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[Finance](#)



Introduction

Auditors are responsible to provide an independent opinion on the true and fair view of the financial statements after he has acquainted himself with all the relevant and reliable evidences with the client. Auditor is expected to a professional adroit with sufficient proficiencies and competence to assess whether the view that has been portrayed by the financial statements represent the true financial position, financial performance and changes in the financial position.

In this paper our focus will not only be on the practices of auditing but also will be to the extended perspective to the auditing as a demand driven discipline which constantly and continuously meets the expectations arose out of the functional, social and legal constructs. It outlines some reflections on auditing as a demand driven discipline rather than discussing only the practices of auditing. It is very important to understand auditing and its vivid prominent place in the economy and such comprehension can be better done by taking a critical approach to the industry and the audit process. Part of the confusion today surrounding the role of auditing stems from a misunderstanding is its nature and precise role.

Here the objective is not to simply add to the great accumulation of information about audit practices, but to understand and explain them. Business is subject to continuous changes brought about by technological advances, globalization and internationalization, and the ways entities are organized and conduct their business. Management's increasing discretion over corporate accounts, and unprecedented competitive pressure have also increased the danger of fraudulent financial reporting. The

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scandals and financial failures of recent years have been a force driving change, especially in the attitudes of market regulators. Thus corporate reporting and the auditing profession are being swept along by this change.

Genesis and the Evolution of Audit

Auditing starts where accounting ends. The present status of the auditor's report and independent auditing represents the culmination of a century of development. Auditing emerged as a demand driven discipline meaning as an auditor you have an obligation to respond to the demand of the society. Auditing comes with another four significant terms that is accounter, accountee, accounts and accountability. The term audit originates from the Latin word audire, which means "to hear." At the time of industrial revolution accounting was oral or verbal. As there was no financial statement in the industrial revolution and many of the parties interested in the audit findings were illiterate, audits were presented orally. Accounting and auditing both are European contribution. At the then time manorial system was found in Britain. The land owners had vast number of lands and property and managing those was tough. So they employed "Agent" to manage those properties, here conflict of interest arose and thus the demand for audit emerged. Now we can divide the time frame of the origin of auditing into following five chronological periods: (i) Prior to 1840;

(ii) 1840s-1920s;

15

(iii) 1920s-1960s;

(iv) 1960s-1990s; and

(v) 1990s-present.

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Prior to 1840

By and large, 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.

1840s-1920s

The emergence of a “ middle class” during the industrial revolution period provided the funds for the establishment of large industrial and commercial undertakings. In response to the socio-developments in the UK during this period, the Joint Stock Companies Act was passed in 1844. 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

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1920s-1960

The growth of the US economy in the 1920s-1960s had caused a shift of auditing expansion from the UK to the USA. 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 world economy continued to grow in the 1960s-1990s. This period observed an important development in technological advancement and the magnitude and complexity of the companies. Here the auditor’s roles are found that the duties of auditor among others were to affirm the truthfulness of financial statements and to ensure that financial statements were fairly

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presented. Hence, the function of auditors with regard to the audit of financial statement generally remained the same as per the pervious period. 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.

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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 prolonged beyond the basic financial statement attest function. 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. Presently, the ultimate objective

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of auditing is to lend credibility to financial and non-financial information provided by management in annual reports; however, audit firms now-a-days have been largely providing consultancy services to businesses.

Brought materials from science n took help from anthropology, medical science, engineering etc. Audit has learnt how to theorize by logical deduction or induction from science, behavioral pattern form sociology, ethical conducts from anthropology, technical aspects from engineering discipline and much more. We can show some of them in following table:

Discipline Contribution

Science Logical

Sociology Behavioral

Anthropology Ethical

Engineering Technical

Contribution of Audit to the Advancement of Civilization

Our life starts with a set of obligations because we deal with resources.

Resource is a pervasive thing and these are always scarce. At the beginning of human civilization there was no accounting, so no accountability and thus no auditing. But after the emergence of Double-entry Bookkeeping System documented by Franciscan monk Luca Pacioli in 1494, the transactions were being recorded in the accounting record book. Luca Pacioli was the purchase manager of his monastery and was responsible for carrying out of economic tasks of that monastery. He was driven by spiritual perception and accountability which means that he was a civilized person. His tasks were controlled by ethical behavior and his job was similar to today's auditor's job.

At the ancient time when Coffee House Culture was established, entrepreneurs sailed across the sea with venture capital. So at the then time fiduciary relationship builds up among the entrepreneurs with venture capital. But after that they found that it is easy to make money and they started to execute fraudulent activities. So at last here comes demand for protection which was the harbinger of audit discipline. Without audit there is no justification for accounting, there is no way to stop distortion in financial statements. To survive, every profession must have some criteria e. g it must be of

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And audit helps to develop the sense of accountability among people which is an essential trait of moral tradition. Ethical conduct has a great impact on human civilization and thus audit helps us to be ethical by its legal construct because audit is very much within the law. Right thinking is necessary for right actions, which means one has to behave in right way by obeying the enacted law, rules and regulation and by becoming truthful, honest, kind, and not hampering other's interest etc. Audit by its functional, legal and social construct helps us to establish that every action has to be justified i. e will be accountable at the end of the day no matter it was personal or institutional undertaking. It indicates that audit as a professional discipline was very much active to develop ethical behavior of the people which is a

very important element in the way to the advancement of civilization. Role of auditors

Though auditors have various types of roles to play, the present role of audits obviously did not emerge full-blown. An auditor's functions generally starts with reviewing, testing, comparing of relevant evidences and ends with reporting to the client. Functional construct dictates that the practical experience of auditors is a factor in elaborating the audit function but this will be conditioned by the particularities of the cases and the environments in which they have occurred. Theoretical implications and empirical testing in auditing can help to make available more explanations and better understanding of the procedure, even if this again depends, to large extent, on the assumptions, models and substantive hypotheses taken into account.

Legal framework dictates the audit profession in a compulsory way. The mandates, the pronouncements, regulations, rules, laws, and acts provide the frame and set out bounds and minimum responsibility of the audit profession, like any other profession. The inherent complexity and the technical nature of the audit profession used to be and till now the reason of pervasive and horrendous regulations that often dictate the profession's present stature and future continuity. As a consequence, audit profession has experienced a lot of prominent legal cases and actions thereon resulting from the notorious crimes. In the aftermath of recent scandals, as they in fact continues to be occurred and disclosed with a huge shake to the profession, there have been calls for enhanced corporate governance and risk management, as well as increasing quality and scrutiny in auditing.

The strongest and sever debate has been on two issues in auditing, the “privity of contract” and “foreseeability”. The debate revolves around the arguments on whether there is a contract between the auditors and the society, or the argument that auditors are expected to have the competence to foresee which parties are going to be affected by the opinion. We are going to discuss some legal proceedings on these issues in the following section -

Comments from a number of cases that were to some extent borne out by decisions will make it clear that even though there is some uncertainty, the extent of the potential liability of the auditors has widened. One of the inherent weaknesses in the audit standard is that the dictums that are set to guide the conducts of the auditors are often subjective.

The term privity of contract can be used to defend the auditors from a successful litigation against them whereas the issue foreseeability brought in an insight of unlimited liability of the auditors. Some authors referred the inception of the foreseeability as a chunk in the armor of the profession.

An example of this can be found in the case of Candler vs. Crane, Christmas & Co., wherein the court applied the “Privity Doctrine”. However, disagreeing with the majority Lord Justice Denning wrote a strong dissenting opinion, which later gained widespread approval.

In fact, in Hedley Byrne & Co. vs. Heller & Partners Ltd. The House of Lords adopted Lord Denning’s argument in establishing that a third party who had relied to his detriment on a negligent misstatement could sue despite the absence of privity of contract. In that case, Heller & Partners Ltd., a
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merchant banking firm, provided incorrect data in response to a request from National Provincial Bank for credit information on Easipower Ltd. Heller & Partners knew the credit information would be communicated to a specific unidentified customer of National Provincial Bank.

In reliance on the credit information, Hedley Byrne, the unidentified customer, extended credit for services rendered to Easipower Ltd. Easipower then went into liquidation. The House of Lords ruled that accountants and other professionals owed a duty to any third person with whom a “special relationship” existed. It opined that a “special relationship” arose in Hedley Byrne because of a “voluntary assumption of responsibility” by the defendant to the plaintiff. The law Lords agreed that a “special relationship” includes more than a fiduciary or contractual relationship; however, they failed to specify criteria for deciding when a “special relationship” arises, and thus, when a duty of care comes into existence.

The clear trend in the law of negligent misstatement immediately after Hedley Byrne was toward expanding the scope of duty to more third parties. In general, the basis of the scope of duty or “special relationship” moved from “voluntary assumption” of responsibility by the defendant to the third party’s “reasonable reliance” to “foreseeability.”

The application of the foreseeability concept gained currency in *Anns vs. London Borough*. Although the facts of *Anns* do not deal with accountants, the case established a two-prong test of liability for negligent misstatements. “The first prong asks whether the defendant’s carelessness may be likely to injure the suing party:

First, one has to ask whether, as between the alleged wrongdoer and the person who has suffered damage there is a sufficient relationship of proximity or neighborhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter- in which case a prima facie duty of care arises. If the first question is answered affirmatively, a duty of care arises. The second prong examines any considerations that could reduce or eliminate the scope of the duty owed: " It is necessary to consider whether there are any considerations which ought to negative, or to reduce or limit the scope of the duty or the class of persons to whom it is owed or the damages to which a breach of it may give rise." The practical effect of the decision in the case of *Anns* was to render almost any sequence of events foreseeable, leaving any limitation on liability to the vagaries of ad hoc policy assessments freed from precedential constraints.

In the context of accountants' liability to non-clients for negligence, the *Anns* foreseeability test was applied in *JEB Fasteners Ltd. v. Marks Bloom & Co.* In that case, JEB Fasteners acquired all the shares in a private company having relied on an unqualified audit report produced by accountants Marks Bloom. The financial statements contained numerous errors and thus, the stock acquired by JEB was overvalued. Although the auditors were unaware of any specific takeover bidder at the date of the audit, they later became fully aware of the identity and progress of the bidder and were in touch with him and supplied relevant information. JEB Fasteners sued the auditors for damages claiming the provision of negligent auditing services. The Queen's Bench Division ruled that the appropriate test for establishing a duty of care

is whether the auditors knew or reasonably should have known that a person might rely on the audited financial statements for making a decision.

The Anns foreseeability test was also followed in the Outer House of Session in Scotland in *Twomax Ltd. v. Dickson, McFarlane & Robinson*. In that case the court dealt with three separate legal claims from investors who had bought shares in a closely held company. The firm went into bankruptcy shortly after the investors acquired their shares. As in *JEB Fasteners*, the defendant accountants were found to owe a duty of care to the plaintiff investors. The fact that the accountants knew or should have known that the potential investors might rely on the audited financial statements was deemed sufficient to create proximity, thus giving rise to a duty of care. The widening ambit of accountant liability to third parties was arrested in *Caparo Industries Plc v. Dickman*.

As has been already detailed, in a unanimous decision, the House of Lords ruled that an auditor of a public company, in the absence of special circumstances, owes no duty of care to an outside investor or an existing shareholder who buys stock in reliance on a statutory audit. In the process, the court fashioned a three-prong test for an auditor's duty of care.

Since *Caparo*, the courts have continued to limit the imposition on auditors of a duty to non-clients for negligent misstatements. A case in point is *James McNaughton Papers Group Ltd. v. Hicks Anderson & Co*. The facts involved the plaintiff's takeover of its rival, MK, which had been in financial distress. MK's accountants prepared draft financial statements, which were shown to the plaintiff. Reversing the trial court judge, the English Court of Appeal

found that the accountants owed no duty of care to the plaintiff. In doing so, the court cited Caparo and noted that in England, a “ restrictive approach is now adapted to any extension of the scope of the duty of care beyond the person directly intended by the maker of the statement to act on it.” In the case in question, Lord Justice Neill’s opined that the important factors to consider in addressing the scope of duty question are the purpose for which the information was prepared and communicated, the relationship between the accountant, client, and third party, the size of the class to which the third party belongs, and the extent of the third party’s reliance.

One of the most significant post-Caparo decisions is Morgan Crucible Co. Plcv. Hill Samuel Bank Ltd. In this case, the plaintiff sued a target firm’s auditors and investment bankers. First Castle Electronics, the takeover target, and its investment bankers released a circular stating that an initial hostile takeover bid was too low because it did not place sufficient value on a projected profit rise. First Castle’s accountants had issued a letter, contained in the circular, stating that the forecast had been prepared in accordance with First Castle’s accounting policies. The acquiring firm raised its offer price (the “ second takeover bid”) but later claimed the profit forecast was negligently prepared. The English Court of Appeal ruled, as in Caparo care. The widening ambit of accountant liability to third parties was arrested in Caparo Industries Plc v. Dickman.

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The English Court of Appeal ruled, as in *Caparo*, that the accountants did not owe a duty of care to the plaintiff before the first takeover bid. Significantly, in *Caparo*, all the accountant’s representations relied on by the plaintiff had been made before an identified bidder had emerged. Although the English Court of Appeal did not decide that a duty of care arose with regard to the second takeover bid, it indicated such a claim was not bound to fail. The reasons were that it was foreseeable the plaintiff would suffer a loss if the profit forecast was inaccurate, the defendant accountants knew the identity of the plaintiff and intended the plaintiff to rely, and much of the information in the profit forecast was available only to the defendant.

From a sociological standpoint, it can be claimed that auditors should act on the best interest of the society by whom the scarce resources have been assigned to a third party. These parties, known as separate management, were expected to discharge the responsibility of a steward. But the society, with a lot of frustrating surprises, experienced something beyond their imagination and suffered from the loss of their wealth.

The audit emerged on the ground that, there should be an independent party who can give them assurances on the credibility of the financial reporting prepared on the basis of the factual, credible, verifiable, reliable and relevant evidences. According to David Flint (1988), 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. Here Flint argues that audit exists because interested individuals or groups are unable for one or more reasons to acquire for them the information or reassurance they require, conflict of interest between preparer and the users of information, complexity of subject matter and the audit process, remoteness of users from subject matter and preparer.

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. All in all, an audit function that carried out plays a critical role in maintaining the welfare and stability of the society. Over the decades there are changes in needs and expectation of the society. So it has been observed that these 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. But the society, unexpectedly found some surprises, which was beyond their imagination and suffered from the loss of their property.

Here arises the question of expectation gap which means the difference between what the society expects auditors are doing and what actually auditors are doing. Thus Porter (1993) has identified two components of the expectation gap: the reasonableness gap (i. e. the gap between what society expects auditors to achieve and what they can reasonably be expected to accomplish) and the performance gap (i. e. the gap between what society

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can reasonably expect auditors to accomplish and what they are perceived to achieve). The misunderstanding between audit beneficiaries and auditors lies in puzzling the role and responsibilities of auditors and the nature of audit function. More precisely, the expectation gap is concerned with the auditor's role in relation to fraud detection and its performance at particular activities (Humphrey et al. 1993, Lin & Chen 2004). From the social expectation there evolves a trio of relationship among society, auditor and manager and it is expected that every benefit must be justified by enhanced social rules.

Critical Analysis of the Audit Profession

Before critically analyzing the audit profession, we have to know the definition of audit. An audit of historical financial statements has been defined as a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria, and communicating the results to interested parties. It is a form of attestation service in which the auditor issues a written report expressing an opinion about whether the financial statements are in material conformity with generally accepted accounting principles or other recognized criteria.

Here we found some special trait of audit: A systematic process, objectively obtaining and evaluating evidences, assertions about economic actions and events, degree of correspondence, established criteria, communicating the results and the last one is interested users. To analyze the contribution critically, questions to answer is “ how auditors meet the demand of the <https://assignbuster.com/as-a-demand-driven-discipline-essay-sample/>

society? Is auditing an added-value function? How should auditors respond to continuous environmental changes? How efficient are the traditional auditing techniques today? What changes, if any, should be made to improve the efficacy of auditing?" etc.

As per functional construct of audit, today the primary objective of auditor is to express an expert opinion whether or not a set of financial statements of a company's affair give a true and fair view. It is generally expected by the users of financial statements that the auditors will have exercised reasonable care and judgment before expressing such an opinion. To provide such an appropriate opinion auditor has to examine the books of account, the underlying internal control systems and transaction documentation, the accounting assumptions, bases and conventions used in the preparation of the financial statements.

This examination should have enabled him to collect evidence, and it is this evidence which gives a rational basis for forming judgment. But auditor works on the sampling basis as it is time consuming and costly to collect and test all the documents and evidences. So here occurs sampling error and it involves unavoidable risk. At the end it can be said that as auditor do not perform his tasks in front of the stakeholders, there always remains a question about the transparency of their tasks.

Audit is very much within the law and Legal framework explains the audit profession in an obligatory way. An auditor shall perform the duties with professional competence, integrity, objectivity and due care, having regard to the public interest. For instance the term " expertise" and " professional

due care” to some extent are subject to interpretation from different standpoints. Moreover, the Standards and Guidelines in issue do not cover all areas of auditing. The auditing guidelines dictate to collect sufficient, appropriate reliable evidence to form a reasonable opinion. The standards suggest to be directed by the persuasiveness of the evidence which in essence is subject to judgment. Auditor is obliged to maintain and develop his or her professional competence. He/she shall observe any particular instructions given by the partners or by the general meeting or equivalent governing body, insofar as these instructions are not in conflict with the law, the articles of association, the rules, the deed of partnership, international auditing standards, good auditing practice, or the principles of professional ethics.

An auditor or his/her assistant is not permitted to disclose to an outsider any information received while carrying out the duties, unless it is otherwise provided. It is observed that generally auditor performs his activities within the scope of legal validation. Prior to 1964, it was quite onerous for a third party user of financial statements to sue an accountant in the United Kingdom for negligent misstatements. This was essentially because of the prevailing view that there is no liability for negligent misrepresentation made by one person to another who had relied upon it to his detriment, in the absence of any contractual or fiduciary relationship between the parties or fraud. For years a debate has rumbled along in auditing over what ‘ought to be’. Practitioners generally argued that auditing was an applied discipline and meeting market expectation by expressing the opinions on corporate

financial statements was sufficient. So from legal construct it can be said that auditors have met the demand of the society mostly.

We found that auditors have socially constructed the concept of expectation gap in order to justify their difficulties to meet the public's expectations. In other words, the audit profession claimed its role is to protect the interests of all audit stakeholders but it is unfortunately not sufficient to meet their expectations. Serving public interest appears as an ideology which is supposed to guide the action of the auditors whereas their efforts are oriented to protect themselves from audit failures and auditor litigations. The expectation gap acts as an "excuse" invented by the profession to get away from direct condemnation.

It is the primary responsibility of management to detect and prevent fraud but auditor has an important role to play to the prevention and detection of fraud. Society expects that auditor will help to detect the misstatement and fraud done by management and will act to their best interest. But it's a common misconception which creates the expectation gap. The changing nature of audit objectives has given rise to public's expectations. Today, we admit that there is a gap between public perceptions of auditors' responsibilities and what auditors really do. In others words, what we expect from the audit function, differs from the profession's understanding of its duties. According to Christopher Humphrey expectation gap can never be removed, it can be reduced. Auditor acts in the relationship of reciprocity which means that both parties will protect each others interest but in a legal way.

Here the parties are auditor and management. Auditor has more reason to attach with management rather than shareholders. And at the end of the day auditor is a human being and thinks rationally about his self-interest and he tries to maximize it. No human being is hundred percent perfect. Auditing is a value- adding function which creates credibility of information presented on the financial statements. Society generally has faith on the assurance provided by the auditor. But auditors are incapable of meeting society's demand fully, because it is impossible to remove expectation gap wholly. By renting reputation audit can amplify the trustworthiness of its function and meet up society's demand and thus can reduce the expectation gap.

Conclusion

Audit emerged because society demanded. It is a demand driven discipline that has functional, legal and social construct and these constructs performed as a catalyst to the surfacing of audit profession. With the advancement of civilization, audit emerges as a separate discipline & contributes to the economic & social advancement. Our resources are scarce and those resources are owned by different stakeholders. To manage these resources and property another party was assigned called agent. So here comes the conflict of interest between the principles (owner) and the agents (manager). To lessen the conflict of interest, a third party arises here to serve as an assurance provider who is known as auditor.

The original purpose of the audit was to assure that honest and accurate accounting for money and property had been performed in the affairs of state, in the services of governments and other public bodies, and in the affairs of early businessmen. As time has passed, the concept of auditing has

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enlarged in line with economic and industrial developments. Now-a-days audit serves a vital economic purpose and plays an important role in serving the public interest to strengthen accountability and reinforce trust and confidence in financial reporting. For that reason changes have been taken place to promote greater transparency in the audit and accountability in auditors but there are continuing demands for further improvements to be made. Audit profession must try to maximize the benefit of the audit service and does its best to protect the interest of the various stakeholders and try to fulfill the expectations of the society.

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