

# Historical Evolution of Audit Theory and Practice

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**Abstract** - The separation of ownership and control due to industrial revolution and expansionary system of businesses has brought the need for checks and balances by the owners of the businesses. Decision making requires information that is exhaustive, consistent, reliable, and credible and such there is need for cross-examination of records for effective decision making. Starting from fraud detection to attesting to credibility of financial statements are auditing practices. As every field of study has its root, thus this paper examined the historical evolution of audit theory and practice from ancient civilization till present age and focusing on the way forward as regards the future of audit. A desk research was conducted and from the review, it was discovered that lots of transitions have occurred in audit theories and practices over time as business world turns digitalized, thus leading to past audit practices becoming outdated and auditing evolution has reached a critical juncture whereby auditors may not have choice than to adjust to the new technology age system. It is imperative that accountants and auditors ultimately lead the way in adoption and implementation of technology-enhanced auditing.

**Keywords:** Ancient civilization; Industrial revolution; Auditing, History; development

## 1. INTRODUCTION

Information is power in taking crucial decisions by human beings relating to their daily living, as important as information is, it could as well be disastrous and result to total collapse of lives and businesses. Every stakeholder desires credible and reliable information in their decision making and this call for checks on the records to ensure credibility. In reference to financial statement of corporate bodies, several users, both internal and external, are involved; it is imperative for such information to be accurate and complete to drive consistent decision by the users of the information (Kumar & Mohan, 2015)[22]. The consequences of possessing unreliable information is not only detrimental to the decision makers but also to the firm itself and the society at large; banks as a stakeholder may incur substantial loss if it grants loan based on incredible information, employees may become jobless, likewise other investors tends to lose their investments. In curbing information incredibility, independent examinations of financial statements are invented by various users, and this has been in practice since the emergence of industrial revolution till current period. It is believed that auditing the financial statement would lead to its credibility, objectivity, reliability, completeness, and accurate enough to guide users in making meaningful and unbiased decision.

Every field of study including “auditing” has root which can be traceable in literature through existence of historical records. R. G. Collingwood said, “By understanding the past, we incorporate it into our present thought and enable ourselves by developing and

criticizing it to use that heritage for our own advancement”. Also, John R. Wildman made a statement “Each new generation must learn for itself. But each new generation will think more intelligently if it knows what its predecessors have thought and done”; thus mapping the history and development of auditing can be benched on the assertion of Collingwood and Wildman (Stettler, 1994)[34]. The need for auditing arose due to the wideness in the complexity and interconnectivity of the society; explosive expansion of business activities and industrial transition resulted into the emergence of auditing (Zhang, Pawlicki, McQuilken, & Titera, 2012)[39].

According to Owolabi, Jayeoba and Ajibade (2016)[29], the root of audit could be traced to the latin word “Audire”. This word has gained several attentions since its first use and it has been explained in diverse ways as check, control, review, inspect, examine, among others. Audit process started in most of the ancient civilized world of Rome, Greece, China and Egypt where clerks were chosen in monitoring and checking the goods of the merchants; over the centuries, auditing has evolved from traditional to modernized audit system (Audit Monk, 2017)[3]. At the beginning, the focus of auditing is to detect frauds and ensure proper records of source documents. Auditing has taken a new dimension from fraud detection to laying credibility to information reported but those in the affairs of the firm. It has become a dynamic process targeting at meeting the needs of the stakeholders

## 2. EVOLUTION OF AUDITING

Evolution of auditing has been widely discussed in literature, Owolabi, Jayeoba and Ajibade (2016)[29]; Teck-Heang, and Md-Ali, (2008)[35]; Kumar and Mohan (2015)[22]; specified that the evolution of auditing emanated before 1700 and its development has been classified into five chronologically stages.

**Prior 1700:** the people of the State, Scribes were referred to as Auditors working under the Audit Ordinates (Kings, emperors, Churches, and the state). This practice was well known and discovered in 1394 in the City of Pisa as well as Italian City State. The major focus of audit as at then was to ensure that there was no occurrence of defalcation in government accounts and this was usually conducted by the government officials (Brown, 1962). The major reason for carrying out audit during this era was to detect and punish the thieves for the funds changing direction, and, to protect people's assets which was the propositions of policeman theory.

### 2.1 Policeman Theory

In line with Hayes, Dassen, Schilder and Wallage (2005)[18] postulation, the policemen theory suggested the responsibility of auditors solely rests on detection and prevention of fraud. These functions seem complex and serious considering the contemporary auditing functions where auditors are saddled with the responsibility of provision of reasonable assurance and verifying the truth and fairness as contained in the auditing standards. However, before now, this seemed not the case, according to policeman theory, the auditing function then, was searching, discovering, and prevention of audit as the responsibility of auditors. The theory suggested that it is the responsibility and duty of auditors to search, discover, and possibly prevent fraud occurrences in companies. Fraud detection and prevention was the hallmark of audit, however, according to the new auditing standards, the primary objective of an audit is not fraud detection, rather an expression of a true and fair position of the financial statement prepared and presented by the management.

The new International Standards on Auditing stipulates that auditors are to provide a reasonable assurance and authenticate the true and fair position of the company's financial statements. The issue of fraud detection and prevention as a sole audit exercise had raised lots of debates in literature, especially where cases of fraud, insolvency, and bankruptcy have been recorded months after a true and fair expression report had been expressed in the financial statement of clients audited by the auditors. This has put huge reservations, reasons to doubt the thoroughness and quality of audited financial statements. This has put the auditors under high pressures and instigated a wide expectation gap between what the public expected from the auditor's report and what the auditor has so far offered in the financial statements.

**1700 – 1850:** Till this period, Auditing has not been fully developed; it was still a checking activity but has expanded its scope to other regions of the world. According to Boyd (1905)[5], Brown (1905)[8], and Lee, (1986)[23] during this era, what was known as auditing was record checking and it was discovered in the ancient civilizations of China, in Egypt as well as in Greece. The present-day audit got its root from the checking activities which occurred around 350 B. C. in Greece. Similarly, the ancient Exchequer of England set up during the ruling of Henry 1 between also 1100 and 1135 in England also engaged in such checking activities as obtained in Greece. Gul, Teoh, Andrew, and Schelluch (1994)[17] reported that checkers were appointed as audit experts saddled with the responsibility of ensuring that all transactions relating to revenue and expenditures were appropriately documented and accounted for. The officers engaged with proper accountability and documentation during this era were the first to be referred to as "auditor". The focus of audit in this era was for fraud prevention and detection (Abdel-Qader, 2002)[1]. Similarly, these activities of account checking were discovered in States of Italian City; where the Merchants of Florence, Geneo and Venice engaged checkers in cross-examining the wealth (money) brought by the sailing-ships' Captains on their returns from the Old World and within boundaries of the Continent of Europe. There was no industrial evolution during this era and majority of businesses were managed by the owners, thus no agents to monitor through audit. Conclusively, the focus of audit in 1700-1840 was basically to prevent fraudulent activities and to ensure that officers saddled with fiscal responsibilities were honest and accountable (Fitzpatrick, 1939)[14].

**1840s-1920s:** Ricchiute, (1989)[32] explained that this was an era of industrial revolution especially in the United Kingdom (Gill & Cooserat, 1996)[16]. Brown (1962)[7] opined that the emergence of industrial revolution led to expansions in business operations into large-scale structures, which brought corporate system of enterprise into existence. The production operations developed from manual-based to machine -based; factories of large capacities were established; there was need for huge fund for facilitating the boom in the expenses as a result of the industrial expansion. The need for huge capital during this era of industrial evolution led to the existence of third parties in finance, called intermediaries; responsible for proving funding means for the establishment of commercial undertakings and industries (Abdel-Qader, 2002)[1]. This era birthed stock market, being a new system, it was highly unregulated with waving speculations in stock prices. Due to this, lots of financial failures occurred which led many investors into unlimited liabilities and business failures. According to Porter, Simon, and Hatherly (2005)[30], failures of businesses during this era created the need of regulated and registered auditing practices as a profession in order

to protect the collapse of businesses and save investors from huge debts. This also led to the enactment of first Joint Stock Companies Act in 1844 in the United Kingdom (Brown, 1962)[7].

According to the Joint Stock Companies Act enacted in 1844, it was stipulated that “Directors shall cause the Books of the Company to be balanced and a full and fair Balance Sheet to be made up”. Leung, Coram, and Cooper (2007)[24] mentioned that the Act contained the right and procedures for hiring auditors to carry out account verifications of corporate bodies. From 1900, the entities were required to make available the balance sheet to the investors in accordance to the requirements of the Act and as stipulated by the statutory audit under the Companies Act 1862 of United Kingdom.

Porter, et al (2005) [30] asserted that during this era, managers of companies were the accountant saddled with the responsibilities of ensuring that resources committed to his care were effectively and efficiently utilized and duly accounted for. Also, during this era, it was the selected shareholders, chosen by the entire shareholders as their representatives, who were used as auditors, cross-examining the records provided and presented by the managers. Brown (1962)[7] professed that the audit practices in 1840s to 1920s were mainly verifications of records of business transactions carried out by the managers; ensured that accounting records were properly kept; and financial statements were well prepared and presented as stipulated by the Act. Audit practice during this era brought the involvement of the court because of the enacted Act which was a binding law (Porter, et al., 2005)[30]. Dicksee (1892) cited in Leung, et al, 2004, concluded that audit functions during this era goes beyond fraud detection but also the detections of technical errors committed by the managers as well as errors of principles. Responsibilities of auditors in 1840s to 1920s was to detect fraud and portray the liquidity position of the corporate bodies as shown in their balance sheet.

**1920s-1960s:** This era brought the extension of full revolution of audit practices from United Kingdom to United States due to economic expansion which occurred in the United States between 1920s and 1960s. this period birthed the recovery from the Crash of Wall Street in the United States, resuscitating the economy from financial depression. Business entities were crowded with investments, which facilitated rapid development of the stock market and credit-financing Institutions. The expansion in businesses due to industrial revolution led to the separation of the ownership from management duties; engagement of agents in managing the businesses. During this era, detection of fraud was not the primary reason for audit but ensuring that the financial statements prepared and presented by the management to the shareholders were credible and reliable in taking crucial decision, while fraud and error detection could occur accidentally. Also, assessment of the financial statement for true and

fair view began at this period and led to the increased expectation of users of financial information.

In 1920s to 1960s, large business corporations emerged with huge volume of business transactions and this led to sampling audit as all the books of accounts could not be verified (Brown, 1962)[7]. The sampling depends on the size and the nature of business engaged in by individual corporations to address the issue of materiality effect (Queenan, 1946)[31].

The critical principles of auditing were made prominent during this era due to reported cases of misappropriations like the case of McKesson and Robbins (1938) and that of Royal Mail However, the audit of profit and loss account was only made mandatory with the enactment of Securities and Exchange Commission Act was enacted in United States of America in 1934 and Companies Act in United Kingdom in 1948. The Act stipulated that audit of profit or loss account was mandated. The development of auditing was greatly affected by the evolvement in socio-economic environment. Auditors relied on internal control of the corporations during this time since not all the records could be verified due to the volume; audit evidences, documentations and working papers were derived from both internal and external sources; the focus of audit was to verify the true and fair view of financial statements; audit was not limited to profit or loss account as examination of balance sheet was involved and germane; and physical observation of external and other evidence outside the “book of account” (Porter, et al., 2005)[30].

Audit practices during this era aligned with the propositions of auditing theories as developed by several theorists; namely, the agency theory (as mentioned by Berle and Means in 1932)[4]; Lending Credibility Theory, and theory of inspired confidence developed by Limperg (1932)[26].

## 2.2 Agency Theory

According to Nwachukwu, Ogundiwin and Nwaobia (2015)[28], agency theory was first mentioned by Berle and Means (1932)[4] but popularized by Jensen and Meckling (1976)[21]. The theory describes the principal-agent relationship that exists between owners of the firms and the management team that runs the firm. Scholars have argued that the theory assumes that both parties want to maximize their own utility. Therefore, it is possible that not all the actions of the agent are in alignment with the preferences of the principal, which is wealth maximization. The principal wants to control the actions of the agent by monitoring the agent. These measures of the principal leads to additional costs referred to Agency costs and incentives to the agents which invariably reduce the company profitability (Porter et al., 2005)[30].

## 2.3 Lending Credibility Theory

The lending credibility theory suggested that the primary function of the auditors is to add value and credibility to



the financial statement prepared by the management. According to the theory, credibility is a priceless and inestimable commodity that can be offered by the auditor to the public. In other words, the lending credibility theory posited that a financial statement is absolutely void and insignificantly valueless if credibility lacking. The theory posited that credibility enhances users' confidence in using the financial statements, it can add value to investment decisions and that reliability of financial statements is a virtue that every audited financial statement should possess. Generally, it is believed that auditing will add credibility to financial statement and at the same time reduce information asymmetry created by the separation of ownership and management, resulting in possible bias and conflict of interest, especially where managers often times are seen to be opportunistic in their action since they have privileged information that the other stakeholders do not have, as such they can use it to pursue their own interest to the detriment of the shareholders and other stakeholders. The demand and supply of audit services in the recent times has gone to the point that a joint audit is required to enhance more credibility and lend credence to the financial statements. Accordingly, a joint audit is being solicited based on the prior cases of compromised and financial scandals of high profile cases of the likes of Enron and Arthur Andersen, some of the problems started when Arthur Anderson acted and played dual roles of management in preparing the financial statement and turn back to play the role of statutory auditor to the same financial statement, this incident led to one of the problems of doubts to the credibility of such reports.

## **2.4 Theory of Inspired Confidence**

The facts behind the theory of inspired confidence arose due to outsiders' interest in the affairs of the company, and incidentally, these outsiders are not privy to lots of information about the affairs and running of the company, hence high need of audit services and the supply of that services lie in the hands of auditors. The theory of inspired confidence was developed by Limperg in the year 1932. This demand is in response to the desire of users of financial statement otherwise called interested third parties in the affairs of companies, who are craving accuracy and accountability from the managers saddled with the responsibility of managing the operational activities of the company in return for their investments and also to ensure that the report prepared by the managers reflect the true position of the affairs and health condition of the companies. Theory of inspired confidence suggests that auditors' certification in its expression of opinion after an audit exercise gives the shareholders and other stakeholders' confidence regarding the credibility and reliability of the financial statement of companies. The issuance of routine financial statement of the company gives investors and interested parties bases

to take informed investment decisions and value to expected returns for their investment from the company (Hayes et al., 2005)[18].

The outsiders expect accountability to be realizable through periodic issuance of financial statement to show information about the company. These third parties believe that it is possible that managers could provide a biased financial statement owing to possible conflicts of interest, and more so, the managers do have privileged information not available to the shareholders, since the shareholders do not have direct and complete control of all documents nor have the expertise to verify the facts as presented, it is rather natural and proper that auditors who are independent persons are allowed to vouch for the credibility and true position of the financial report prepared by the management. As expected, auditors should endeavor to meet the growing demands of audit services to enable the user make investment and portfolio diversifications decisions. The utmost desire of the public is that auditors should live to this responsibility of fair representation and true independence to meet public expectations.

**1960s to 1990s:** As the economy of the World kept evolving; businesses become more-technology driven; the corporate transactions turned more complex, and the need for effective capital market and more credible and reliable information by the stakeholders. The major role of auditing during this period (1970s) was to lay credibility on the financial information and to strengthen the effectiveness of the stock market (Porter, et al., 2005)[30]; The New York Times on 6 April 1975 as cited in Leung, Coram, Cooper, Cossarat. and Gill (2004)[25]. Leung et al., (2004, p.10)[25] stated that "the duties of auditors, among others, were to affirm the truthfulness of financial statements and to ensure that financial statements were fairly presented." Davies Paterson, and Wilson (1999)[12] reported that auditing at this time took a new turn as auditors still relied on the internal control similar to the practice in 1920s and 1960s; the ascertainment and documentations of the system of accounts of the corporation in accordance with the information flows and verification of internal control were carried out by the auditors.

Effective internal control lessens the burden of auditors in terms of the level of detailed substance testing to be conducted. According to Salehi (2008)[33] reliance on internal control system become cumbersome, inefficient and expensive as expansion of corporations increased, auditors made use of more analytical techniques which led to the development of risk-based auditing in mid-1980s (Turley & Cooper, 1991).

The use of computers and advanced technology-driven auditing tools emerged during this era, which facilitated quick audit procedures (Porter, et al., 2005)[30]. Leung, et al., (2004)[25] reported that during this era, the scope of audit practices expanded beyond the shore of laying

credibility to financial statements as auditors engaged in other advisory services

**1990s-present:** Rapid changes occurred in audit practice during this era. Other engagement by auditors became more prominent to the extent that in 2000, auditors earned more from it than the normal audit services in United States (Boynton, Johnson, & Kell, 2006)[6]. Also, business risk approach to auditing became fully implemented Adoption of the business risk approach in turn enhances auditor's ability to fulfill these responsibilities (Porter, et al., 2005)[30]. The reported cases of financial scandals and collapse of corporation especially giant companies, for example Xerox, Enron, Waste Management, Sunbeam, WorldCom, and Adelphia; became alarming and worrisome during this era and questioning the credibility of financial statements and confidence in the work of auditors (Boynton et al., 2006)[6]. This resulted to high level of litigation and majority of big accounting and auditing firms separate their consulting functions in the companies with stifled policy to attain audit independence and improved the quality of audit. According to Leung et al., (2004)[25], strong reforms were made by the accounting bodies, stock exchange commissions as well as governments to strengthen the practice of audit during this era.

### **3. HISTORY OF AUDITING – NIGERIA PERSPECTIVE**

Before 1960, when Nigeria got independence, it was under British colonization and nearly all the activities of the nation were controlled by British rulers. According to AbdulGaniyy (2013)[2] the first set of people to be referred to as accountants in Nigeria were trained under British rulership. According to Owolabi, Jayeoba and Ajibade (2016)[29] company ordinances enacted prior to 1960 stipulated that companies were only statutorily required to hire auditors but the requirements for the appointment were not specifically stated in the ordinance neither did it reflect that the auditors should be qualified accountant. Therefore, most of the people appointed as auditors during this period were not British trained' accountants nor qualified accountants. Although, with the lapses in the ordinance, Nigeria still had qualified accountants trained by the British; few of them qualified as Chartered accountants under professional accountancy bodies of England and Wales and that of Scotland of which Pa. Akintola Williams was among the few. He was founder of the first and the oldest Indigenous Accounting firm in Nigeria. The firm formerly registered as Akintola Williams & Co. (Now Akintola Williams Deloitte) was established in 1952. Over the years, Deloitte has built up a strong representation in several major African cities and has successfully undertaken a variety of business advisory and consulting assignments for clients in Nigeria and elsewhere in Africa.

In addition, prior 1960 audit practice was not restricted to companies but also to government. Public accounts have been subjected to audit as far back as Colonial era. In 1866, Colonial Branch of the Exchequer & Audit Department was established and responsible for public account audits. There was a development in 1910 when the Colonial Audit Service, reporting to the Secretary of State of the Colonies was founded. Also, in 1910, there was an appointments of Southern and Northern Nigeria heads of Audit. The merger of Southern and Northern Nigeria Protectorates led to the establishment of Nigeria as a nation in 1914; and at that time, there was a development of an audit section as a division of the Central Secretariat located in Lagos. The first Audit Ordinance in Nigeria was enacted in 1956, and the Ordinance (s7) stipulated that "the Directors of Audit was responsible to the Governor, but under the supervision of the Director General of the Overseas Audit Service". In 1956, there was a creation of Federal Audit Department as a section within the Ministry of Finance. Nigeria was later divided into three regions, namely, the Western region, Northern region, and the Eastern region with each region having its own Director of Audit.

In 1960, after Nigeria became independent, the need for the Country to have its own accountancy body became prominent and the qualified chartered accountants in Nigeria united to establish The Association of Accountants in Nigeria (AAN). The Association was incorporated in 1960 but obtained its legal recognition with 250 members in 1965 as the Institute of Chartered Accountants of Nigeria (ICAN, 1965), established by an Act Parliament (No. 15). Subsequently, other related Professional bodies were established; the Association of National Accountants (ANAN) was established in 1979, incorporated in September 1983 although became Chartered on 25 August 1993 by Decree 76 of 1993 (IFAC, 2019). Also, The Chartered Institute of Taxation of Nigeria (CITN) was established in 1982 and Chartered by Act No. 76 of 1992 to regulate Tax Practice and Administration in the country. The Financial Reporting Council (FRC) of Nigeria was established by the Financial Reporting Council of Nigeria Act, No. 6, 2011. Until 1993, only the members of the ICAN were entitled to practice as accountants and statutory auditors in the country but since the establishment of the FRCN in 2011, this activity has been monitored and controlled by FRCN. FRC represents the umbrella of all the Accounting Professional bodies in Nigeria under which all the Professionals operates. Presently, ICAN has approximately 21,850 active members as reported by the institute as financial members as at 20<sup>th</sup> October, 2020 (ICAN, 2020).

#### 4. AUDITING – PRESENT AND THE FUTURE

Over decades now, Computer Assisted Audit Techniques (CAATs) comprised new developmental audit strategies designed for more effective and efficient audit practices. As effective as these techniques seemed, it has limitations; and with the speed of development in technology; the techniques had lost its recency and became outdated. CAATs operations were not similar to real-time data streams and not capable of resolving fraud occurrence or irregularities optimally. According to Cangemi (2010)[9], the era of traditional audit practices has passed, rather than backward-looking audit, business of today requires proactive audit practice which is forward-looking. Cangemi (2010)[9] believed that there is a need for real-time solutions, and that firms should transit from using CAAT to more advanced audit techniques that is technology driven in conformity to projected business evolvement to enhance stakeholders trust in audit reports.

According to Teeter and Vasarhelyi (2011)[36] firm data management, nature of information system and reporting software are determinants of the procedures to follow in auditing such firms. A manually prepared reports can only be examined manually while automated and more robust auditing process are engaged when the records of the firm are kept using automated system; and also, their reports are prepared using highly-tech driven accounting software. To determine the potential utility of a robust auditing system, an organization should first consider the extent to which its data is automated. It is suggested that for a firm to achieve more efficient and effective audit, such should automate its reporting process; as fraud, errors and irregularities are easily detected through automated audit than manual. A technology-driven business processes will possibly enhance the quality of audit.

Digitalization has broadened the information needs of different stakeholders in the firm and the advent of technology-driven business environment, decision making process is faster than the traditional perspectives. The need for speedy delivery of information to the stakeholders (investors, creditors, customers, employees) is paramount; as business owners no longer wait till the traditional financial statements are presented to the users before taking decisions. As stakeholders requires spontaneous information, management should also be careful of the credibility of the information made available which drive the need for consistent audit process. In order to ensure that the information available to stakeholders are credible and reliable for decision making; the need for all-round auditing processes is highly demanded for firms to effectively edge over the available limited resources and take competitive

advantage in the present and upcoming real-time global economy (Lombardi, Bloch, & Vasarhelyi, 2014)[27]. Apparently, future audit perspective is no longer a new development as diverse of techniques have been suggested for its achievement (Gale, Ascui, & Lovell, 2017)[15]. Remote auditing has been in practice but its full actualization cannot be overemphasized now than ever as most organizations, audit firms inclusive, work from home. Preparation for the future of audit placed a reality on accounting firms that there is need to develop tech-savvy working-group who can respond faster and more efficiently. As the world is evolving, auditing with advanced technology is necessary, more emphasis should be placed on critical reasoning skills than traditional view. Likewise, auditing requires a healthy sense of professional skepticism, most especially, in remote auditing (CPA, 2020)[11].

#### 5. CONCLUSION

Auditing, dated as far back as found in Ancient history and lots of reforms have been made to its practice since then till recent time; despite this, there are still cases of financial scandals occurring in companies across the globe, even among firms with qualified audit reports, audited by giants of audit (Big-4). Also, the outbreak of global pandemic has reshaped accounting and audit professions, and a proof that existing system of audit process need to be braced up to the level of evolutions in business. Although, nothing new in technologies used in conducting audit in recent time but its full application is more required now, as audit needs to pace with the real-time economy. Therefore, auditors may not have choice than to adjust to the new system. The outbreak of COVID-19 has taken businesses from the manual view to technology driven, likewise the audit process (Fischer, 2020)[13]. According to Castka, Searcy and Fischer (2020) the use of Technologies has facilitated the transition in audit practice from physical to remote auditing during the COVID-19 crisis. With the current situation of the economy, accounting and audit practice should be fully technology-driven. It is imperative that accountants ultimately lead the way in adoption and implementation of technology-enhanced auditing.

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