, et al (2005) opined that the provision of advisory services emerged as a secondary audit objective in the period of 1960s-1990s. Since then, the role of auditors has always been highly associated with such advisory services.

3.5 1990s-present

The auditing profession witnessed substantial and rapid change since 1990s as a result of the accelerating growth at the world economies. It can be observed that auditing in the present day has expanded beyond the basic financial statement attest function. According to Porter et al (2005), present-day auditing has developed into new processes that build on a business risk perspective of their clients. The business risk approach rests on the notion that a broad range of the client’s business risks are relevant to the audit. Advocates of the business risk approach opined that many business risks, if not controlled, will eventually affect the financial statement. Furthermore by understanding the full range of risks in businesses, the auditor will be in a better position to identify matters of significance and relevance to the audit profession on a timely basis.

Since the early 1990s, the audit profession began to take increased responsibility to detect and report fraud and to assess, and report more explicitly, doubts about an auditee’s ability to continue in conformance with society’s and regulators’ increasing concern about corporate governance matters. Adoption of the business risk approach in turn enhances auditor’s ability to fulfill these responsibilities (Porter, et al., 2005).

Presently, the ultimate objective of auditing is to lend credibility to financial and non-financial information provided by management in annual reports; however, audit firms have been largely providing consultancy services to businesses. By 2000, consulting revenues exceeded auditing revenues at all the major audit firms in the USA. Regulators of the auditing profession and the investing public began to doubt whether audit firms could remain independent on audit issues when the firms were so dependent on consulting revenues. The quality of audits is being placed under scrutiny after a series of financial scandals of public companies such as Sunbeam, Waste Management, Xeror, Adelphia, Enron and WorldCom. The collapses of these giant corporations had brought about a crisis of confidence in the work of auditors (Boynton & Johnson, 2006).

As a consequence of the high level of litigation and criticism against the auditors, nearly all large accounting firms split their consulting arms into separate companies and made announcements on their more stringent rules and measures to ensure better independence and audit quality. In addition, a spate of radical reforms was undertaken in various countries, by the accounting bodies, governments, stock exchange commissions and academics to strengthen the audit practice (Leung, et al., 2004). Some of the key reform activities include:

(1) The Sarbanes-Oxley Act (The US)

In response to the fall of Enron the Sarbanes-Oxley Act was implemented. It outlines the rules on auditor independence, for example, the control of audit quality, and the rotation of audit partners as well as the prohibition of conflict-of-interest situation. Furthermore, the act also requires auditors to report to the audit committee on those significant matters. The Public Company Accounting Oversight Board which oversees audit firms and their procedures and the enforcement of accounting standards is also established as a result of this act.

The Sarbanes-Oxley extended the duties of auditor to audit the adequacy of internal controls over financial reporting. This is in view of the fact that a number of commissions recognized the importance of internal control in preventing financial statement misstatement.

(2) Ramsay report (Australia)

As a result of the collapse of HIH Insurance Ltd, the Australian Government Commission engaged professor Ian Ramsay to investigate the issue of auditor independence. It was recommended that auditor independence can be improved through the following ways:

Include a statement in the Corporations Act that auditors are to be independent;

Require auditors to declare to the Board of Directors that their independence is maintained;

Prohibit special relationships between the auditor and client;

Establish an auditor independence supervisory board;

Establish an audit committee to oversee the issue of non-audit services, audit fees, scope disagreements and auditor-client relationships.

Although the overall audit objectives in the present period remained the same, i.e. lending credibility to the financial statement, critical changes have been made to the audit practice as a result of the extensive reform in various countries. Leung, et al (2004, p. 24) is of the opinion that such reform has implicated the auditing profession in the following ways: "(i) The role of auditors is expected to converge: refocusing on the public interest, redefining audit relationship, ensuring integrity of financial reports, separation of non-audit function and other advisory services; (ii) The audit methods revert to basics i.e. risk attention, fraud awareness, objectivity and independence, and (iii) increase attention on the needs of financial statement users".

In summary, the review of the historical development of auditing has evolved the audit function through a number of stages. Auditing first emerged in the form of ancient checking activities in the ancient civilizations of China, Egypt and Greece. However, the practice of modern auditing did not become firmly established until the advent of the industrial revolution in the mid nineteenth century in the UK. The audit practice in the mid 1800s to early 1900s can be regarded as "traditional conformance role of auditing" as auditing was mainly concerned with ensuring the correctness of accounts and detecting frauds and errors. Over the past 30 years or so, the auditor played an "enhancing role" by enhancing the integrity and credibility of financial information. Today, auditors are expected not only to enhance the credibility of the financial statement, but also to provide value-added services, such as reporting on irregularities, identifying business risks and advising management on the internal control environment (Cosserat, 2004). However, extensive reforms were implemented in various countries as a result of the collapse of big corporations; it is expected that the role of auditors will converge. Leung, et al (2004, p. 23) claimed that the role of auditors has moved from "mere conformance through an enhancing role to a convergence role". It is evident that the paradigm of independent auditing has shifted over the years. It is believed that it may continue to shift in the future.

4. Conclusion

A review of the historical development of auditing has shown that the objective of auditing and the role of auditors are constantly changing as they are highly influenced by contextual factors such as the critical historical events (e.g. the collapsed of big corporations), the verdict of the courts, and technological developments (e.g. advancement of computing systems and CAATs). It can be observed that any major changes in these contextual factors are likely to cause a change in the audit function and the role of auditors. As a result, auditing is seen to be evolving at all times.

Mautz (1975, p. 2) claimed that the audit function in a market economy ultimately evolved by social consent because:

> Society either accepts or rejects the role of a professional group assumes for itself, in time the group either finds a role acceptable to society or the group disappears. As conditions and apparent needs change, society may reject roles formerly considered accepted so professional groups must continually be alert to the desirability of role modification and revision.

However, it is important to note that the change in society's expectation and the response of the auditing profession towards these changes are not always at the same pace. Hence there is a natural time gap between the changing expectation of the users and the response by the profession and due to this time gap there arises what has been stated as the expectation gap or audit expectation gap (Saha & Baruah, 2008). Even though the existence of such a natural time gap is inevitable, Flint (1998) advises that auditors should be sensitive to the changing expectation of the relevant groups while at the same time containing these expectations within the constraints of what is possible. He also claims that there are inevitably economic and practical limitations on what an audit can do, and this is something which those who wish the benefit must understand.

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