THE NEW ARCHITECTURE FOR AUDITING STANDARDS

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ABSTRACT: The purpose of this paper is to challenge the conceptual basis upon which the current auditing standards are based. The paper critically appraises the Auditors’ Code published by the Auditing Practices Board and containing the nine fundamental and enduring principles upon which current auditing standards are based. It is argued that the nine enduring principles should be replaced by seven enduring tensions – the fault lines of auditing – so as to rethink the conceptual basis of auditing standards. Further research should be carried out to test the robustness of the seven enduring tensions as the basis for standard setting. A first step might be to map the existing standards onto the new conceptual basis. Standard setters can deploy a new architecture for auditing standards and one that addresses the tensions inherent in auditing. Standard setting should be recognised as an activity dominated by ethical choices and concerns.

KEY WORDS: auditing; professional ethics; standards

1. INTRODUCTION

Shortly after its formation in 1991 the then Auditing Practices Board (APB) established a working party under the chairmanship of John McFarlane to prepare a discussion paper on the future of audit. The working group felt that its deliberations should be founded upon an understanding of the enduring principles of auditing. A statement of these principles was consequently published in The Future Development of Auditing (APB, 1992), refined in The Audit Agenda (APB, 1994) and published in final form as The Auditors’ Code (APB, 1996). In 2002 the APB was re-formed and brought under the Financial Reporting Council. The Code has been revised by the re-formed APB, most recently in 2008 (APB, 2008), but it remains virtually the same as the original. According to the APB (2008, p. 5) the Code provides a framework of fundamental principles which encapsulate the concepts that govern the conduct of

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audits and underlie the APB’s ethical and auditing standards. Currently in issue from APB are:

(1) a series of five ethical standards relating to the independence, objectivity and integrity of external auditors; and

(2) 30 ISAs which are the operational and reporting standards.

The latter are published in six series (the 200 series through to the 700 series) and deal with the audit as a process in roughly chronological order starting with the establishment of the auditor’s responsibilities and ending with the auditor’s report to shareholders. The APB has from 2004 adopted, with some adaptation to local requirements, the Standards (ISAs) of the International Auditing and Assurance Standards Board (IAASB). In addition to the ISAs it has adopted the IAASB’s International Standard on Quality Control (ISQC) 1 which deals with quality control for audit firms. The epicentre of standard setting for the UK standards has therefore shifted to the IAASB, and the recommendations for standard setting made in this paper, though developed in the context of the APB and its Auditors’ Code, may now need to be applied at the level of the international standard setting body (the IAASB), as well as the level of the APB.

The Auditors’ Code gives nine fundamental principles of auditing. It is deontological in nature, the principles being presented as universal and enduring. This paper revisits the Code and focuses on the inherent tensions between, and sometimes within, the principles espoused. This paper posits that there are no enduring principles of auditing, only enduring tensions. Instead of nine enduring principles the paper identifies seven lines of tension. Thus, the challenge for the standard setters is to develop auditing standards that position audit on each of these fault lines.

2. THE ENDURING TENSIONS

The seven enduring fault lines of auditing identified by the authors are:

- Primary stakeholders vs the public interest.
- Clear communication vs association.
- Independence and objectivity vs accountability.
- Judgement vs rigour.
- Objectivity vs providing value.
- Insurance vs assurance.
- Personal vs corporate accountability.

The first five are drawn from the Auditor’s Code and the final two are drawn from the authors experience and in the authors judgement should be included. The first additional tension that the author has included is audit as assurance versus audit as insurance. Frequently, and often on the advice of the professional indemnity insurers, legal action against auditors is settled out of court highlighting a tension between audit as assurance and audit as insurance. The author observed that a major factor in APB’s discussion of the wording of proposed auditing standards was its potential impact in litigation against auditors, leading the author to conclude that the tension between assurance and insurance is a major issue for standard setters and should be included in any list of enduring tensions.
The second additional tension the author has included is that between individual and corporate responsibility for the audit. This emerged as an important issue in the discussions surrounding The Audit Agenda (APB, 1994) and it lies behind the Agenda’s recommendation (p.39) that the audit reports be signed by the responsible audit partner for and on behalf of the firm in his or her own name in addition to the name of the firm.

The seven enduring tensions or fault lines are now discussed in turn.

**Primary stakeholders vs the public interest.** This tension is acknowledged in the first principle of the Code when it states: Auditors act in the interests of primary stakeholders, whilst having regard to the wider public interest. It is possible to go beyond the tension between primary stakeholders and the public interest, to consider the tensions between all stakeholders in the audit, including directors, lenders, employees, creditors, and of course auditors. Even within the audit firm there are tensions between the practitioner and the administrative managerial components (Carpenter et al., 1994).

**Clear communication vs association.** The Code asserts a clear professional duty for auditors only to allow their reports to be associated with documents which contain other (unaudited) information if they have no cause to believe that the other information is misleading. It follows that in respect of the annual report outside the financial statements, the auditor is giving a silent negative opinion. No opinion is stated but if it were, it would give the “negative” assurance that the auditor had no cause to believe that the information is misleading. Silent opinions and negative assurance opinions do not provide a clear expression of opinion or set out the scope of the work necessary for a proper understanding of negative assurance. What the Code says on association is contrary to its other principle of clear, complete and effective communication. And yet there are occasions when auditors, given the complexities of the auditor’s position in a litigious environment, may only be comfortable with a negative assurance and/or a silent opinion. Standard setters have to judge when and in what circumstances such an approach is permissible.

Potentially the tension between clear communication and association increases as the information content of the annual report outside the financial statements increases. For example, if investors consider the Operating and Financial Review to be an important document would they benefit from a clear statement of the auditor’s opinion of it?

**Independence/objectivity vs accountability.** It has long been recognised that accountability has an impact upon the exercise of professional judgement. The Code sees independence in terms of the appearance of independence. Independence/objectivity as a state of mind might be interpreted in terms of a facility (a personal trait) to reach the same judgement via the same articulation and reasoning irrespective of the environment of accountability. Yet we know that the pattern of accountability does affect judgement, so the only true independence/objectivity is when there is no accountability for the auditor. This would place independence/objectivity as the antithesis of accountability in the sense that any accountability is capable of reducing objectivity.

The tension therefore is between the need for auditors to be independent/objective, a condition that implies the auditor should be free to judge impartially without
reference to the interests of stakeholders in the audit, and accountable, a condition that implies the auditor should be conscious of and influenced by, the interests of the stakeholders. The nature of this tension depends upon which accountabilities are dominant. For example, if audit committees play a major role in the appointment of auditors then this has the significant benefit that auditors’ independence from executive directors is increased. However, their independence from the non-executives of the audit committee is reduced. Auditors may be inclined to give consideration to the issues that the audit committee regards as important rather than making or following their own judgement.

Judgement vs rigour. Auditing of financial statements is inherently a professional judgement using the auditor’s competence and experience to apply principles to the particular circumstances of the audit. Francis (1994) pointed out that auditing is not so much a set of generic principles but rather it is the process of giving understanding or meaning to those principles through their application in the given circumstances of the auditee. This view is supported by those sociologists who argue that there can be no unswerving application of principles or of rules (MacKenzie, 2008 who builds on Barnes, 1982; Bloor, 1997). Proper usage of a principle, which is conceptually a high level rule, is developed step by step, in processes involving successions of on the spot judgements. Suchman (1987, 1993) makes similar arguments in respect of procedures. She argues that procedures are designed to be contextually independent, yet, like utterances in a conversation, have to be interpreted with respect to the particulars of the situation in which they are used. Thus, procedures are invariably incomplete specifications of action.

The Code equates rigour with thoroughness and scepticism. Scepticism is an inclination to disbelieve and seems to say that auditors should require a high quality of evidence and be willing to seek further evidence if in doubt. Used in his way rigour seems to moderate the exercise of judgement by saying that judgement is made after a thorough investigation and not before. There is no real tension between judgement and the APB’s interpretation of rigour. However, there is a well-recognised tension between judgement and an interpretation (see, for example, Chambers Twentieth Century Dictionary) of rigour as the unswerving enforcement of law, rule or principle. Rigour in this sense of rigidity is at odds with judgement. The tension therefore is whether the principles, rules and procedures of auditing, should be applied judgementally according to context or rigourously (rigidly) without reference to context. The fear is that too many rules and procedures designed to cover as many situations as possible changes the mindset of the auditor from one of independent judgement to one of unthinking compliance. This is a tension that has received much recent attention from the auditing profession (Audit Quality Forum, 2006).

Independence/objectivity vs providing value. According to the Code the auditor provides value not only by adding to the reliability of financial reporting but through constructive observations arising from the audit process. In order to evaluate whether a set of financial statements reflect a business’ financial performance the auditor needs to get close to the business and its directors. This is implied by the Code’s principle of competence which demands an understanding of financial reporting and business issues. In getting close to the business the auditor may be
encouraged to see the business as the directors see it, with potential consequences for the auditor’s objectivity. In addition it is this close understanding of the business that helps to make the auditor’s observations and recommendations valuable. The paradox is that this role of “Mr Inside” may be at odds with the value that capital markets and shareholders attribute to the audit which is a function of the auditor’s position as an objective outsider. Thus, the auditor has to be both “Mr Inside” and “Mr Outside” and to maintain a balance between understanding and advice on the one hand and objectivity on the other. The implication is that audit failure can come from the auditor being either too close to, or being too distant from, the business. Constructive observations to directors and officers arising from the audit process can include a recommendation for improved systems or the identification of other needs that can be met by consultants working for the audit firm. Where the observations constitute or lead to non-audit services, there is an additional tension arising from the perception that the auditor’s independence and judgement on the audit will be impacted by the rewards available from the non-audit services.

In the public sector where the pattern of auditor accountabilities is quite different to the private sector, the tension between adding value and independence/objectivity takes on a different character. Here, the tension is between the audit as confirmation and the audit as challenge. Whilst the basic audit function is one of confirming the reliability of the financial statements, adding value in terms of the functioning of the organisation requires the auditor to challenge how the organisation goes about meeting its policy objectives (the value for money audit). Thus, the auditor and the audit stakeholders have to be comfortable with both the audit as confirmation and the audit as challenge - two rather different mindsets.

**Insurance vs assurance.** Litigation has always been a major concern of the stakeholders in the audit and one where the interests of stakeholders diverge. (See for example, the differing views of Pasricha, 2002 of audit firm Ernst and Young and Richards, 2004 of Morley Fund Management.) Following the Companies Act 2006 (Sections 534-536) a company may, with the agreement of shareholders as a body, enter into a contract with its auditors to limit the auditor’s liability. However, it remains to be seen how often shareholders as a body will agree to this and, if they do, how it will affect the auditor’s liability to third parties to the contract, including individual shareholders.

In a highly litigious environment there develops a tendency for the audit to become implicitly a joint product of (audit) assurance and insurance. The audit report provides assurance but the auditor’s signature also provides a target for legal action by investors if the financials turn out to be unreliable. The audit firms take out professional indemnity insurance to cover the risk that they are negligent in the conduct of the audit. The auditors are only liable if they are negligent, owe a duty of care to the plaintiff, and the plaintiff can establish that any loss is the result of a reasonable reliance on the defective financials. In some cases that have come to court the difficulties in establishing these three criteria, has led to damages not being awarded, even though the auditor had not conducted a competent audit. However, many other cases, on the advice of the auditors’ insurers, are settled out of court even when the auditors are not necessarily at fault. It is this latter situation that is equivalent...
to insurance. Audit evidence is not a guarantee and so financials can be unreliable even after an unqualified audit report and a well conducted audit. If this risk is carried by the auditor or their insurer then we have an insurance product. Any insurance of financial statement reliability is based upon a risk assessment which is a professional judgement the auditor is often in the best position to make. Indeed the insurance concept sits comfortably within an audit profession where risk is a primary discourse. The audit work may become viewed as an examination not only to provide assurance but to determine the financial statement risk and hence the insurance premium element within the audit fee.

**Personal vs corporate responsibility.** The Companies Act 2006 (s503) requires the auditor’s report to state the name of and be signed by the senior statutory auditor who is in effect the audit engagement partner thus acknowledging that partner’s personal responsibility. However, that partner signs for and on behalf of the audit firm whose name also appears on the audit report.

The extent to which the audit opinion is the responsibility of an individual audit engagement partner as opposed to the responsibility of the corporate audit firm discharged through a corporate process, is a significant issue since it highlights the nature of quality control within the audit firm. There are review requirements set out in ISQC 1. Formal review of audits within the audit firm sets up a mode of accountability for the audit partner as opposed to the self-accountability associated with independent judgement. In a sense therefore the personal vs corporate responsibility debate is an extension of the independence/accountability and judgement/rigour dilemmas already posed.

Maintaining self-accountability is important to the issue of whether the market concentration on four big audit firms allows sufficient choice. If there is sufficient self-accountability we can regard the client’s choice of auditor as being any one of a large number of audit engagement partners each one of which happens to be committed to one of four global resource and accreditation networks (Hatherly, 2003, p.32).

**3. THE IMPLICATIONS FOR AUDITING STANDARDS**

The first implication relates to how standard setters perceive or conceive of the audit. Instead of the audit being seen as a set of enduring fundamental principles it should be seen as a set of enduring tensions – audit’s fault lines. The first duty of standard setters should be to identify these fault lines and to position the audit upon them. Each auditing standard should then explain how it relates and gives meaning to, the positions taken on audit’s fault lines.

The position taken on one dimension constrains the position that can be taken on another. By way of example, a position which emphasises judgement implies high personal responsibility, while a position that emphasises high levels of accountability implies clear communication of how judgements have been made. It follows that the fault lines are in fact interdependent dimensions of the audit, and these interdependencies in turn suggest the audit as a network of tensions with only the main fault lines being discussed in this paper. In the jargon of factor analysis, variables can load on more than one dimension. One consequence of interdependency is the holism of
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audit standards. There should not be, as we have at present, a set of largely technical, operational and reporting standards and a separate set of ethical standards. The current ethical standards in particular, with their routine observations upon independence, are inadequate for dealing with the pervasiveness of the ethical dimension of auditing.

Whereas the extant development of principles based standards can be seen as the application of judgement in a professional process, the positioning of audit upon its fault lines is much more of a political/social/ethical process balancing the interests of audit’s stakeholders. The latter process suggests three strands that influence standards development being:

- the identification of the consequences of standards, a process where experience and technical understanding can play a big part;
- notions of fairness to audit’s various stakeholders impacted by these consequences; and
- the self-interests of individual standard setters in terms of the consequences for the stakeholder group to whom each standard setter belongs.

Notions of fairness are dependent upon the culture of the individual standard setters concerned including the culture of the organisation from which the individual comes. The three strands embrace modes of ethical reasoning other than deontology, being utilitarianism (consequences - the most good for the most people), justice (fairness), egoism (self-interest – the ethic being that one should not expect others to look after you) and relativism (there is no universality since ethics are a product of cultural background). Standard setting is a process that combines experience of auditing with much ethical reasoning and the output of the Board will be highly dependent upon the mix of ethical reasoning favoured by the members of the Board. The ethical standards of the Board are every bit as important as the ethical standards for individual audits.

Insofar as self-interest is unavoidable then the composition and cultural background of the membership is a crucial influence on the Board’s output. It is noteworthy that the constitution of the APB limits Board members eligible to carry out audits to 40 per cent of the Board membership. There is no similar condition applying to the membership of the IAASB. At the international level there are additional considerations of achieving balance, notably in terms of geographical representation and representation from economies at different levels of development. (IAASB, March 2006, Terms of Reference, Section 4.0).

It is particularly important that the standard setters identify and take account of the unintended consequences of auditing standards. Michael Power (1994, p. 34) was one of the first to articulate this problem. He pointed out that auditing is not neutral with respect to the activities it inspects. He argues, for instance, that in a value for money (VFM) setting that audit does as much to construct definitions of quality and performance as to monitor them, leading to managing by numbers which enables a drift towards centralised forms of control and displacement of concerns about good policy by concerns about good management. Clearly an audit that shapes the conduct of the auditee in this way is not a fully independent audit, highlighting the tension between independence/objectivity and providing value.

In these ways the primary concerns of auditors and managers becomes auditability itself-leading to a bureaucracy of process and documentation that distracts
from the real objectives of both the organisation and the audit. Thus, there is a tension between the organisation’s auditability on the one hand and on the other, the efficiency and effectiveness of both auditor and auditee. Whilst auditability might be an advantage for the stakeholders in the audit and notably for the auditors, a loss of efficiency and effectiveness is a clear disadvantage.

4. CONCLUSIONS

The Auditing Code which provides the fundamental principles behind current auditing and ethical standards, presents auditing as a set of enduring principles. This paper argues that auditing is more appropriately conceived as a set of enduring tensions, resolved through standard setting as a substantially ethical, rather than technical, process. Accordingly the role of standards is less about the implementation of principles and more about the positioning of audit as the intersection of competing forces. Thus, auditing standards require a new conceptual basis.

The seven enduring tensions (eight if you include auditability vs efficiency/effectiveness) put forward in this paper are a preliminary attempt to identify these competing forces and are described as the fault lines of auditing. Further research needs to be conducted into their reliability and appropriateness. As a first step it would be helpful to map the existing auditing and ethical standards onto the seven dimensions. This would almost certainly reveal some dimensions that were given too little consideration in terms of standards whilst others may be over specified, pointing the way forward for a substantive revision of the standards. Indeed auditing standards might be restructured as seven series of standards, each series corresponding to one of the enduring tensions. The ethical and technical reasoning associated with the positioning on each fault line should be dealt with together and not in separate standards.

REFERENCES: