

A new definition of the purpose of audit

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I am sharing this note in the hope of attracting comment on it.

Although the readers of this blog, seemingly like the world at large, do not get overly excited by accounting issues they really do matter. The smooth operation of markets, the functioning of the mixed economy and the management of the macroeconomy of the country are all dependent upon the availability of reliable accounting data.

The problem with both accounting and audit is that there is good reason to believe that we have not had data of that quality. In fact, we have had nothing like it.

I am at present working on a project that does, at least in part, feed into the government's current consultation on audit reform. As part of that process I have prepared a note, part of which is reproduced below, on the purpose of audit.

My suggestion is that this purpose has historically been misstated. The focus it has had on solely meeting a supposed shareholder need that was only of relevance in a small proportion of companies has led to what has been called an expectation gap. Users have rightly felt that they have not received the assurance that they required from auditors because auditors have defined themselves as not having the responsibility to deliver it.

Now the government has said that audit is of concern in all public interest entities, and suggests defining these to include many organisations that do not have shareholders. At the same time it has suggested that shareholders must remain the focus of audit concern, which makes no sense.

I address these issues in this note, on which comments would be appreciated.

Background to this note

The government has said in its White Paper (WP) on audit reform^[1] that “**having a clear and unambiguous statement as to the purpose of an audit could help people understand the outcomes that are expected from the audit process**”^[2].

We think this an appropriate objective. Unfortunately, the White Paper does not offer such a statement. The purpose of this note is to suggest what that unambiguous purpose of audit might be.

Audit in the public interest

Audit is an issue of greatest concern with regard to what the government refers to in its WP as public interest entities (PIEs).

We welcome the suggestion within the WP that these need not just be public companies but that they might also, for example, be large private companies and what the government describes as ‘third sector entities with a public purpose’^[3]. **Examples of these that it has supplied include universities, charities and housing associations**^[4].

The implication of this definition of a PIE is twofold. The first is that the focus of accounting cannot solely be on the information that shareholders might require, although the WP states that in its opinion their interests remain of primary concern^[5]. **Given that there are no shareholders in the examples of third sector entities that the government suggests are PIEs it must follow that the information needs of other user groups for the accounts of PIEs must be of at least as much significance in those cases.**

Second, this also means that whilst the WP defines the main shareholder use of corporate reporting is in making informed, long-term investment and engagement decisions^[6] **it must follow that this cannot be the universal primary purpose of this data since most third sector PIEs do not have shareholders whilst large privately owned companies rarely have shares that may be traded in the way that those of publicly quoted companies can be. This must mean that however important the information supplied to some groups of shareholders to assist with investment decision making might be this purpose cannot be the singular focus of accounting or audit, and a broader definition must be found.**

The WP recognises this by accepting the recommendation of the Brydon Review of auditing that suggested that “auditors [should] act in the public interest and have regard to the interests of the users of their report beyond solely those of shareholders”^[7].

It is our suggestion that much of the so-called expectation gap with regard to

audit[8] arises because of the current lack of awareness that audit has to date been solely focussed on the singular needs of shareholders when considering issues relating to investment decisions when the broader public have expected it to meet the requirements that the wider definition of a PIE might now suggest to be appropriate.

Unfortunately the WP fails to close this expectation gap, as the Brydon Review also failed to do before it. As evidence, despite the comment from Brydon noted above on the public purpose of audit Brydon actually suggested that the purpose of audit should be:

“To help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements.”

This definition, which the WP supports, does not embrace the wider concept of a PIE that the WP uses and as such is not appropriate for use. As a result another definition is required.

A new definition of the purpose of audit

We suggest that an appropriate definition of the purpose of audit that meets the test that the WP lays down noted in the first paragraph of this note is:

The purpose of the audit of a public interest entity (PIE) is to report that the reasonably anticipatable information needs of all the users of the financial statements of that PIE are met by those financial statements on which the auditor is asked to offer opinion and to remedy any defect in such supply if it is found to exist or to report that this has not proved to be possible.

The users of financial statements

The definition of audit that we propose requires that the users of the financial statements of a reporting entity should be defined. We suggest that they shall be considered to be:

- * Its shareholders;
- * Its other suppliers of capital;
- * Its past, present and future employees;
- * Its trading partners;
- * Its regulators;
- * Its tax authority;
- *

Civil society that is likely to have an interest in its activities including those people living in the communities that it serves; their local, regional and national governments and those who serve in them or seek to do so; researchers, journalists and others who seek to hold the reporting entity to account for its actions and all those impacted by the economic, environmental and social externalities that the PIE creates as a result of its activities.

What the auditor must report on

In our opinion the auditor of a PIE must be required to proactively report on the following issues when submitting their audit report on the financial statements of a PIE:

- * Whether the nature, extent, location, scale and identity of the reporting entity is appropriately recorded and reported within the financial statements;
- * Whether the entity has maintained books, records and systems of internal control likely to both record and report the substance of all of its transactions and to properly identify the risk of error and fraud arising;
- * Any material error or fraud identified within the PIE during the course of the period and the action taken to address the issue arising;
- * Whether an appropriate accounting framework has been adopted for the preparation of the financial statements, in the process confirming whether any conflicts exist between the accounting framework used by the reporting entity and those used by its constituent entities; how any such conflicts that might have arisen have been resolved; and whether any necessary departures from the approved accounting framework have been considered or used in the course of ensuring that the financial statements do provide the information that meets the needs of the users of the financial statements, and what the consequences of that departure from that agreed framework might be;
- * Whether the additional information not regulated by an agreed accounting framework that must be disclosed to ensure that the reasonably anticipatable information needs of all the users of the financial statements of the PIE is included in the financial statements;
- * Whether having considered all these issues they are of the opinion that the reasonably anticipatable information needs of all the users of the financial statements of the PIE are met by its financial statements on which the auditor has been asked to offer opinion and that they do as a result present a true and fair view of its affairs.

[1]
<https://www.gov.uk/government/publications/restoring-trust-in-audit-and-corporate-governance>

[2] Para 6.1.8

[3] Para 1.3.29

[\[4\]](#) *ibid*

[\[5\]](#) *Page 17*

[\[6\]](#) *Para 7.3.*

[\[7\]](#) *Para 6.3.3.*

[\[8\]](#) *Para 6.1.3*