The relationship between accounting and auditing – professional activities that are joined at the hip

1. Background

The future of audit is being debated in the UK[1] [2]. Whilst audit is not just an issue for what the government calls public interest entities (PIEs)[3], the focus of their concern is on such entities because they are the ones whose failure might cause greatest disruption within the economy, and loss to those involved with them.

The Corporate Accountability Network believes that audit does need reform within the UK[4]. However, it is our belief that the audit of a set of accounts or financial statements[5] cannot be considered as an issue that can be addressed independently of those accounts. It is our opinion that audited accounts are ultimately an inseparable whole. As such we suggest that the success or failure of auditing and accounting in meeting the needs of the users of those accounts cannot be separately appraised.

In this briefing we review the history of both accounting and auditing and how they have developed together, in tandem, and inseparably. As we noted a consequence, the conclusions underpinning the current proposals for audit reform are entirely misplaced, and

[1] https://beisgovuk.citizenspace.com/business-frameworks/audit-and-corporate-governance-review/
[2] The consultation papers relating to this process are noted in the references noted at the end of this Briefing.
[3] The Corporate Accountability Network has issued a separate Audit Briefing on what it considers an appropriate definition of a PIE might be.
[4] See our separate Audit Briefing on the reasons why audit might need reform.
[5] We treat these terms interchangeably.

unless the government takes notes of this in its forthcoming proposals anything that it might suggest will not be fit for purpose.

2. Purpose of this note

To understand the purpose of audit reform it is vital that the following issues be correctly framed within the discussion that takes place:

a. This history of auditing;
b. The relationship between accounting and auditing over time;
c. The current state of that relationship.

In this note it is suggested that:

i. The history of auditing and accounting are inseparable;
ii. There has never been a time when auditing has been an activity separate from accounting;
iii. To suggest now that accounting and auditing can be separated is to misunderstand the relationship between these two issues;
iv. What we must do, instead, is understand how this relationship must be redefined.

This note concentrates on the historical developments of auditing and accounting: most conclusions will be presented in a separate note.

3. The assumptions underpinning the current audit debate

It is suggested that the assumptions that underpin the existing proposals for changes to the audit in the UK are:

1) That there is such a thing as an audit independent of the accounting of the entity to which it relates;

2) That in a commercial environment an auditor can form an objective opinion upon the accounts of their client;

3) The auditor can report without asking whether the accounting framework used by the entity on whose accounts they are offering opinion is fit for purpose;

4) The quality of an audit can be appraised independently of the accounts to which they relate;

5) A structured form of audit opinion reporting can meet the needs of the users of accounts;

6) The main stakeholder to whom the auditor need address themselves are the shareholders of the entity even though they comprise a subset of just one of the, at least six, stakeholder groups that can be identified for any entity.

To determine whether these assumptions are appropriate it is necessary to consider the history of the relationship between auditing and accounting. The current claims implicit in these assumptions can only be appraised within that context.

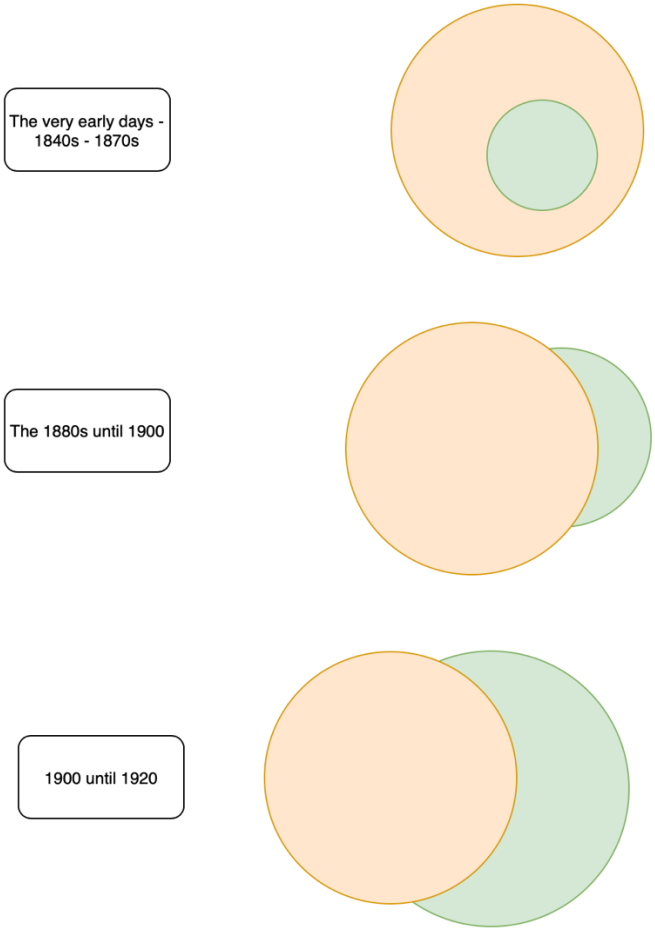
2. The history of auditing shows that the assumptions underpinning most current audit reform proposals make no sense

The noted assumptions have to be understood in their proper context. This requires that they be framed within the context of the history of auditing and also (because as this note shows, the two are inextricably linked) the history of accounting. The review that follows is framed within the context of the UK's history of both. This is because, as an initial literature review suggests, there has been remarkably little research on such important issues, and UK history in these areas has been subject to more research than have most jurisdictions. The main sources are, at this time, Derek Matthews' *A History of Auditing*[6] (and most especially, chapter one) and John Edwards' *A history of corporate financial reporting in Britain*[7]. The opinions offered are also informed by my 45 years of accounting experience in a wide variety of firms and organisations.

The development of auditing over this period can be summarised in two diagrams, each split into a number of broadly relevant eras. The first covers the early period of auditing:

[6] Matthews, D. 2006. *A History of Auditing*. London: Routledge New Works in Accounting History
[7] Edwards, J.R. 2019. *A history of corporate financial reporting in Britain.* London: Routledge Studies in Accounting.

Figure One – the first eighty years of auditing



In each case the beige circle reflects the influence of the auditor and the green the weighting given to the significance of the accounting processes of their client in producing financial statements. The overlap implies the extent to which the auditor was undertaking what are now thought of as accounting activities on behalf of their client.

This second diagram covers the last century:

Figure 2 – the last century of auditing

The boundaries between periods are, of course, not precise. The progression thought these areas needs to be understood can be explained as follows:

a. 1840s to 1870s

The history of auditing pre-dated the rise of the railway company but railway building and related activities transformed commercial as well as social and industrial life, most especially (but not entirely) due to the growth of the incorporation of companies by registration instead of by statute that was possible from the 1850s onwards.

There were almost no rules for the accounting required by these companies to their shareholders in this period, or to anyone else, come to that. Double entry accounting was not commonplace, at least in the early part of the period. Nor was the format of accounts established e.g. profit and loss accounts and balance sheets were not the established norm. Very few companies (even the largest) employed anyone with any accounting skills. There were no formal audit or accounting professions. Audits were seen as protection against fraud, if they existed.

The most commonplace fraud was the payment of dividends out of capital, a practice that put paid to the Railway Mania, that had seen an investment bubble that collapsed by 1849. Many audits were done by amateur representatives of shareholders. But some people with familiar names, like Waterhouse and Deloitte were amongst the early professionals who were called upon to prepare the accounts of companies and then provide their audit opinion, which was usually to confirm that the accounts accorded with the underlying books and records. Truth and fairness had not made an appearance.

In this era it was the auditor who almost invariably assumed responsibility for preparing the accounts of their clients, which activity was a seen as a part of auditing. It was also quite commonplace for the auditor to be involved in preparing accounting entries for their client, which practice continues to this day, at least for smaller audit clients.

b. The 1880s to about 1900

In the second era, which covers the years from approximately 1880 to 1900, two trends developed. The first was that companies began to employ people as bookkeepers, and some even engaged in-house accountants. However, very few companies still actually prepared their final accounts, which was a task still usually left to the auditors, who were now working in firms. Second, those firms were beginning to promote professional institutes to advance their interests. There is as a result evidence of these firms imposing demands on their clients, for example to split

capital and revenue expenditure, and to depreciate assets. However, the focus of audit was very heavily much on transaction testing with a focus on the profit and loss account, which would remain the case for the next century. The balance sheet and its valuation was a decidedly secondary concern.

The content of accounts - a profit and loss account and balance sheet based on double entry bookkeeping (often completed by the auditor as the client did not have the requisite skills) - was becoming normalised.

c. 1900 – 1920

Companies were growing in size during this era. UK railway companies were now the largest companies in the world. The largest, the London & North Western Railway, was led by a director who had made it to the top through the accounting department. The era of the accountant as a manager had arrived. That said, most auditors still prepared their client's accounts, even if by 1911 the Spicer and Pegler audit manual was suggesting that audit independence was a desirable trait. Evidence suggests that this separation of duties was rarely, if ever, encountered in practice. Audit practice had changed little from previous periods and accounts were very largely prepared by those who also declared their truth and fairness, or truth and correctness.

d. 1920 - 1945

The era was characterised by the growth of the multinational company, albeit that this remained a rare beast (as we should recall that it still is, overall). Professionalisation of accounting and auditing was growing, but the overlaps remained very strong. The interaction between auditors and their corporate clients was multi-dimensional, but now also international in some cases. International associations of firms developed but there was little evidence of audit harmonisation as a consequence. Indeed, there is evidence to show that within offices of the same firm consistency of audit practice was limited and largely at the whim of individual partners. Tax was an issue of growing concern, and provided accouting firms with greater opportunity for the provision of other services to their clients.

e. 1945 - 1995

The informality of much of the audit profession, despite the existence of professional firms and institutes and increasing statutory obligations on corporate disclosure within accounts, remained the case during a large part of the immediate post war

era. The idea that the auditor was an objective third party was consistently present in theory during this period, but rarely, if ever in practice. In the UK the growing number of limited liability companies (albeit still small in number by today's standards), all of which were subject to annual audit whatever their size, led to an increase in the size of the audit market, but only a small part of that market served companies able to prepare their own accounts for audit. The separation of roles between the audit and their client did, over the market as a whole, therefore remain the exception rather than the norm.

With professional accountants being banned from advertising their services throughout much of this period the marketing of new services to existing clients became the normal source of revenue growth for most firms, encouraging their diversification into taxation and other advisory services as the period progressed.

Some audit firms grew significantly in size during this period, assisted by the removal of the limit on their membership to no more than 20 members that existed until 1967. However, all audit firms had unlimited liability, which was seen by many as a constraint on growth and an encouragement to diversity in the audit market.

International networks of firms were growing during the course of this period. The concept of 'offshore finance' developed from the late 1950s onwards. Many large firms of auditors began to open tax haven offices. They used these offices to set up corporate structures on behalf of their clients in ways that would have been difficult otherwise, meaning that they embedded themselves into their clients' corporate structures. These affiliated offshore firms frequently provided all the accounting, taxation and other services that were required to operate a client's offshore activities. It was claimed that conflicts of interest were avoided by each audit firm being structured as a group of affiliated entities, each often working in only one jurisdiction, but with all of them working under a common name although without any common ownership, which is still the prevailing norm within the profession.

It is fair to note that the audit itself did develop during this period. Excluding smaller entities, were it remained essentially an accounting exercise with little sign of any additional verification work being undertaken (evidence of which was still widely seen in the 1990s), computerisation changed the focus away from checking substantial quantities of individual transactions towards more systemic approaches whilst new accounting standards substantially refocused work in the balance sheet, and away from the profit and loss account.

f. 1995 - 2012

The era of co-ordinated international auditing and accounting standards arrived to coincide, very broadly, with the arrival of the twenty first century. In the case of the UK at least, this also coincided with the widespread adoption of limited liability by auditors, using the new limited liability partnership structure that became available in 2000 in UK law.

The significant audit change in this era resulted from the replacement of national auditing standards, that had largely developed in the 1990s, by international standards set by the International Auditing and Assurance Standards Board (IAASB). The change was fundamental, at least in the UK. The term 'true and fair' ceased to mean that accounts were a materially correct representation of the financial affairs of an entity that could be relied upon to be both broadly correct and to also include all the information that a reasonably anticipated stakeholder decision-maker might require to inform their judgement, and were instead correct in the sense that they had been prepared in accordance with the requirements of an agreed accounting framework and made the disclosures required by that framework, whether that was sufficient, or otherwise, to meet stakeholder needs. An era of lowest common denominator compliance had arrived.

Second, the arrival of the widespread use of International Financial Reporting Standards (IFRS), and related (and largely derivative) national standards, as a result of the adoption of IFRSs across the European Union in 2005 cemented the change in the IAASB audit process. A single international accounting reporting framework now existed. IFRS and US GAAP (generally accepted accounting standards) were also set on a convergence path, and in some cases are identical.

In effect auditing became a 'tick the box' process with limited legal consequences. The influence of the big firms of accountants (just five in number at the turn of the century, and soon to be four after the demise of Arthur Andersen as a result of the Enron audit failure) should be seen as fundamental in this process of change, which was almost entirely led by partners or alumni of these firms.

A number of other changes were very apparent. For example, democratic control of the accounting and auditing processes by governments was rapidly diminishing. The process of standard setting, whether on the content of accounts or the process of the audit, was being outsourced to the accounting profession. So too was professional regulation being outsourced to them as self-regulation became prevalent.

At the same time the number of audits required tumbled. In 1990 all UK companies required audit. By 2000 under 10% did as all smaller entities had this requirement, and even the need for third party accountant involvement in their affairs, removed from them as a result of a demand that 'red tape' be removed from smaller business.

Despite this firms were growing. The possibility of limited liability created a greater risk appetite amongst firms. This was the era of mass selling of tax abuse schemes[8]. Significant penalties were imposed but there was little immediate sign of changed behaviour.

With regard to the audit the change to IAASB and IFRS standards did, however, make it possible to claim that the auditor and their client might be separated in a way that was inconceivable in the twentieth century. There was, however, little evidence that this actually happened until well after the global financial crisis. The continuing tax scandals were indication of that: audit firms set up arrangements for their clients and then declared them to be true and fair. The continuing rise of offshore activity, in which the major firms of accountants were all intimately involved, was another indication of this[9].

g. 2012 - 2020

The era after the Global Financial Crisis has seen the first real suggestions being made that auditing should be separated from accounting and other advisory services. This has been the result of disquiet that appeared somewhat after the event with regard to auditors' behaviour on behalf of their clients who had to be bailed out as a consequence of failures during the course of the global financial crisis of 2008. It has also risen as a consequence of further failures that have become apparent since then. The demand for audit reforms is a consequence of those failures.

h. Summary

In summary, accounting was a subset of auditing in 1850, and 170 years later there remains a substantial overlap between two professions, with auditors still assuming many responsibilities on behalf of their clients, whether that is intended to be the case, and whether that is permitted by professional regulation, or not. The separation of the auditor from their client, suggested to be appropriate in 1911 by audit firm

[8] https://www.theguardian.com/business/2005/aug/30/5

[9] https://www.researchgate.net/publication/331733027_A_Tax_Map_of_Global_Professional_Service_Firms_Where_Expert_Services_are_Located_and_Why

Spicer and Pegler, still remains a decided rarity, known in theory but very rarely in practice.

4. Conclusions

It is suggested as a result of this review that the assumptions that underpin current audit reforms are wrong. In fact, the opposite hold true, with it being suggested that the following assumptions are appropriate:

A. There is no such a thing as an audit independent of the accounting of the entity to which it relates;

B. In a commercial environment an auditor cannot form an objective opinion upon the accounts of their client: that opinion must always, instead, be subjective, which subjective opinions are precisely what are required;

C. The auditor cannot report without asking whether the accounting framework used by the entity on whose accounts they are offering opinion is fit for purpose;

D. The quality of an audit cannot be appraised independently of the accounts to which they relate;

E. A structured form of audit opinion reporting does meet the needs of the users of accounts;

F. The stakeholder to whom the auditor needs address themselves are all those of the entity i.e. its:

   a. Suppliers of capital, in all its forms;
   b. Trading partners;
   c. Employees, whether past, present or future;
   d. Regulators;
   e. Tax authorities;
   f. Civil society partners, known and unknown to it.

In addition, it is suggested that the assumption that the auditor and their client can be independent of each other is not true. As is noted, this separation has also almost never been evidenced in practice, whatever the accounting profession has liked to claim.

What this then means is that the direction of audit reform, which seeks to maintain current structures of accounting, but to separate the auditor from their client, is wrong. The auditor is not, and cannot be, independent of the accounting of the entity on which they are reporting. As has long been understood in other fields, the process of observation necessarily changes the behaviour of the entity that is observed. This is also true of auditing.

In that case the question is not how the auditor and their client may be separated but how, instead, the responsibilities for the accounting for any company should be divided between the auditor and the reporting entity with the objective of improving the quality, scope and reliability of the information that is received by stakeholders of reporting entities, which is the end goal of this process. The lesson of history is that creating the right balance within this relationship can be beneficial to the overall quality of information supplied. We need to remember this when making recommendations for the future.