



## Origin And Development of Auditing

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**ABSTRACT**

The investing public has historically relied upon audited financial statements when making investment decisions and has depended upon auditors and the accounting profession to confirm the accuracy and completeness of financial information. Auditing evolved and grew rapidly after the industrial revolution in the 18th century with the growth of the joint stock companies where the ownership and management became separate. The audit function was mainly to provide credibility to the financial statements prepared by company managers for their shareholders. Consensus was generally achieved that the primary objective of an audit function is adding credibility to the financial statements rather than on the detection of fraud and errors.

**KEYWORDS**

Economic decisions in every society must be based upon the information available at the time the decision is made. For example, the decision of a banker to make a loan to a business is based upon previous financial relationships with that business, the financial condition of the company as reflected by its financial statements and other factors. The investing public has historically relied upon audited financial statements when making investment decisions and has depended upon auditors and the accounting profession to confirm the accuracy and completeness of financial information. If decisions are to be consistent, the information used in the decision process must be reliable. Unreliable information can cause inefficient use of resources to the detriment of the society and the decision makers. In the above lending decision example, by relying on misleading financial statements, the bank has lost both the principal and the interest. In addition, another company that could have used the funds effectively was deprived of the money. There are several reasons for this remoteness of information, voluminous data and the existence of complex exchange transactions. As a means of overcoming the problem of unreliable information, the decision-maker must develop a method of assuring him that the information is sufficiently reliable for these decisions. In doing this he must weigh the cost of obtaining more reliable information against the expected benefits. The audited information is then used in the decision making process on the assumption that it is reasonably complete, accurate and unbiased.

**THE EVOLUTION OF AUDITING PRACTICES**

The term audit is derived from the Latin term 'audire,' which means to hear. In early days an auditor used to listen to the accounts read over by an accountant in order to check them. Auditing is as old as accounting. It was in use in all ancient countries such as Mesopotamia, Greece, Egypt, Rome, U.K. and India. The Vedas contain reference to accounts and auditing. Kautilya detailed rules for accounting and auditing of public finances in his book "Arthasashtra". The original objective of auditing was to detect and prevent errors and frauds.

Auditing evolved and grew rapidly after the industrial revolution in the 18<sup>th</sup> century with the growth of the joint stock companies where the ownership and management became separate. The shareholders who were the owners

needed a report from an independent expert on the accounts of the company managed by the Board of Directors who were the employees. The objective of audit shifted and audit was expected to ascertain whether the accounts were true and fair rather than detection of errors and frauds. In India the Companies Act, 1913 made audit of company accounts compulsory. With the increase in the size of the companies and the volume of transactions, the main objective of audit shifted to ascertaining whether the accounts were true and fair rather than true and correct. Hence, the emphasis was not on arithmetical accuracy but on a fair representation of the financial efforts. The Companies Act, 1913 also prescribed for the first time the qualification of auditors. The International Accounting Standards Committee and the Accounting Standards Board of the Institute of Chartered Accountants of India have developed standard accounting and auditing practices to guide the accountants and auditors in the day to day work. The later developments in auditing pertain to the use of computers in accounting and auditing.

**DEVELOPMENT OF AUDITING**

The historical development of auditing is divided into the following five chronological periods, viz.(i) Prior to 1840; (ii) 1840s-1920s; (iii) 1920s-1960s; (iv) 1960s-1990s and (v) 1990s - present

**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.

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). 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, to help the merchants 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, (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, during the period of 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.

#### 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 & Cosserrat, 1996). 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. Due to unregulated and highly speculative share market, 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 were in dire need of protection (Porter et al, 2005). Hence, the time was ripe for the profession of auditing to emerge.

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, (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 (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 (1885) 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.

#### 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 was generally achieved that the primary objective of an audit function is adding credibility to the financial statements rather than on the detection of fraud and errors. "Primary responsibility...for the control and discovery of irregularities necessarily lies with management." (1940). 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) "... 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 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, (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 evidences, outside the "books of account".

### 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). Thus the role of Auditors among others, were to affirm the truthfulness of financial statements and to ensure that financial statements were fairly presented. 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". It is due to the increase in the number of transactions which resulted from the continued growth in the size of companies, where it is unlikely for auditors to verify all transactions. 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. For this the auditors are required to gain a thorough understanding of clients' organization, key personnel, policies, and their industries (Porter et al., 2005). Thus it 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. Here, most of the companies used 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 tools to facilitate their audit procedures. In addition the auditors at the same time were providing advisory services to the audit clients. Accounting and auditing during this period has become an industry with strong competition among firms. Thus the role of Auditors in provision of advisory services emerged as a secondary audit objective in the period of 1960s-1990s.

### 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 I (2005), present-day auditing has developed into new processes that builds 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. It is opined that many business risks, if not controlled, will eventually affect the financial statements. 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.

Presently, the objective of auditing is to lend credibility to financial and non-financial information provided by management in Annual Reports. 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, Xerox, 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). In this Process the following types of prominent audits have come into use.

#### 1. External Audit

External audit, also known as financial audit and statutory audit, involves the examination of the true and fairness of the financial statements of an entity by an independent external auditor of the organization in accordance with a reporting framework such as the IFRS. Thus Company law requires external audit on annual basis for companies.

#### 2. Internal audit

Internal audit, also referred as operational audit, is a voluntary appraisal activity undertaken by an organization to provide assurance over the effectiveness of internal controls, risk management and governance to facilitate the achievement of organizational objectives. Internal audit is performed mostly by employees of the organization who report to the audit committee of the board of directors as opposed to external audit which is carried out by professionals - independent of the organization and who report to the shareholders via audit report. The Indian Companies Act, 2013 has mandated certain class of Companies to have Internal Audit.

#### 3. Forensic audit

Forensic Audit involves the use of auditing and investigative skills to situations that may involve legal implications. Forensic audits may be required in the instances of fraud investigations involving misappropriation of funds, money laundering, tax evasion and insider trading, and quantification of loss in case of insurance claims.

#### 4. Compliance Audits

Compliance Audits seek to determine if departments are adhering to federal, state, and University rules, regulations, policies, and procedures.

#### 5. Investigative Audits

Investigative Audits are performed when appropriate. These audits focus on alleged violations of federal and state laws and of University policies and regulations. This may result in prosecution or disciplinary action. Internal theft, misuse of University assets, and conflicts of interest are examples of investigative audits.

#### 6. Information Systems (IS) Audits

Information Systems (IS) Audits address the internal control environment of automated information processing systems and how these systems are used. IS audits typically evaluate system input, output and processing controls, backup and recovery plans, and system security, as well as computer facility reviews.

### DEVELOPMENTS IN AUDIT APPROACHES FROM AUDIT EFFICIENCY TO AUDIT EFFECTIVENESS

In relation to the external audit, perhaps the only constant thing is change. In the 1980s, audit efficiency was probably the major driving force behind audit developments (Burton and Faireld, 1982). Accountancy firms were quite open about this, and Turley and Cooper (1991), following their interviews with senior auditors, were able to conclude that the most important criterion for making the choice of [audit] strategy is the notion of efficiency'. However, there

have been concerns about audit effectiveness (Cadbury Report, 1992) and while there is no doubt that auditors are still very much concerned with efficiency, there is now evidence (Davis, 1996) that things have changed. Given the litigious atmosphere in which the auditors have to operate, they are starting to reassess the objective of the audit and, consequently, how this should be accomplished. So, rather than simply concentrating on how to do their work more efficiently (i.e., the same level of confidence at lower cost), they are now starting to question what, as auditors, they are trying to achieve and thus, what sort of work this requires (what is required to achieve their objectives; that is, effectiveness). Therefore, there appears to have been a move by some firms to reconsider the overall effectiveness of their audit approaches in the light of a re-evaluation of the risks (both audit and commercial) that they face (Pincus et al, 1999) examined audit effectiveness in comparison with audit efficiency, but, essentially, this was just in relation to the auditor's responsibility for fraud detection). The nature of the changes implemented by some firms is such that the developments could almost be classified as an example of 'process re-engineering'. This is likely to have a dramatic impact on what people consider auditing is all about, and could indicate a need for the reassessment of the external auditor's function.

The benefits of more effective audits include improving the reliability of financial statements, enhancing the credibility of investors' confidence in those financial statements, improving management decision making, lowering entities' cost of capital, and increasing the effectiveness of capital markets in allocating resources (Panel on Audit Effectiveness, 2000)

## CONCLUSION

Auditing has made great strides in the past decade, but it has not seemingly kept pace with the real-time economy. Future audit approaches would likely require auditors, regulators, and standards setters to make significant adjustments. Such

adjustments might include (1) changes in the timing and frequency of the audit, (2) increased education in technology and analytic methods, (3) adoption of full population examination instead of sampling, (4) re-examination of concepts such as materiality and independence, and (5) mandating the provisioning of the audit data standard. Auditors would need to possess substantial technical and analytical skills. SOX introduced the first major change in the mandate of the public company audit. This new prescription focuses on auditor assessment of internal controls, a very important step in the assurance of future systems that will be modular, computerized, and often outsourced. The accounting profession now faces an opportunity to further elevate the audit to a higher level of automation. It is imperative that accountants ultimately lead the way in adoption and implementation of the future audit such that they continue to be the professionals of choice relative to audit engagements of the future.

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