AN IDENTIFICATION, EVALUATION AND DEVELOPMENT OF THE THEORETICAL FRAMEWORK OF U.K. COMPANY AUDIT PRACTICES.

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Declaration

I hereby declare that this thesis has been composed by myself and is the result of research carried out by myself.

Rodney J. Ferrier
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ABSTRACT
This thesis is concerned with improving the extent to which the theoretical framework of U.K. company audit practices is understood. The research reported upon herein was carried out in three phases. Firstly, the theoretical framework within which contemporary U.K. company audit practices have been derived was identified. Secondly, that theoretical framework was subjected to a detailed evaluation in order to identify any inadequacies contained therein. Finally, the theoretical framework was developed in the light of the more important of the identified inadequacies.

The thesis consists of four parts. Part 1 is concerned with the nature of company audits, and establishes the scope and limitations of the research project. An examination of the nature of professional organisation suggests that the U.K. auditing profession has responsibility both for establishing the theory and for prescribing the practice of company audits. Since the statement of Auditing Standards and Guidelines contains the clearest expression of theoretical justification for recommended practices, that document is adopted as the source within which the theoretical framework of U.K. company audit practice is to be identified.

Part 2 begins with an examination of the component elements of theories in general and of prescriptive theories (such as company auditing) in particular. The process by which such theories develop is considered and, finally, the theory underlying extant company audit practices is identified on the basis of a detailed examination of the Auditing Standards and Guidelines.

Part 3 subjects the identified theory to a detailed appraisal and a number of criticisms are made. One of the most important criticisms concerns the lack of a foundation to explain the nature and purpose of the company audit function.

Part 4 develops the theory in a way intended to overcome the major criticism levied in Part 3 by providing a theoretical foundation for company audit practices. In so doing, the "fundamental" propositions of U.K. company auditing are identified. It is argued that it is essential to subject such propositions, where possible, to empirical analysis in order to ensure that the theoretical foundations of company audit practices are secure. To facilitate such empirical analysis, some important issues in the verification of company audit propositions are discussed and a pattern of possible future research into the theory and practice of U.K. company auditing is sketched.

By formally structuring the content of the Standards and Guidelines, the theoretical framework of U.K. company audit practice has been identified. This framework plays a number of roles. It provides a body of theory which guides audit research. It acts as a body of knowledge which inhibits the development of inconsistent audit practices. It provides a framework for the solution of problems as they arise and for the determination of appropriate audit procedures as the business environment changes. Finally, it provides a sound basis for arguing against claims that the nature and purpose of the company audit are neither clearly stated nor clearly understood.
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INTRODUCTION

In recent times two important documents, issued under the auspices of the U.K. auditing profession, have suggested the need for an examination of the conceptual basis of company auditing. The first was a report entitled "The Impact of Change on the Accountancy Profession", otherwise known as "The Flint Report" (after its author). This report was published by the authority of the Council of the Institute of Chartered Accountants of Scotland in 1980 and recommended, inter alia, that there should be "a fundamental reappraisal of the function of...auditing measured against the needs of contemporary society". In the foreword, the President of the Institute commended the report "to all those who are concerned to see the existence of, and a future for, an accountancy profession". There can be little doubt that the issues raised in that report were considered to be very important.

More recently, in May 1982, the Director of Research at the Institute of Chartered Accountants in England and Wales made a similar plea for fundamental theoretical research into company auditing. An important research project was stated to be the establishment of "guidelines for decisions in auditing". This project would consider the purposes of an audit and, using that as a base, attempt to develop a framework for assessing the costs and benefits of alternative auditing procedures.

Such calls for basic theoretical research into auditing seem to have come about partly as a result of disagreement and uncertainty as to the nature and purpose of the audit function. Consider, for example,
the following items which appeared in recent issues of Accountancy, the journal of the Institute of Chartered Accountants in England and Wales;

In their report [the Hundred Group] speak of a 'widening gap in the relationship between client and auditor', and suggest that 'unless both take steps to repair this situation, there is danger of developing loss of confidence' (March 1981) 6

There is ample evidence to show that the vast majority of non-financial management regards the overriding purpose of the audit as being to detect fraud, which it is not... (June 1981) 7

Why does the auditor not attest to the reliability of all financial information provided as he used to do when it consisted only of the annual accounts? (July 1982) 8

Firms are not unanimous in identifying precisely what the actual service or benefit provided to society by the auditor is... (November 1982) 9

Such questions and attitudes may be due, in part, to the absence of a precise statement of the theoretical framework within which company audit practices have been derived. Ideally, a precise statement of that framework would specify the scope and limitations of the audit function, justified in terms of the satisfaction of a social need, and would explain the purpose of particular audit procedures.

The objective of this thesis is to answer calls for a "study into the 'conceptual framework' of auditing", for a "thorough examination of the underlying purpose of the audit, of the present-day role of the auditor and of the benefits derived from auditing..." 10. In answering these calls with respect to company auditing, the study will provide the U.K. profession with a set of explicit guidelines to help in the solution of problems and in the answering of
fundamental criticism in the field of company auditing.

In 1961, Mautz and Sharaf\textsuperscript{11} published a seminal work on audit theory. In this work, The Philosophy of Auditing, they contended that

there is a theory of auditing,... there exist a number of basic assumptions... the understanding of which will be of direct assistance in the development and practice of the art of auditing\textsuperscript{12}.

Mautz and Sharaf went on to specify a number of basic postulates "arrived at through [their] own best judgement after considerable thought and experiment"\textsuperscript{13}, upon which a theory could be built.

This thesis is also concerned with improving the extent to which theories of auditing are understood. However, it is based on a belief that there is a way to identify the theory of U.K. company auditing which depends rather less on "best judgement" than that adopted by Mautz and Sharaf. This methodology involves examining the content of professional pronouncements which require the implementation of certain practices in order to identify the assumptions underlying those practices. Adopting this methodology will enable the identification of a body of assumptions which can at least tentatively be accepted as guiding the solution of new problems in company auditing as they arise. If the interrelationships between these assumptions are specified and the precise derivation of company audit practices explained, it could ultimately be possible to solve new auditing problems entirely within an established theoretical framework.

Such an approach, if successful, would have a number of advantages. It would provide a body of theory which could form a common
foundation for research efforts, thus providing guidance to researchers interested in improving and developing both the theory and practice of company auditing. There would exist a body of knowledge acting to inhibit the development of inconsistencies in audit practices. There would be a framework for the solution of problems as they arise and for the determination of appropriate audit procedures as the business environment changes. There would be a frame of reference within which auditors could exercise judgement when faced with unfamiliar circumstances. Finally, there would be a sound basis for arguing against claims that the nature and purpose of a company audit are neither clearly stated nor clearly understood.

The existence of professional pronouncements which contain some explanation and justification for recommended practices, together with the existence of consistent patterns in those practices, suggests that there exists a theoretical framework within which those practices have been derived. However, there has been no attempt to examine the professional pronouncements systematically so as to identify that theoretical framework. As a result, the theoretical framework has not been clearly stated and there has been no attempt to ensure that it is complete and consistent. Similarly, there has been no attempt to ensure that practices derived within the theoretical framework are consistent, justifiable and appropriate.

These issues are approached in this thesis in three phases. In the first, it is intended to identify the theoretical framework within which contemporary U.K. company audit practices have been derived.
In the second, it is intended to subject that theoretical framework to a detailed evaluation in order to identify any inconsistencies or inadequacies contained therein. In the third, it is intended to develop the theoretical framework in the light of those inadequacies which are identified.

In order to implement these phases, the thesis is structured in four parts. Part 1 is concerned with the nature of company audits and the role and purpose of company audit theory. This part begins with an identification of the major participants in the company audit process and presents one possible explanation for the existence of the company audit function. The primary objective of this introductory review is to establish the scope and limitations of the research project. Company audit practice and theory are then examined and the relationship between theory and practice is considered. It is argued that the U.K. auditing profession has responsibility both for establishing the theory and for prescribing the practices of company audits. Of the pronouncements issued by the U.K. auditing profession which specify audit practices, the Auditing Standards and Guidelines\(^1\) contain the clearest indication that the profession is concerned to provide theoretical justification for recommended practices. Accordingly, the Auditing Standards and Guidelines are adopted as the most appropriate source for the identification of the theoretical framework of company audit practice in the U.K.

Part 2 is concerned with specifying the theoretical framework within which U.K. company audit practices have been derived. It begins with an examination of the component elements of theories in general and
of prescriptive theories (such as company auditing) in particular. The process by which such theories develop is considered and, finally, the theory underlying extant company audit practices is identified through a detailed examination of the content of the Auditing Standards and Guidelines.

Part 3 focusses attention upon the foundations and structure of the identified theory. In this part, the theory is subjected to a detailed critical appraisal and a number of inadequacies are noted. One of the most important of these inadequacies is the lack of a theoretical foundation to explain the nature and purpose of the company audit function and, thereby, to justify its continued existence.

The final part of the thesis is an attempt to develop the theory in a way which overcomes the criticism levied in Part 3. This development provides a theoretical foundation for company audit practices and, in so doing, enables those propositions which may be said to be "fundamental" to be identified. It is argued that such propositions are of extreme importance to company audit theory in that if they are shown to be false, a substantial and fundamental change to that theory and to the practices derived within that theory would be necessary. Accordingly, it is suggested that it is essential to subject them, where possible, to empirical analysis in order to ensure that the theoretical foundations of company audit practices are secure. Finally, some important issues in the empirical verification of company audit propositions are discussed and a pattern of possible future research into the theory and practice of U.K. company auditing is sketched.
CHAPTER 1.

THE COMPANY AUDIT FUNCTION.

The first chapter of this thesis is devoted to a general description of the environment of U.K. company audits, and to a discussion of the company audit process. The purpose of this chapter is to provide a framework for more specific subsequent discussion and to delineate precisely the area under study.

Section 1 is a consideration of the nature of the company form of organisation in which the audit process occurs and of the behaviour patterns of participants in companies. In this section the nature of the relationships between company participants is also considered, thereby establishing the basis for one possible explanation for the existence of the company audit function.

In section 2, a possible explanation for the company audit function is presented in terms of the accountability relationships existing within limited companies. As one aspect of this explanation, the roles of accounting and auditing are considered in terms of the discharge of accountability by certain classes of company participant. Although the content of this section presents only one of a number of possible explanations for the company audit function, it does provide a means of identifying those groups who have an interest in company audit reports. In addition, it enables a very general definition of the company audit function to be established, thus providing a basis upon which the remainder of the thesis will be built.
The third and final section of the chapter draws upon the discussions in the first two sections in order to establish the scope and limitations of the research programme undertaken herein.

In summary, the objectives of this chapter are;
1. to provide a possible explanation for the existence of U.K. company audits
2. to suggest a general definition of the U.K. company audit, and
3. to specify the scope and limitations of the research project which is to be the subject of this thesis.
Section 1. Companies

The U.K. limited liability company is a form of business organisation created under the provisions of the U.K. Companies Acts. Companies so incorporated have a legal persona separate from their owners, are able to buy and sell goods and services, are able to acquire, own and dispose of property and are able to engage in legal actions as corporate individuals. As such, companies may be parties to a wide range of market transactions, from the buying and selling of shares in other companies to the trading of commodities and resources on the world's markets.

In general terms, a company may be considered to enter into these transactions in order to satisfy the common goals of the individuals who participate in that company. Functionally, a company may be seen as an instrument by which goods and services are produced for members of a community by others than those who will ultimately consume those goods and services.

This conception of the company as a technical unit in which commodities are produced is one commonly adopted by economists and is known as the "classical model". Shackle, for example, adopted such a model, saying:

as economists we regard the firm as a policy-making centre controlling a productive activity, [the purpose of which is to] make as large as it can the excess...of the value of its outputs over the cost of its inputs.

An alternative conception of the company, known as the "behavioural model", has arisen from Adam Smith's recognition that the pursuit of a firm's goals could be said to serve the interests of society as
a whole. Smith viewed society as a system which attained states of temporary equilibrium, and in which the specialisation and exchange resulting from the formation of firms created wealth in which all members of society could share. The activities of firms could thus be said not only to create a common wealth in which members of a society may share, but also to act as a factor in the attainment of social equilibrium.

In terms of the behavioural model, a company is seen as a system in equilibrium, which receives contributions in the form of money or effort and offers inducements in return for these contributions and individuals are said to participate in the company in order to satisfy their own goals. Thus, the most important inducement offered to prospective participants in a company is the provision of the means of attaining their own goals. These inducements will include "the organisational goal itself, conservation and growth of the organisation" as well as financial and other incentives which will improve the participants' ability to undertake market exchanges in order to achieve their personal goals.

A fundamental difference between the two models lies in the perceived role of the manager. Under the classical model, the entrepreneur (assumed to be the owner and the manager) determines the nature of the productive process to be undertaken and gains any profits or bears any losses which are incurred. The activity of management is seen primarily as the manipulation of resources. On the other hand, the behavioural model assumes that the role of management is to maintain organisational equilibrium by allocating each participant inducements sufficient to ensure continued
participation. Management is seen as the control group, the members of which, like other participants, have personal goals which they hope to attain through their participation in the organisation. Unlike other participants, though, they are charged with the responsibility for maintaining the existence of the organisation.

Perhaps the most appropriate way of looking at the role of management is to consider that management fulfills those functions posited by both the classical and the behavioural models. Chambers, for example, suggests that in order to gain an adequate sense of the character of the management role it is necessary to consider the company as an economic instrument of production and distribution as well as a cooperative system of voluntary participation;

A business organisation is both a firm in the economists' sense and an administrative system in the organisational theorists' sense, and it is both simultaneously.

The managerial role can therefore be thought of as having at least two distinctive aspects. The first is the responsibility for maximising the future wealth of the company, through the process of resource manipulation (the classical model) and the second is the responsibility for ensuring that, as far as possible, the demands of the various participants are met out of the company's wealth so that continued participation of those groups is assured (the behavioural model).

Both aspects of the managerial role necessitate action in markets, either to obtain the contribution necessary for the firm's productive operations or to ensure the profitable distribution of the product. Each of these classes of transaction will involve distributions of wealth to various groups of company participant.
Since the wealth of a company is limited, it is unlikely that it is possible to satisfy the demands of every participant. Under these circumstances, it is reasonable to assume that participants who are able to wield the greatest power over management will have the greatest likelihood of obtaining their desired share of the available resources. Similarly, it is likely that coalitions between groups of participants will tend to be formed. The members of any group which is able to enter into a coalition with management will be in a position to influence management wealth allocation decisions in their own favour.

The most frequent coalition in companies is between management (the directors) and the owners of equity capital (the shareholders). This coalition is supported by custom as well as statute, and is so pervasive that the classical model of the firm does not distinguish between these groups. Indeed, it is sometimes argued that the primary goal of directors is to maximise the wealth of the shareholders, an argument which results in the consideration of directors merely as agents of the shareholders.

However, to consider directors as nothing more than agents of shareholders is to deny the power that directors have to make decisions despite protestations from the shareholders, and to enter into temporary coalitions with participant groups other than shareholders. Further, it denies the fact that directors constitute a distinct group of company participant, the members of which have their own goals and value systems. More importantly, it fails to recognise the possibility that the interests of directors and those of shareholders might not coincide and that directors could wish to
influence the decisions of shareholders in order to serve their own interests. As will be argued in more detail later, one of the factors which operate to prevent directors improperly influencing the decisions of shareholders is the independent external audit.

These comments concerning relations between shareholders and directors are equally valid with respect to other groups of participant. It is reasonable to suppose that the objectives of directors and those of other groups of participant will not always coincide, and that in circumstances where there is a conflict of interest, directors will attempt to influence the decisions of the other groups. That directors are in a position to be able to attempt this is the result of the relative power of directors vis-à-vis the other participant groups, a power which derives from the fact that other participant groups grant directors the right to enter into market exchanges, or otherwise dispose of resources which are not owned by them.

Four major groups in addition to directors and shareholders can be considered to participate directly in companies; employees, customers, suppliers and financiers. Each of these four groups, by their continued participation, grant directors the power to enter into transactions with resources which have been contributed in the past and to enter into contracts which involve transactions with future contributions of resources. From the point of view of the individual participant, however, the power to deal with future contributions is revocable at any time by a decision to withdraw participation. In the case of shareholders, financiers and other providers of capital, the power of directors to deal with past
contributions might also be revocable by the withdrawal of those past contributions.

It is only possible to ensure continued survival of the firm as long as the various groups maintain their participation. The directors will therefore adopt a number of strategems in an attempt to retain participation by those groupsﬁ. One such strategem, for example, could be the provision by directors of information about past dealings in contributed resources, in order to demonstrate their ability to ensure that contributed resources are used effectively.

However, the provision of information by directors can be a double-edged sword. On the one hand, participants are provided with information on which they can base a decision concerning future participation. On the other hand, directors are given the opportunity to provide misleading information in an attempt to retain the continued participation of other groups, even though continued participation may be unwise.

From the shareholder's point of view, for example, it may be unwise to retain an investment in an unprofitable company. In order to decide whether to disinvest, the shareholder requires information about the profitability of the company. If directors are to ensure that shareholders do not dispose of their shares, it is necessary either to operate profitably or to give the impression that operations are profitable. Since directors are responsible for the provision of information concerning profitability, they have both the motive and the opportunity to generate misleading information. Similar arguments could be presented regarding the other groups of
direct company participant. The requirement for information as a basis for decisions by participants, and the need to ensure that the information is not misleading are the result of the relationship of accountability, which has in turn resulted in the development of the functions of accounting and auditing.
Section 2. Accountability, accounting and auditing.

The relationship of accountability may be said to arise when one party is granted revocable powers by another party. Under such circumstances, the former party is accountable to the latter for the proper exercise of those powers. An inability to account adequately could lead to the revocation of powers which have been granted. Whether powers have been exercised "properly", and whether an account is "adequate" will be matters for judgement by the party which has granted the revocable powers. It is clear that the relationship of accountability implies the use of information in order to judge the propriety of the exercise of power by the accountable party.

The relationship of accountability exists between directors and other participants in companies. On the one hand, directors can be said to be accountable to all groups of participants, for a failure to account adequately could result in a revocation of the power of directors to deal in resources presently owned by participants. For example, directors can be said to be accountable to employees for wages and conditions, accountable to creditors for the adequate servicing of their debt, and so on. Such a relationship of accountability is most apparent between directors and shareholders, where the initial capital of the company has been provided by shareholders who have also given directors the power to deal with that capital. Accordingly, the directors are accountable to shareholders for the way in which they deal with contributed capital.
In addition, some participant groups can be said to be accountable to the directors. Employees, for example, are given powers to deal in the company's resources and could be held accountable by the directors for the adequate exercise of these powers. Similarly, suppliers are given some of the company's resources in exchange for goods and services, and could be held accountable by the directors for the quality and for the timing of supply of those goods and services.

One way in which the duty of accountability can be discharged is by the provision of information. In those cases where it is possible to revoke past granting of powers (i.e. where resources contributed in the past can be withdrawn), the owners might wish to withdraw their resources if they are dissatisfied either with the way in which directors have exercised the powers they have been granted, or with the way in which an account has been rendered. In companies, such a relationship exists between shareholders and directors and between directors and employees. As a result, information systems have developed within firms which enable an account to be rendered by the accountable group.

In the majority of cases, it has been found convenient to report in predominantly financial terms, and the information systems developed to provide these reports have become known as accounting systems. The system for reporting to directors by employees is a part of the management accounting system and the system for reporting to shareholders by directors is a part of the financial accounting system. It should be emphasised, however, that the distinction between management and financial accounting is by no means a
clear-cut one, and the systems often overlap. Indeed, they could both be considered to be component parts of a single accounting system.

Although the discharge of accountability (especially between shareholders and directors) has traditionally occurred through the provision of formal financial reports, it does not necessarily follow that those reports are adequate for that purpose. Normanton considers that "to be accountable means...to give reasons for and explanations of what one does". However, conventional financial statements do not give reasons for the actions of directors and rarely provide explanations of what has been done. Rather, they disclose certain historical "facts" about the financial dealings of the company and might disclose nothing about the extent to which the directors have been successful in attaining company objectives.

Whatever information is provided, accountability will only be discharged successfully where the receiver of the information is able to judge, to his own satisfaction, that the exercise of power by the accountable party has been acceptable and that the information which has been provided is sufficiently reliable to enable the judgement of acceptability to be made with confidence.

Where the members of the accountable group are responsible for the generation of the information by which the exercise of their powers will be judged, there are grounds for supposing that their interest in the outcome of those judgements could conflict with the need to provide information of the necessary reliability. In the absence of any means of verifying the information provided by accountable
groups, the veracity of those groups must be relied upon. Since there are grounds for doubting that veracity, doubts about the reliability of the information could arise. As a result, there will be a need to obtain some indication as to whether the information can, indeed, be relied upon in judging the adequacy of the discharge of accountability.

This argument provides the basis of a possible explanation for the company audit function. The process of examining financial reports provided in discharging an obligation to account may be called an "audit". In terms of the above argument, an audit would be conducted in order to provide some indication of the reliability of the reports under examination. In the context of companies, reports provided by one group of participants to another in consequence of the relationship of accountability would be subjected to an audit so that the receiver of the report would be provided with some guidance as to whether that report is reliable.

As with accounting, two primary arms of the company audit function can be identified; where the reports provided by employees to directors are under examination, the process is part of the internal audit function, and where the reports are those provided by directors to shareholders, the examination is part of the external audit function. And also as with accounting, to distinguish between internal and external audit on the basis of the reports under review is by no means clear; internal and external auditors are frequently concerned with the same financial information.

It is, however, possible to draw a clear distinction between
internal and external audit on the basis of the auditor's relationship with the company. Internal audits are carried out by employees of the company, whereas external audits are carried out by independent professionals. The external auditor is paid a fee, rather than a salary and is appointed under the provisions of the Companies Acts by the shareholders, rather than by the directors. Internal auditors are concerned, inter alia, with providing the directors with an indication of the reliability of information given to them by others. External auditors are concerned with providing shareholders with an indication of the reliability of information provided to them by the directors in discharge of the duty of accountability.

This notion of an external audit constitutes the basis for the remainder of the thesis. Specifically, the thesis is concerned with an examination of external company audits carried out under the provisions of the U.K. Companies Acts. Within that context, the focus of attention is the theoretical framework within which company audit practices are derived and, consequently, the extent to which the company audit is likely to give an adequate indication of whether financial information provided by directors to shareholders is reliable.
Section 3. Objectives of the study.

Although accountability has been suggested as a justification for the existence of the company audit function, it must be recognised that a range of other possible justifications could be made. That is to say, there is a range of possible theories of company auditing which could constitute a framework for the derivation of practices.

One advantage of justifying the external company audit in terms of the discharge of accountability is that it focuses attention upon the groups involved in the external audit process and thereby provides a means of establishing the limits of the present study. Although reports generated in discharge of accountability might be used in a wide variety of decisions, by a wide variety of decision-makers, the parties most intimately involved in the accountability process as it occurs in companies are directors, shareholders and auditors. Accordingly, this thesis is concerned with the audit of financial reports provided by company directors to company shareholders.

A further limitation of the study is that it is confined to company audits carried out in the U.K. under the provisions of the Companies Acts, which provide for both the presentation of financial statements by the directors and for the independent audit of those statements. It is common to find that the law is closely involved with accountability relationships, wherein it seeks to impose controls over [the accountable party] so as to protect the owner or whoever deposited resources with [that party].

Audits carried out under the provisions of the U.K. Companies Acts
can only be conducted by members of prescribed professional accountancy bodies. Such audits are conducted within the terms of statutory provisions and according to the contents of various pronouncements made by the professional bodies.

As is argued more fully in Chapter 3, professional pronouncements have had a significant effect upon the determination of company audit practices in the U.K. and also have significant theoretical content which explains and justifies at least some of the recommended practices. Since the Auditing Standards and Guidelines, issued in May 1980, contain the most recent explicit theoretical statements concerning the company audit process, the identification and evaluation of the theoretical framework of U.K. company auditing carried out in this thesis is based primarily upon the content of that document.

The thesis is also based on the assumption that the reader is aware, in general terms, of the nature of the U.K. company audit process. That is, no detailed explanation of company audit techniques is provided, except within the context of company audit theory. Similarly, a familiarity with terms commonly used by company auditors is assumed.

If the auditor's opinion is to provide shareholders with an indication of the reliability of the financial statements prepared by directors, it is necessary for shareholders to believe the auditor to be a reliable judge of the quality of financial reports. If the audit report fails to provide shareholders with an indication of the reliability of the financial statements because shareholders
do not believe the auditor himself to be reliable, then the audit cannot be said to serve a useful function. The extent to which shareholders are likely to believe that the auditor is a reliable judge of financial statements does not depend solely upon the audit techniques which have been adopted and the nature of the accounting techniques used in the preparation of the report. It also depends upon the existence of a logical and consistent structure of audit theory which underpins audit action, for without such a structure, it will not be possible to judge whether audit actions are consistent, justifiable or appropriate.

It is the purpose of the remainder of this thesis to explore further the relationship between company audit practices and audit theory, to identify the theory within which company audit practices in the U.K. are derived and to subject that theory to a detailed analysis. By so doing, it will be possible to judge whether company audit practices are consistent, justifiable and appropriate. If these qualities are lacking, there will be no grounds for accepting the audit report as an indication of the reliability of financial statements. Nor will there be grounds for claiming that company auditors perform a useful function. In a sense, we are about to audit the auditor.
CHAPTER 2

THE NATURE OF A THEORETICAL FRAMEWORK OF COMPANY AUDIT PRACTICES

Since the purpose of this research study is to identify and evaluate the theoretical framework of U.K. company auditing practices, the first task must be to examine the nature of what it is that is to be identified and evaluated. That is, before a search for a theoretical framework of U.K. company auditing practices can begin, it is necessary to be clear about the nature of such a framework. An examination of the concept of a "theoretical framework" is the subject of this second chapter, and will be dealt with in three sections.

Section 1 considers the nature and purpose of theories, particularly in the context of company auditing. The purpose of this consideration is to define "theory" and "theoretical framework", thereby describing in general terms the subject of this thesis. These definitions are also the basis of the research reported herein.

Section 2 examines the nature of the company audit process in order to determine the extent to which the philosophy of science can be relied upon in the identification of a theoretical framework of company auditing. It is argued in this section that, despite important differences between company auditing and the scientific process, the philosophy of science does provide concepts useful in the study of company audit theory. In particular, structural attributes of theories in the physical sciences are accepted as appropriate to theories in company auditing.
Section 3 then draws upon the philosophy of science in order to establish a structure appropriate to company audit theory. It is argued that the structure presented in this section satisfies the criteria necessary for it to be appropriate to company auditing and, as a result, that it provides a useful paradigm for the identification of a company audit theory. This idealised structure will be drawn upon in Chapter 4 in order to identify the theoretical framework of U.K. company audit practices.

In summary, the objectives of this chapter are;

1. To determine the nature and purpose of a theoretical framework of U.K. company auditing,
2. To establish the extent to which the philosophy of science can validly be brought to the study of company audit theory, and
3. To propose a structure, based on the literature of the philosophy of science, by which the theoretical framework of U.K. company auditing might be identified and evaluated.
Section 1. Theories and theoretical frameworks.

The term "theory" may be used in either a broad or a narrow sense. When used broadly, it refers to a field of study or subject matter. In company auditing, "theory" in this broad sense refers to a wide range of conceptual issues including, for example, concepts relevant to the analysis and structuring of audit situations, to the solution of auditing problems and to the application of audit techniques under various conditions. These theoretical issues are related only by virtue of common subject matter, and theory, in this sense, is not necessarily structured or organised at all.

If, on the other hand, "theory" is used in a narrower sense, it refers to

a set of statements...ordered by the relation of deducibility ...[so that] no statement in the theory remains isolated: every statement is either an assumption or a conclusion.

To refer to theories in this narrower sense is to refer to a set of claims or assertions which are logically related and which, as a result, exhibit an internal structure. To view something as a theory in this narrow sense is to view it as a set of "logically related propositions".

In the literature of the philosophy of science, the role of science is often considered to be to derive an explanation of nature in its own terms, together with all that follows from doing that successfully, such as the ability to predict how things will behave and hence to control them.

Thus, the primary purpose of science seems to be to build theories which explain natural phenomena. Accordingly, a scientific theory can be considered to be a system designed to
offer an intelligible, systematic, conceptual pattern for the observed data. The value of this pattern lies in its capacity to unite phenomena which, without the theory, are either surprising, anomalous or wholly unnoticed.  

Accordingly, it can be argued that the usefulness of a scientific theory lies in its ability to unite surprising, anomalous or unnoticed phenomena. By identifying such phenomena, it becomes possible to explain and predict real events with greater precision. In general terms, scientific theories enable man increasingly to become the master of his environment.

However, a number of factors suggest theories in the field of company auditing are unlikely to have precisely the same role. For example, a fundamental difference between auditing and science is that it is possible to legislate to change the audit function in a manner which is entirely impossible with respect to natural phenomena. The "laws" of nature cannot be amended or revoked in the way that laws governing the company audit function can be.

This suggests, perhaps, that a theory of company auditing would have a purpose rather different to a theory in the physical sciences. It is, in fact, quite possible for this to be the case, since two possible roles of theory have been identified in the literature. The first, discussed above in the context of the physical sciences is to explain what exists (a descriptive, or positive theory). The other, which might be more appropriate to company auditing, is to derive what "should be" (a normative theory).

In fact, both descriptive and normative roles have been presented in the literature as being appropriate to company auditing. Hamilton, for example, suggested that a theory of auditing "is concerned with
describing why observed auditing activities are what they are\textsuperscript{6}, suggesting a descriptive role for company audit theory. On the other hand, a normative approach to audit theory was apparently adopted by the American Accounting Association in A Statement of Basic Auditing Concepts. In this statement, the Committee on Basic Auditing Concepts intended to develop a statement which, inter alia,

- develops the objectives and criteria which guide the planning, conduct and discharge of the audit function, and

- derives the skills and attributes essential to conduct an audit and fulfill the role of auditing in society\textsuperscript{7}.

The one attribute that company auditing theories intended to fulfill either role would have in common is that they would be concerned with company auditing procedures. A descriptive theory would attempt to explain and justify existing procedures. A normative theory would attempt to explain and justify desirable procedures. Thus, to the extent that existing procedures are desirable procedures, a theory of company auditing would be both normative and descriptive. So the purpose of a theory of company auditing seems to be twofold; to explain and to justify.

Thus, the claim that there are some similarities between a theory of auditing and a theory in the physical sciences is at least partly justified, in that both are concerned with explanation.

As suggested earlier, explanation in the physical sciences is achieved by establishing a pattern which unites surprising, anomalous or unnoticed phenomena. The establishment of a pattern in the field of company auditing, with similar purposes, could assist greatly in the development of company audit practices. For example, such a pattern could result in the identification of anomalies such
as inconsistencies between practices and objectives, or between different audit practices. Similarly, a pattern which disclosed that certain audit practices were inappropriate, or which revealed that the justification for the audit process had not been established, could only result in the profession being forced to take steps to remove such anomalies and, thereby, ensure that company auditors provide a service based on consistent, justifiable and appropriate practices.

In summary, it would seem that a theory of company auditing would have both descriptive and normative purposes. Initially, such a theory would provide an explanation of why company audits are justified, of why shareholders and others accept the expense involved in the conduct of the audit examination. If this explanation is acceptable, the normative statement that "company financial statements should be subjected to an audit" could be made and, at the same time, an explanation of the role of the company audit could be provided. If the theory were extensive enough, it could go on to derive those practices which are appropriate to and consistent with the attainment of whatever objectives have been specified as justification for the existence of the company audit function.

Thus, as in the physical sciences, one role of a theory of company auditing seems to be to identify and specify the nature of order which exists in the real world. The "real world" which is the subject of company audit theory is the body of company audit practices. By constructing a theory which consists of arguments concluding with company audit practices, those practices will be
explained and justified within a specific framework. Accordingly, a theory which derives a body of practices will constitute a "theoretical framework" for those practices.

As has been suggested earlier, one of the purposes in identifying a theoretical framework of company audit practices is to enable inconsistent, unjustified or inappropriate practices to be identified. In order to identify such practices it is necessary that there be criteria by which the existence of inconsistency, lack of justification or inappropriateness can be judged. As discussed above, the literature of the philosophy of science suggests that theories, in the narrow sense, provide such criteria.

Since this similarity between company auditing theories and theories in the physical sciences has been identified, and since a structured theory will provide the means by which inconsistent, unjustified or inappropriate company audit practices can be identified, the term "theory" will be used in this thesis in the narrow sense to refer to a particular structured set of statements which results in the derivation of company audit practices. The consistency, justifiability and appropriateness of practices will be judged within the context of the framework provided by such a theory.

Since there are these similarities between theories in auditing and in the physical sciences, it will be desirable to construct theories in the field of company auditing on the same basis as theories in the physical sciences. That is, one way of establishing a pattern which successfully identifies inconsistent, unjustified and inappropriate company audit practices is to structure a theory of
company auditing in a way that is similar to theories in the physical sciences, and to subject the fundamentals in that theory of company auditing, as far as possible, to the same sort of examination as that to which the statements in a theory in the physical sciences are subjected.

However, the philosophy of science ought not be relied upon without some consideration of the relationship between the practice of science and the practice of company auditing. Differences between methodologies could well suggest important qualifications to the adoption of concepts from the philosophy of science to the field of company auditing.
Section 2. Company auditing as a scientific process.

The process of company auditing could be described as a process of inquiry. In the most general terms, the external company auditor is presented with a number of assertions about the financial attributes of a company and the transactions into which it has entered and conducts an inquiry in order to determine whether those assertions are supported by the available evidence. In company audits, these assertions appear within the financial statements which are required by legislation to be provided by directors to shareholders.

When company auditing is conceived of as a process of inquiry, the similarity between it and research in the physical sciences is suggested. This comparison appears on a number of occasions in the literature. Since this thesis will be relying to some extent upon the philosophy of the physical sciences, it is necessary to spend some time on a consideration of the nature and importance of the differences between the methodology of company auditing and that of science. It will be argued that a strict analogy between company auditing and science is untenable, and an investigation of the differences will serve both to clarify further the nature of company auditing and to indicate the extent to which reliance can be placed upon the philosophy of science in an identification and evaluation of the theoretical framework of company auditing.

The "scientific method" is commonly held to consist of the process of collection of facts by careful observation, followed by the generation of a hypothesis which will explain the facts, then by a deduction of the consequences which follow from that hypothesis and,
finally, the collection of more observations to provide empirical support for the hypothesis. Caws, for example, suggests that observation is the first stage in science when he states that

in some sciences [the work of collecting and classifying facts] is almost the only objective at the moment, not because the workers in those fields would not like to do other things, but because they are still laying an observational foundation.

The nature of the company audit process suggests that there are a number of parallels between audit methodology and the "scientific method" outlined above. For example, an auditor could be said to conduct research into the financial affairs of the client company so that an "observational foundation" for the audit opinion is established.

Although there are good grounds for identifying a number of similarities between scientific research and audit methodology, it is important to identify the points of departure in this analogy, lest undue reliance be placed upon the philosophy of the physical sciences in an attempt to establish a theory of company auditing or to explicate the nature of company audit activity.

A first point of departure between audit and scientific activity concerns the nature of the two areas. Science is ultimately concerned with both generating and testing hypotheses and the literature of scientific methodology does not suggest that either one of these activities is more important, or of more interest, than the other.

Company auditing, on the other hand, is primarily concerned with only one of these activities; the testing of hypotheses. The primary hypothesis for the auditor is that a particular set of
financial statements show a "true and fair view". In order to determine whether this hypothesis is valid, the auditor will conduct a number of audit tests designed to collect evidence about the validity of other subsidiary hypotheses.

For example, the auditor will not be able to express an opinion that company financial statements give a true and fair view if those statements include fictitious assets. Accordingly, the auditor will conduct tests in order to determine whether the subsidiary hypothesis that the financial statements include no fictitious assets is valid. For the company auditor, both the primary and subsidiary hypotheses have already been proposed; the hypothesis of truth and fairness is proposed by legislation and the subsidiary hypotheses depend upon accepted relationships between the accounting records and the real world.

A further difference between the two activities concerns the nature of hypotheses which are subjected to testing. Whereas scientists are primarily concerned with hypotheses about relationships existing in the real world, the hypotheses considered by auditors involve expectations and values as well as facts. Consider, for example, an auditor who wishes to determine whether the amount disclosed in a balance sheet for a depreciable asset is "true and fair". In deciding whether this is so, he will be concerned with at least three hypotheses; (a) that the asset exists (a factual problem), (b) that the asset has a specific, finite expected life (an expectational problem) and (c) that the chosen depreciation method is appropriate (a value problem).
An additional caveat in the use of scientific methodology as an analogy for company auditing concerns differences between the evidence which is available to company auditors and that which is available to scientists. The evidence on which an auditor must base his judgement is rarely conclusive and is frequently only marginally persuasive. For the scientist, resources and time are more likely to be available for the collection of more conclusive evidence. Similarly, the factual problems which scientists face are of a general class for which nearly conclusive evidence is likely to be available. For very many of the problems faced by auditors, conclusive evidence is simply unavailable.

Finally, a most important difference between audit methodology and scientific methodology concerns the purpose of the activities. The objectives of science are usually stated in terms of the "production of knowledge", the "search for truth" or the "explanation and prediction of events". It is not the objective of company auditing to add to the store of human knowledge or to enable the explanation and prediction of events. No laws (universal or particular) are established by company auditors as a result of their audit activity. Auditors and scientists face different problems and have developed different approaches to those problems. Any attempt to see a strict, or even a very close, analogy between auditing and science is doomed to failure.

This general conclusion is an important one for what follows in this thesis. If it is to be at all possible to draw upon the philosophy of science in an attempt to identify and evaluate a theory of company auditing, it is necessary to distinguish clearly between
audit practice and audit research on the one hand, and scientific practice and research on the other. Whereas the practice of science constitutes scientific research, the practice of auditing does not constitute auditing research.

Accordingly, the reliance which is placed upon the philosophy of science in this thesis is not grounded on the claim that the company audit process is the same as, or is substantially similar to, the scientific process. Rather, it is based on the general conclusion reached in the first section of this chapter that any similarities which can be identified are at a level of theory rather than at a level of practice.

Thus, despite some important differences between company auditing and the physical sciences, there is one level at which the philosophy of science can provide concepts useful to the study of company audit theory. That level concerns the structure of theories'.
Section 3. The structure of a theoretical framework of company audit practices.

It has been argued earlier that there are two major aims in building a theory of company auditing. The first is to provide a justification for the existence of the company audit function and, in so doing, to specify the objectives of company auditors. The second is to enable inconsistent, unjustified or inappropriate company audit practices to be identified and eliminated. In order to demonstrate that it is possible to achieve these aims, it is necessary to show that there exists a structure according to which a theory of company auditing can be built.

The Financial Accounting Standards Board (FASB) has described a conceptual framework as

a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function and limits of [the area of activity].

This notion of a conceptual framework is akin to that of a theoretical framework discussed earlier. According to the FASB, if such a theoretical framework is to lead to consistent practices together with a prescription of the nature, functions and limits of the area of activity, it would need to consist of a set of structured statements, at the basis of which would be "fundamentals" or "underlying concepts" which guide the way in which practices would be developed. Such concepts can be held to be "fundamental" because "other concepts flow from them and repeated reference to them will be necessary in establishing, interpreting and applying... standards."
If a structure identified within the literature of the philosophy of science is to enable the aims inherent in building a theory of company auditing to be realised, it would need to facilitate the achievement of three things. Firstly, it would need to provide a structural ideal according to which a specific theory of company auditing could be constructed such that the practices derived within the theory can be evaluated in order to determine whether they are consistent, justifiable and appropriate. If this criterion were not met, it would not be possible to determine whether the ideals of consistency, justifiability and appropriateness of audit practices had been achieved.

Secondly, the structure would need to facilitate subsequent development and improvement of the theory. If this criterion were not met, the theory would be unable to adapt to changes in the environment of company auditing, to new business practices or to new legislative provisions. In short, it would stagnate and soon become irrelevant.

Thirdly, the structure would need to enable the identification of those statements which are to be considered fundamental and which, as a result, would fulfill the role specified by the FASB of enabling standards to be established, interpreted and applied. If this criterion were not met, it would not be possible to determine whether the theory had been developed on the basis of a secure foundation.

Lakatosian research programmes

A theoretical structure which is applicable to company auditing is
suggested by the philosophy of Lakatos\textsuperscript{15}, in which it is argued that theoretical progress depends partly upon the extent to which a particular body of theory successfully guides research. Without suggesting that Lakatos' philosophy results in the only structural model applicable to company auditing, it does provide one way of conceiving of a structure which would
(a) provide for the specification of relationships between component elements of a theory,
(b) provide a basis for further theoretical development,
(c) enable the specification of a central core of fundamental statements or underlying concepts, and
(d) provide the means of identifying inconsistent, unjustified or inappropriate audit practices.
It would therefore enable the aims in building a theory of company auditing to be achieved.

At the centre of Lakatos' philosophy lies the notion of a 'research programme', which is a theory evolving as evidence is presented which identifies its inadequacies. A successful research programme is one which leads to the solution of existing problems and to the suggestion of further problems as the scope of the theory expands. Lakatos calls this a "progressive problem-shift"\textsuperscript{16}. In terms of the concepts introduced earlier, a Lakatosian research programme is reflected in a developing theoretical framework of company audit practices. There could well be a number of different theories of company auditing, each of which constitutes a separate theoretical framework, and research effort into each of these frameworks will be warranted as long as progressive problem-shifts are occurring.
Supporters of one theory will direct their research towards the collection of evidence and development of argument which either supports their own theory or refutes an alternative one.

The structure of a theory provides both positive and negative guidance to research efforts, in the form of two kinds of methodological rules. A 'negative heuristic' discourages supporters of a particular theory from undertaking research which is directed towards the refutation of any part of a 'hard core' of basic assumptions within that theory. In order to avoid refutation of these basic assumptions by supporters of an alternative theory, it is necessary to build a 'protective belt' of auxiliary hypotheses so that any 'refuting' evidence can be redirected and the basic assumptions of the theory remain intact. Transformations will occur in such a way as to protect the basic assumptions and to tend to preserve the structure. If there comes a time when the evidence against a particular theory is such that it cannot be accounted for by valid changes to the protective belt then that particular theory must be abandoned, or the evidence ignored.

If a decision to abandon an existing theory is to be made, it is necessary that an alternative theory exists, or can be constructed which is not only supported by the evidence which supported the earlier theory, but which also accounts for (at least some of) the evidence which caused the abandonment of the earlier theory.

The positive heuristic, to use Lakatos' description, "consists of a partially articulated set of suggestions or hints on how to change,...modify, sophisticate, the 'refutable' protective belt".
The positive heuristic guides the development of auxiliary hypotheses and techniques for empirical investigation.

A theoretical structure derived from the philosophy of Lakatos which is applicable to company auditing can be diagrammed as follows;

Levels I and II of this structure represent the "hard core" of a particular theory of company auditing and would contain two general classes of argument. One class of argument, specified in the first level, would establish the necessity for a company audit and, in so doing, would specify the primary objective to be achieved by company auditors. Hence, this class of argument would provide an explanation and justification for the existence and acceptance of
the company audit function.

The other class of argument, specified in the second level of the proposed structure, would demonstrate that it is possible to achieve the specified primary objective by the adoption of certain general classes of procedure designed to attain secondary objectives. That is, having argued that the audit function achieves a useful purpose (identified as the "primary objective"), it is then necessary to demonstrate that the adoption of certain general classes of procedure which would result in the attainment of secondary objectives would lead ultimately to the attainment of the primary objective. As a result of these two classes of argument, company auditing can be defined and both primary and secondary objectives established.

The remaining levels in the proposed structure would contain two general classes of statement; additional assumptions and recommended practices. Successive levels of the proposed structure would contain increasingly specific assumptions and practices and, in general, specific practices would be recommended in order to implement the more general practices in the higher levels of the theory. For example, the second level could contain a statement to the effect that company auditors have an objective to form an opinion as to the truth and fairness of financial statements. The third level could then contain an assertion to the effect that it is only possible to form an opinion by collecting evidence. As a result, a requirement for the company auditor to collect evidence would be derived. Successive levels in the structure would derive increasingly specific techniques for the collection of audit
evidence. There could be any number of these levels in a particular theory, depending upon the perceived benefits of recommending increasingly specific audit practices.

A brief example will serve to illustrate the components of each level in a theory constructed according to the proposed structure. In presenting this example, it must be emphasised that the intention is not to develop a complete theory. Rather, the purpose is solely to illustrate the kinds of statements which might appear in the various levels of a theory of company auditing which is based upon a Lakatosian "research programme" structure. Accordingly, the argument does not contain definitions of important terms, nor are all of the assumptions underlying the argument explicitly stated. Similarly, the truth or otherwise of the statements is not an important issue, and the question of whether the statements are even in principle empirically verifiable is not to the point at this stage.

The argument may be diagrammed as follows;
where relevant statements are;

[1.0] Procedures which are beneficial to society should be implemented.

[1.1] It is beneficial to society if resources are allocated to more efficient companies.

[1.2] Resources should be allocated to more efficient
companies.
(derived from 1.0 and 1.1)

[1.3] In order to allocate resources to more efficient companies, it is necessary that shareholders be provided with the means of identifying more efficient companies.

[1.4] Shareholders should be provided with the means of identifying more efficient companies.
(derived from 1.2 and 1.3)

[1.5] If shareholders are provided with company financial statements and with an indication of the reliability of those statements, then shareholders will be provided with the means of identifying more efficient companies.

[1.6] Shareholders should be provided with company financial statements and with an indication of the reliability of those statements.
(derived from 1.4 and 1.5)

[1.7] If an auditor reports to shareholders on the truth and fairness of the financial statements, and if shareholders believe that report to be reliable, shareholders will be provided with an indication of the reliability of financial statements.

[1.8] The auditor should provide a report to shareholders on the truth and fairness of the financial statements and should ensure that the report is believed by those shareholders to be
In order to ensure that the audit report is believed by shareholders to be reliable, it is necessary for the auditor to adopt procedures which will ensure the efficient conduct of the audit.

Auditors should adopt procedures which will ensure the efficient conduct of the audit.

In order to ensure the efficient conduct of the audit, it is necessary to minimise audit work.

The auditor should minimise audit work.

In order to minimise audit work it is necessary to place as much reliance as is justified upon the company's system of internal control for the generation of evidence about the truth and fairness of the financial statements.

The auditor should place as much reliance as is justified on the company's system of internal control.

In order to place as much reliance as is justified on the company's system of internal control, it is necessary to determine the extent to which reliance on that system of internal control is justified.
[5.2] The auditor should determine the extent to which reliance on the company's system of internal control is justified.
(derived from 4.2 and 5.1)

[6.1] In order to determine the extent to which reliance upon the company's system of internal control is justified, it is necessary to evaluate that system of internal control.

[6.2] The auditor should evaluate the company's system of internal control.
(derived from 5.2 and 6.1)

[7.1] In order to evaluate the company's system of internal control it is necessary to record that system of internal control.

[7.2] The auditor should record the company's system of internal control.
(derived from 6.2 and 7.1)

The first level of this example provides an explanation for the existence of company auditing which is based fundamentally on the requirement to adopt those actions which are beneficial to society. That requirement is reflected in statement 1.0. This first section argues that the company audit is justified because it provides shareholders with an indication of the reliability of financial statements. In so doing, the statement that auditors should report on the truth and fairness of financial statements, ensuring that the report is believed by shareholders to be reliable, is derived (statement 1.6). This statement, being the first normative
The second level contains an example of an argument which indicates the means of attaining the primary objective. This argument suggests that the identified primary objective can be attained by adopting procedures to ensure that the company audit is conducted efficiently. Accordingly, a secondary objective of audit efficiency is established. These first two levels could be said to constitute a "hard core" since the refutation of any statement within those levels would mean either that the justification for the existence of company auditing is invalid or that the attainment of the secondary objective would not lead to the attainment of the primary objective. In either case, this particular segment of the theory would have to be abandoned, or the evidence ignored.

The remaining levels III - VII would constitute part of the "protective belt" of the theory, containing statements which require increasingly specific audit procedures to be adopted, ending with a requirement for the auditor to record the company's internal control system. According to a Lakatosian structure, this protective belt can be changed or amended in order to adapt to changing circumstances without questioning the hard core, or theoretical foundation of the framework.

There is nothing to prevent the derivation of even more specific company audit practices within the suggested structure so as ultimately to specify all audit practices appropriate to the
recording of the internal control system. In practice, however, that would prove an extremely difficult task because of the vast range of circumstances which could possibly be encountered by the auditor. It would be, however, quite possible to establish appropriate audit procedures for various general class of circumstance, determined within a consistent theoretical framework. Specific audit techniques adopted would, in turn, be based upon and consistent with these general classes of derived procedure, although those techniques would be determined by the exercise of judgement by individual company auditors in specific circumstances.

Statements within the argument can be classified according to two general schemas. Firstly, they can be classified according to whether they have been derived from earlier statements or introduced as underived assertions. Secondly, they can be classified according to whether they are normative (statements of what should be) or descriptive (statements of what is). Classification according to these schemas results in the following matrix, in which the numbers refer to statements in the argument;

<table>
<thead>
<tr>
<th>Derived</th>
<th>Asserted</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.2,1.4,1.6,1.8</td>
<td>1.0</td>
</tr>
<tr>
<td>2.2,3.2,4.2,5.2</td>
<td>1.1,1.3,1.5,1.7</td>
</tr>
<tr>
<td>6.2,7.2</td>
<td>2.1,3.1,4.1,5.1</td>
</tr>
<tr>
<td>Derivative</td>
<td>Descriptive</td>
</tr>
<tr>
<td>6.1,7.1</td>
<td></td>
</tr>
</tbody>
</table>

The matrix indicates that the argument contains three general classes of statement. Those statements with odd numbered suffixes
are asserted descriptive statements which are subject to dispute, empirical investigation and possible falsification. Statements with even numbered suffixes are normative statements derived from an earlier normative statement and an additional assertion.

The third type of statement within the argument is the single asserted normative statement. This is statement 1.0, the claim that procedures which are beneficial to society should be implemented. This statement is, in fact, the foundation of this entire justification for the existence of company auditing and if it is not accepted as valid, there is no reason to accept the remainder of the argument. As is argued more fully in Chapter 4, it seems that a generally acceptable "fundamental normative statement" must constitute the basis of any theory of company auditing. If specific practices are derived from earlier, more general practices, a "most general" practice must be established somewhere to avoid an infinite regression.

Although the argument contains no derived descriptive statements, there is no reason why such statements could not appear. Indeed, as will become apparent in Chapter 5, many such statements are likely to appear in a fully developed theory of company auditing.

The construction of the argument suggests that the final conclusions of the theory (i.e. derived practices) could be rejected on any of three grounds; the argument might be logically invalid, there might be no consensus that the fundamental normative statement reflects a desirable action, or one or more of the assumptions might be refuted by the available evidence. This implies that the specification of a
theory of company auditing is likely to lead to a range of possible research projects.

The distinction between statements in a theory which comes about because of the concepts of "hard core" and "protective belt" provides a means of guiding research projects. Statements which occur within the "hard core" would be fundamental to the theory, and evidence which casts doubts upon any statement within the "hard core" would amount to a fundamental attack upon the theory. Thus, supporters of the theory would be encouraged to conduct research designed to strengthen the "hard core" or to amend the "protective belt" in the light of criticism, whereas opponents would be encouraged to conduct research designed to identify flaws in the hard core. Thus, the theory would be subjected to detailed investigations which could only lead to further development and improvement of the company audit function.

The proposed structure suggests that company audit practices should ideally be specified by first establishing a theoretical foundation and then deriving practices on the basis of that foundation in combination with additional (verified) assumptions. If practices were to be derived in this way, it would be possible to ensure at each stage of the derivation that the necessary qualities of logical rigour and empirical support were being met. It could well be expected that a theory constructed in this fashion would be the best possible at the time of construction.

There is little evidence to suggest that U.K. company audit practices have been specified in this purposive fashion. If
anything, the practices have been established for some time and it is only comparatively recently that any concern for providing a theoretical justification for those practices has been reflected in the literature.

Under conditions where little attention has been paid to the development of a theoretical framework it is possible that practices could be inconsistent, unjustified or inappropriate. There comes a time under these circumstances when it is necessary to ensure, firstly, that a theoretical framework for company audit practices is specifically stated and, secondly, that that framework is both consistent and complete. This thesis is based on the assumption that the time for providing these assurances with respect to company auditing has now arrived.
CHAPTER 3

THE SOURCE OF THE THEORETICAL FRAMEWORK OF COMPANY AUDIT PRACTICES

In the previous chapter, the task of defining and explicating the nature of a theoretical framework of company audit practices was undertaken. The next stage in the process of identifying such a theoretical framework is to determine an appropriate source. That is, having defined what is to be identified, the next task must be to establish where the search ought to be carried out. That task is the subject of this chapter.

It was argued in the previous chapter that there is little evidence that a theoretical framework of extant company audit practices has already been identified. Accordingly, it is not possible to consult any document which precisely specifies a theoretical framework of company auditing. Rather, it is necessary to consider a number of possible sources which provide some justification, explanation or analysis of company audit practices. Of those sources, the most appropriate will be that which specifies audit practices which are applicable to most, if not all, company audits and which also provides explanation of and justification for those practices.

The chapter consists of two sections. In the first, possible sources of company audit practices are considered. In particular, legislation, common law and the profession are identified as exerting important influences over company audit practices and, therefore qualify as possible sources of a theoretical framework for those practices. It is argued that the profession exerts the major influence in the determination of company audit practices and,
accordingly, professional pronouncements on auditing are adopted as the most appropriate source for the identification of the theoretical framework of company audit practices. Of those pronouncements, the Auditing Standards and Guidelines are considered to provide the clearest indication of possible explanations and justifications for recommended practices. As a result, that document is adopted as the primary source of theoretical statements which are to be analysed and structured according to the model described in the previous chapter.

The second section of this chapter provides further support for the choice of the Auditing Standards and Guidelines as the source of the theory of company auditing. In this section, it is argued that the profession has responsibility for generating theory, as well as for prescribing practices. The extent to which the profession has fulfilled this responsibility is discussed and it is argued that the content of the Auditing Standards and Guidelines reflects, at least in part, recognition of the profession's responsibility for theory generation.

In summary, the objectives of this chapter are:
1. To establish the Auditing Standards and Guidelines as the appropriate source for the identification of the theoretical framework within which U.K. company audit practices have been derived and
2. To establish the nature of the profession's responsibility for the generation of a theory of company auditing and to examine the extent to which that responsibility has been discharged.
Section 1 The determinants of company audit practices

The process of inquiry undertaken by company auditors involves the adoption of a range of practices intended to result in the collection of evidence about the various hypotheses under review. To a large extent, these practices have been standardised under the influence of companies legislation, common law and professional pronouncements, although much of company audit practice is still dependent upon the professional judgement of individual auditors.

Since there are these different influences upon company audit practices, it is possible that the literature in each of these areas could provide a basis for the identification of a theoretical framework of company audit practices. In order to decide which body of literature is the most appropriate source of a theoretical framework, it is necessary to examine the extent of the influence over practices exerted in each case.

The influence of companies legislation

U.K. companies legislation has had only a very general effect on company audit procedures through the specification of the general ambit of the audit examination and the prescription of the nature of the audit report.

Legislation has influenced the general ambit of the company audit by specifying the financial statements which are to be subject to audit. Under the provisions of the Joint Stock Companies Registration Act 1844, it was necessary only to present a balance sheet, which was then subject to examination by the auditor. In
1856, the requirement for compulsory audit was removed. Audits became a provision of Table B of the Companies Act 1856, which contained a set of model articles to be adopted at the shareholders' discretion. Direct legislative influence over the ambit of the company audit ceased.

This influence was restored in the Companies Act of 1900, which reinstated the requirement for every company to have an audit. Under the provisions of this Act, auditors were once again required to report only on the balance sheet. The audit was still limited to the balance sheet under the provisions of the Companies Act 1929, and it was not until the Companies Act of 1948 that auditors were given responsibility for the examination of the profit and loss account in addition to the balance sheet. Accordingly, company audit procedures have had to develop in response to this expansion in reporting responsibilities. The Companies Act 1948 has been followed by additional Companies Acts in 1967, 1976, 1980 and 1981. Together, these Acts specify the nature of the financial statements to be prepared by directors, the form of disclosure to be used and the basis upon which items in those statements are to be measured. In turn, this increased legislative influence over company financial reporting has determined the areas and directions in which company audit procedures have had to develop.

For example, the Companies Act 1981 provided that small and medium-sized companies (as defined in the Act) may file "modified" accounts with the registrar of companies. Where the directors of a company decide to take advantage of this option to file modified accounts, the auditor must provide the directors with a report stating
whether, in his opinion, the requirements for exemption from submitting full accounts have been satisfied. Thus, new legislative provisions concerning financial disclosure have, in respect of some companies, caused new company audit procedures to be introduced.

Companies legislation has also provided general guidance to the determination of procedures by specifying the form and content of the audit report. The Joint Stock Companies Registration Act 1844 required the presentation of a "full and fair" balance sheet. The Companies Act 1900 required a "true and correct" view, and in the Companies Act of 1948 the present requirement for a "true and fair" view was introduced.

Under present statutory regulations, the auditor is to state expressly whether, in his opinion, the company's balance sheet and profit and loss account
a) have been properly prepared in accordance with the Companies Acts, and
b) give a true and fair view of the company's affairs as at the end of its financial year and of the company's profit or loss for its financial year.

In addition, the auditor is required to report on other matters by exception. Three implications of an unqualified report are:
a) that proper books of account have been kept,
b) that the balance sheet and profit and loss account are in agreement with the books of account, and
c) that the auditor obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purposes of his audit.
Accordingly, auditors are required "to carry out such investigations as will enable them to form an opinion" on those matters. Although the companies legislation does not prescribe the procedures to be undertaken in the audit investigation, the nature of those procedures is significantly influenced by legislative specification of the terms in which company auditors must express their report.

The influence of common law

Common law has had a similar effect to that of legislation upon the development of audit procedures. That is, guidance as to the areas in which the practice of auditing must develop has been given, although the precise specification of the appropriate procedures to be adopted has been left to the professional judgement of the auditor.

An early case which had such an effect was Leeds Estate Building and Investment Society v Shepherd, 1887, in which Stirling, J., said;

> It is the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet, but to see that it is a true and accurate representation of the company's affairs.

As a result of this decision, auditors were required to introduce procedures for determining whether transactions were ultra vires the directors.

The influence of common law on audit procedures is illustrated in the development of procedures for verification of stock. In re The Kingston Cotton Mill Co., Limited case of 1896 it was held that it was not the duty of the auditor to take stock, and that it was
reasonable for the auditor to accept the certificate of a responsible official as to the level of stock, in the absence of suspicious circumstances. Audit procedures for the verification of stock were therefore confined at that time to the acceptance of certificates.

In re The Westminster Road Construction and Engineering Co., Ltd. 1932 it was held that it was the duty of the auditor to check the value at which the work-in-progress inventory was shown in the balance sheet; he was required to test the accuracy of the figures given to him, whether there was a certificate or not.

The auditor's responsibility for the verification of stock was further extended as a result of the decision in the 1967 case of re Thomas Gerrard and Son Ltd, the dicta of which may be regarded as the long-awaited indication that the Kingston Cotton Mill decision should no longer be relied upon as a binding precedent in relation to the verification of stock-in-trade by auditors.

This decision imposed a legal obligation on auditors to attend the physical stocktake; it was no longer sufficient to rely upon a certificate from management. Although attendance at stocktake was common practice by this time, the decision in re Thomas Gerrard did influence accepted procedures in that the Institute of Chartered Accountants in England and Wales subsequently issued Statement U9, Attendance at Stocktake (1968) and Statement U11, Stock-in-trade and Work in Progress (1969). These statements represented official recognition that it was necessary for company auditors to attend the stocktake and to conduct tests on the physical existence of inventory.
Although case law provides some indication of the nature of company audit procedures, and certainly provides considerable explanation and justification for the introduction of those procedures, it is unlikely that a theoretical framework of company auditing identified on the basis of common law would be complete. This is suggested by two factors. Firstly, far more cases involving the liability of company auditors are settled out of court than ever come before the judges for a decision. Thus, the courts do not have the opportunity to issue judgements concerning a wide range of company auditing practices. Similarly, common law decisions are only concerned with contentious matters. Since a complete theoretical framework must explain and justify all company auditing practices (whether contentious or not), a framework identified on the basis of common law would be inadequate.

As with legislation, case law has provided only a general indication of the areas in which development of company audit practice has been necessary, and the techniques which have emerged as a result of this guidance have depended upon the professional judgement of auditors. Determination of those practices has resulted in the emergence of a number of generally accepted auditing techniques which have become standardised under the influence of professional pronouncements and the audit manuals of large firms.

The influence of the profession

It could be suggested that an appropriate source to consult in order to identify company audit practices would be the audit manuals of large audit firms. These manuals prescribe the techniques to be
adopted by the employees of particular audit firms under various circumstances. Considered as a whole, there is a substantial degree of correspondence between the content of audit manuals of different audit firms. This suggests that they could be said to contain descriptions of extant company audit practices. However, it must be recognised that such manuals remain specific to individual firms, and to generalise from those specific manuals to company audits in general would be of doubtful validity. In addition, the manuals are almost exclusively procedural in their content and give little indication of a theoretical framework within which those procedures could have been derived. They are therefore of little use in an attempt to identify a theory of company auditing.

An alternative suggestion for a possible source of the theoretical framework of company audit practices is the profession. It is a professional requirement that practices adopted by all company auditors must comply with the standards set by the profession\(^\text{13}\). Thus, a source of audit practices which apply to all company audits are documents which specify those standards. If such documents can be shown to be both applicable to all company audits and to provide justifications and explanations for the specified practices, a claim that they could be adopted as a basis for the identification of the theoretical framework of company audit practices would be justified.

The U.K. accountancy profession has pursued a policy of issuing pronouncements on a wide range of accounting and auditing matters, especially over the last decade. Currently, the four professional bodies whose members qualify as company auditors\(^\text{14}\) issue joint pronouncements which are applicable to company audits carried out in
the U.K. Arguably, the most important auditing pronouncement currently in force is the statement on *Auditing Standards and Guidelines*, issued in April 1980. This statement represents something of a watershed in the development of professional regulation of U.K. company auditing, for it is the first general statement issued by the combined U.K. professional bodies which deals with notions of principle, as well as practice.\(^{15}\)

In that statement, Auditing standards are considered to "prescribe the basic principles and practices which members are expected to follow in the conduct of an audit"\(^{16}\), and auditing guidelines give guidance on:

- (a) procedures by which the Auditing Standards may be applied
- (b) the application of the Auditing Standards to specific items appearing in the financial statements of [companies],
- (c) techniques currently being used in auditing,
- (d) audit problems relating to particular commercial or legal circumstances or to specific industries.\(^7\)

Both the standards and the guidelines are concerned with prescriptions and guidance as to audit practice. The only difference between standards and guidelines is that the practices prescribed in the standards are thought to be more basic and, therefore, more generally applicable. It is important to note that the professional bodies felt it impracticable to establish a code of rules sufficiently elaborate to cater for all situations and circumstances which an auditor might encounter\(^8\), and that the auditor's ability to exercise sound professional judgement is indispensible in the decision as to which specific audit procedures to employ in any particular situation.

Supplemented by the various pronouncements on professional ethics,
the Auditing Standards and Guidelines provide a general overview of company audit practice and the principles underlying that practice. The body of professional pronouncements in general and the Standards and Guidelines in particular could be described as the means by which the professional bodies guide the company auditor in the exercise of his professional judgement. This guidance takes the form both of statements of recommended practice and of explanations and justifications for that practice.

Since all members of the professional bodies are bound by the provisions of the Standards and Guidelines and since all company auditors in the U.K. are required by law to be members of a professional body 19, the Auditing Standards and Guidelines are relevant to all audits carried out under the provisions of the U.K. Companies legislation. The Standards and Guidelines also reflect the general requirements of companies legislation and of common law decisions.

Thus, the Standards and Guidelines contain practices which apply to all company audits carried out in the U.K. and, although they may lag behind the most recent developments in audit practice, they do reflect the major influences of legislation and common law upon audit practice. Accordingly, the Standards and Guidelines can be adopted as the most specific source of audit practices which apply to U.K. company audits.

Not only do the Standards and Guidelines reflect what is required by the law 20 and what are considered best audit practices, they also attempt to explain and justify those practices. If it can be argued
that the profession has a responsibility to generate a body of theoretical knowledge, the explanations and justifications of practices to be found within the Standards and Guidelines could be considered to be at least a partial discharge of that responsibility. As a result, a detailed analysis of those explanations and justifications may properly be undertaken in order to identify a theoretical framework of company audit practices.
Section 2. Company audit theory and the profession.

In the previous section it was argued that the U.K. auditing profession has accepted responsibility for the determination of audit practices, allowing at the same time for the exercise of professional judgement by individual practitioners. It was further argued that, as a result of this acceptance of responsibility, the profession issued the pronouncement on Auditing Standards and Guidelines, which contains statements of practice relating to U.K. company audits generally and which constitute the basis of generally accepted company audit practices. It was also suggested that the Standards and Guidelines contain explanations of and justifications for the recommended practices and that these explanations and justifications could be considered to be a set of theoretical statements. In this section, the responsibility of the profession for the establishment of a body of theory is explored further.

Since the professional bodies are able to influence the actions of individual practitioners through the imposition of auditing and ethical standards, it can be said that the actions of company auditors are determined within the framework of the theory (if any) which has been accepted by the profession\textsuperscript{22}. As such, that theory will be of fundamental importance to the consistency, justifiability and appropriateness of company audit practices. However, it might be that the professional bodies have no responsibility for the development of a body of theory, but rather are concerned only with prescriptions or proscriptions of behaviour on an ad hoc basis. If it can be shown that the profession is responsible for the development of theoretical knowledge as part of a general
professional responsibility, and that the issue of the Standards and Guidelines reflects at least an attempt to fulfill that responsibility, then those standards and guidelines could be consulted in order to identify the theoretical framework within which company audit practices have been derived. Since it has already been argued that the Standards and Guidelines are an appropriate source for the identification of audit practices applicable to all company audits in the U.K., it is necessary to consider briefly whether the profession also has a role to play in the generation of theoretical knowledge which underlies those practices.

The literature of the sociology of professions contains a wide variety of studies, from attempts to list the "essential qualities" of a profession \(^2^3\) to considerations of the role of radical thought by members of a professional organisation \(^2^4\). In the great majority of these studies, professional responsibility for the development and use of specialist theoretical knowledge has been a key issue. Turner and Hodge, for example, claim that

> An ubiquitous assumption in writing on professions appears to be that a profession has an essential underpinning of abstract principles which have been organised into a theory, set of theories or at least a complex web of theoretical orientations \(^2^5\).

In considering whether professions are socially desirable institutions, two major approaches have been adopted, in both of which the role of specialist theoretical knowledge is crucial. In the first approach, professions are considered to be positive influences, acting to attain social stability and providing a "bulwark against threats to stable democratic processes" \(^2^6\). In the
alternative view, professions are considered to be harmful monopolistic bureaucracies attempting to establish an elitist class, the members of which "enjoy a more complete and more secure authority than any historical ruling class".27

Those authors who subscribe to the favourable notion of professions28 base their subscription on the argument that professions are responsible and trustworthy repositories of theoretical knowledge; that because professionals are altruistic and collective-oriented, rather than self-oriented, they will ensure that there is a steady and peaceful evolution of knowledge and that knowledge is applied in the interests of members of society. Parsons, for example, feels that the collectivity-orientation of professions "ensured that science would be applied in the service of man".29

Writers who subscribe to the opposing viewpoint see the growth of professions as a proliferation of experts and technocrats who are men of narrow specialisation concerned primarily with the maintenance of their monopolistic position by the increasing mystification of specialist knowledge. This increasing mystification is thought to lead to a situation in which judgements by professionals are quite inscrutable to those outside the profession. In turn, it is thought that if those outside the profession cannot interpret the judgements of professionals, criticism of those judgements becomes impossible. The professionals are thereby absolved from the need to justify their actions by reference to a body of theory.
If this negative conception of professions has any basis, increasing mystification could well lead to a situation in which professional judgements were quite inscrutable even to other professionals. Actions by members of the profession could become misguided at best and random at worst; there could be an increasing tendency toward anarchy. In other words, if a profession failed to develop a theoretical framework within which practices could be derived, that profession (according to this unfavourable notion of professions) would be likely to degenerate into a completely unjustified and unjustifiable institution.

Those attempts to characterise professions by a listing of traits or functions, which avoid the controversial issue of the social desirability of professions, also stress the importance of theoretical knowledge. Millerson, for example, identified twenty-two key elements of professions by considering the work of twenty-one other authors. Among the most frequently cited elements was the requirement that professional skill be based on theoretical knowledge. Similarly, Barber argues that one function of professions is to develop a high degree of systematised knowledge since "it is important to society that such knowledge be used primarily in the community interest". According to Barber, the proper repository of this knowledge is those who fully understand the implications of practices based on that knowledge - the professionals.

Irrespective of the approach taken to a consideration of professions, the importance of theoretical knowledge receives substantial emphasis in the literature. Commonly, custodianship and
development of theory appear to be considered as important aspects of professional responsibilities. Whether a particular professional organisation is able to discharge these responsibilities adequately depends, in part, upon the power and prestige relationships within the profession and upon the degree of external influence which can be brought to bear upon the professional organisation. It could be argued, for example, that the appointment of senior members of the profession to committees charged with making proposals for change is to appoint those whose self-interest inevitably leads them to oppose change. James and Peloille argue that to charge senior members with responsibility for change is to demand of them "that they change the very system which was the source of their own authority and prestige and which had given them the power to bring about reform".33.

Innovations in the development of a theory which underlies professional practices might be seen to be desirable only when such innovations do not threaten the position of those in authority within the profession or the position of the profession in society.34. The security of the position of a profession within society and the likelihood of research innovations being seen as desirable depends upon the degree to which the profession is subject to external influence. For example, if the position of a profession in society depends upon continued support by patrons or legislation, innovations which might influence that support could be seen as threatening and, therefore, undesirable despite any intrinsic merit they may have.

Some writers hold that company auditing is in such a position of
comparative weakness, due to the extreme importance of support by legislation and by large business corporations\(^35\). This position of weakness is compounded by the fact that auditing is just one aspect of the activities of members of the accountancy profession. Many members are employed directly by the large companies which are subject to audit\(^36\). Thus, company audit practices can be significantly influenced by individuals employed within the group which is itself subject to audit. At the very least, these members will have a voice in the acceptance or rejection of any proposed changes to audit practices or to the theory which underlies them, in that they have the right as members of the professional organisation to comment on proposals before they are instituted\(^37\). They can even lobby for change after proposals have been implemented.

The history of the accountancy profession lends support to the claim that it has been subject to some degree of corporate control\(^38\). Initially, the accountancy profession evolved to serve the needs of business management during the late eighteenth and early nineteenth centuries. The profession developed as a result of the need to determine the rights and obligations of creditors and partners in businesses which could not meet their debts.

Accountants came into existence about the middle of the eighteenth century when some individuals found they were able to correct "business accounts which had fallen into a state of confusion", or to undertake the "supervision and realisation of bankrupt estates and the settlement of competing claims on the proceeds"\(^39\). It was only later that the attest function of the modern company auditor developed, with the advent of the joint-stock company. Since that
time, the growth of the accountancy profession has closely paralleled the growth of companies subject to audit and today only a relatively small number of large firms of auditors are responsible for the great majority of the audits of large public companies.\(^{10}\)

Johnson argues that the effect of the influence of client companies in the accountancy profession has been to create a situation where "the pursuit of basic knowledge is stressed less than knowledge specifically related to the needs of the [client]"\(^{11}\) and that, as a result, knowledge has tended to become specific in content and local in application. He suggests that theoretical knowledge has become less important than knowledge of specific techniques relevant to the client's peculiar circumstances, creating an environment in which it is possible that a large number of mutually inconsistent but equally acceptable techniques could have developed.

If the above comments constitute a description of the U.K. auditing profession which is at all accurate, it is likely that the profession has placed little emphasis upon theoretical research and has made little attempt to justify existing practices by the identification and formalisation of a theoretical framework. A brief examination of the professional literature reveals that there are no pronouncements which could be said to specify a theory of company auditing. In fact, until very recently there was little evidence that the U.K. auditing profession had devoted much time at all to a consideration of the underlying justification for recommended company audit practices. Even in the Auditing Standards and Guidelines, explanations and justifications are not presented in the form of coherent arguments. Rather, they are scattered
throughout the statement[^2]. Since there is no clear presentation of a theoretical structure within the Standards and Guidelines, it will be necessary to undertake a detailed analysis of that document if the body of theory which underlies present company audit practices is to be identified.
Summary

This and the previous chapter have been concerned with answering two important questions before the identification and evaluation of the theoretical framework of company audit practices could begin. Those questions were;

a) what is the nature of the theoretical framework that is to be identified and evaluated? and

b) where is the most appropriate place to look for that theoretical framework?

The first of these questions was addressed in Chapter 2, which was concerned with the nature of "theory" and "theoretical framework", as these concepts apply to the field of company auditing. A major conclusion of Chapter 2 was that the literature of the philosophy of science may be consulted in order to identify structural concepts applicable to company audit theory. Accordingly, the philosophy of Lakatos was examined and a structural paradigm for U.K. company auditing theory was proposed. It was argued that this paradigm enables the objectives inherent in attempts to develop a theory of company auditing to be satisfied and was adopted as the structural model for the identification of the theoretical framework of U.K. company audit practices.

The present chapter has argued that the most appropriate source to be consulted in order to identify a theoretical framework of company audit practices is the body of professional pronouncements in general and the Auditing Standards and Guidelines in particular. Some evidence from the literature of the sociology of professions
was presented to suggest that the U.K. auditing profession has a responsibility to construct a theory (or, at least, a "complex web of theoretical orientations") which will provide a framework for the determination of company audit practice. It was further suggested that there is little evidence that the profession has explicitly recognised this responsibility and undertaken research efforts designed to lead exclusively to the development of a theoretical framework for company audit practices. It was also argued, however, that despite the Auditing Standards and Guidelines being primarily of a practical nature, they do contain non-practical statements and will, with careful analysis, lead to the identification of the theoretical framework within which U.K. company audit practices have been derived.

Although it could not be argued that the Standards and Guidelines contain a fully developed theoretical framework (i.e. a theory of auditing), it was suggested that there exists sufficient "theoretical orientation" within that document to enable the identification of the theory within which practices recommended in the Standards and Guidelines have been derived. Accordingly, that document was adopted as the basis of a detailed analysis to be undertaken in the next part of this thesis in order to identify the theoretical framework within which company audit practices have been derived.
CHAPTER 4

THE IDENTIFICATION OF THE THEORY OF U.K. COMPANY AUDITING.

This chapter is concerned with establishing the means by which the theory of U.K. company auditing is to be identified. The first objective is to provide a set of criteria by which statements identified within the Standards and Guidelines can be classified so as to provide an indication of the function of those statements and the extent to which they are empirically verifiable. This issue is addressed in the first section the chapter, where the component elements of theories are examined and classified according to the structural role they play.

The second objective is to apply the general conclusions concerning theory components to the specific case of company auditing. In this way, the structure of an auditing theory is established and the role of particular statements in that structure clarified. This issue is addressed in the second section.

The third section provides an extended example of how the adopted theoretical structure is applicable to the identification of a theory of company auditing. In this section, the U.K. company auditing literature is examined in order to identify statements which could play a role in a theory of company auditing. Those statements are then organised according to the adopted structural model and the basis of two possible theories is established. The power of the adopted model is thereby illustrated and the feasibility of the remainder of the research project is demonstrated.
The final objective is to consider the methodology by which the content of the Standards and Guidelines is to be analysed in order to identify the implicit theoretical framework within which recommended company audit practices have been derived. By drawing upon the first three sections of this chapter, the final section describes the methodology by which the objectives of the research project will be achieved.

In summary, the objectives of this chapter are;
1. To provide a set of criteria by which the component elements of a theory of company auditing will be classified,
2. To describe the major elements of a theory of company auditing.
3. To illustrate the use of the adopted structural model in the identification of a theory of company auditing, and
4. To describe the methodology to be adopted in order to identify the theory contained within the Auditing Standards and Guidelines.

In Chapter 2 it was stated that, for the purposes of this thesis, "audit theory" is to be used in a narrow sense to refer to a set of statements structured according to the rules of deductive logic. Such a theory would constitute a framework within which consistent, justifiable and appropriate company audit practices might be derived. In order for practices to have these qualities, it has been suggested, it is necessary for the theoretical framework within which those practices are derived to have the same qualities. The determination of whether a particular theoretical framework does indeed possess those qualities is facilitated if that framework has been formalised to a high degree.

In order to present a formalised theory of company auditing, it is necessary to consider the ways in which theories are built and the kinds of statements which are likely to occur within a theory of company auditing. As indicated in Chapter 2, a deductive theory contains two general classes of statement; premises and conclusions, which are related by a deductive argument. This argument will be referred to as the "formal system" of the theory.

Within the formal system, some premises will be assumed, whereas others will be derived from earlier statements in the system. Similarly, some conclusions will represent the final statements in the system whereas others will constitute the basis upon which later statements depend. That is, some statements which are conclusions will also act as premises in the further development of the argument.
In the context of company auditing, the ultimate purpose of the formal system is to enable the derivation of company audit practices which are consistent, justifiable and appropriate. It is therefore likely that statements of practice will constitute the conclusions of the formal system. Some of these statements of practice will be intermediate conclusions (i.e. they will play a role in the derivation of other, more specific, practices) and others will constitute the final specific practices recommended on the basis of the formal system. Since the formal system under examination is that contained within and implied by the Standards and Guidelines, statements of practice will be of two general types. The first, and most common, will be those practices which company auditors are expected to apply. As such they will be called "rules". In general, any statement within the formal system which requires action by the company auditor will be considered to be a "rule".

The second type of practice to be found within the Standards and Guidelines will be those which company auditors may undertake if they wish, although there is no requirement or recommendation to do so. Such practices will be called "permissions".

Rules and permissions relating to specific company audit practices will be derived on the basis of earlier statements within the formal system (some of which could themselves be derived practices). Since one of the major objectives in presenting a formal system of company auditing is to derive practices which are justifiable, earlier statements on which those practices are based should also be justifiable. If the earlier statements are themselves practices,
they will be justified by the validity of the arguments in respect of which they constitute conclusions. Other classes of statement which are not conclusions, however, must be justified in some other way.

In general, the inclusion of such statements in a theory of company auditing will be justified either by demonstrating that the statements are true or, if they are not truth-functional, by demonstrating that their inclusion is acceptable to those who are directly concerned with the company audit process. Truth could be established either by the collection of empirical evidence or by the presentation of definitions referring to the component elements of statements such that the statement is true by definition. A theory which contains empirically verifiable statements will be less subject to arbitrary change (particularly if the statements have been verified) than one which depends upon definition. It is therefore desirable that a theory of company auditing be based, as far as possible, on empirically verifiable statements rather than on definition. Such empirically verifiable statements are called "propositions".

Propositions are of extreme importance in all theories. In fact, it has been suggested that theories are nothing more than a set of propositions;

\[ T \text{ is a theory} \quad \text{if and only if} \quad T \text{ is a set of propositions that is} \quad \text{believed to be somewhat plausible, potentially explanatory, relatively fundamental, and somewhat integrated}. \]

For \( T \) to be a theory, it is necessary... that \( T \) be a known proposition (or set of propositions).

A theory is a connected set of propositions.
Since propositions are of such importance to theories, it is necessary to consider in some depth the nature of such statements.

Propositions
The nature of propositions has been the subject of extensive philosophical debate for a number of years and it is much beyond the scope of this thesis to become overly involved in that debate. The literature does, however, suggest that propositions are considered to be expressed by statements which, in turn, are given the form of sentences. In this most general sense, propositions are taken to be the content of sentences.

If the function of a sentence which expresses a proposition is held to be "to pick out a state of affairs and say that it obtains"⁵, then the proposition can be considered to be a "bearer of a truth value"⁶. That is, the proposition itself could be either true or false. A proposition is defined as "a definite statement which can be true or false to some extent".

Since propositions are taken to be definite statements, one proposition could be expressed by a number of different sentences. For example, the sentence "the majority of audit reports are issued under the Companies Acts" could be expressed in the equivalent form: "A minority of audit reports are issued other than under the Companies Acts". Similarly, one sentence could express a number of different propositions. For example, the sentence "although the majority of audit reports are issued under the Companies Acts, some are issued under the Friendly Societies Act" contains at least two propositions: that most audit reports are issued under the
Companies Acts and that some audit reports are issued under the Friendly Societies Act.

A proposition consists of at least three components; two terms and another member the function of which is to describe the nature of the connection between the two terms and to assert that that connection in fact exists. All statements which can be expressed in the form of two terms and a copula and which could be true or false will be held to be propositions. Defined in this way, propositions consist of concepts in relation, are expressed in the form of sentences containing terms in relation, and assert something which might or might not be true.

Although the essential aspect of propositions is their truth-functional nature, truth-functional statements are not always sufficiently specific to enable their truth or falsity to be determined. In the Standards and Guidelines, for example, statements appear which, although truth-functional, are not immediately testable. As an example, paragraph 12 of the Auditing Guideline on planning, controlling and recording states that "Management structures vary between firms of auditors". This statement, although truth-functional, must be made more specific if evidence concerning its truth or falsity is to be collected. In its present form, it is unclear whether the discovery of just two firms of auditors with different management structures would confirm the claim, or whether the discovery of two firms with the same management structure would refute the claim. General truth-functional schemas such as this will be referred to as "propositional functions", and can be converted into propositions
either by specification of variables or by quantification.

Specification of variables involves ensuring that the variables in a propositional function take specific values. For example, the above propositional function could take the form of a proposition if it were expressed as;

"Firm A has a different management structure to firm B"

Alternatively, a proposition can be derived from a propositional function by the addition of a quantifier. If this method is adopted, the above propositional function could become;

"No two firms of auditors have the same management structure"

As suggested earlier, the formal system could also contain statements which are included only on the grounds that they are generally acceptable. That is, they are not empirically verifiable and are by their very nature tentative and subject to dispute. Definitions, particularly of technical terms, fall within the class of such statements.

To summarise, a schema of statements which appear in the formal system of a theory is follows^7;
<table>
<thead>
<tr>
<th>Conceptual form</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>Propositional Function</td>
<td>Firms have different management structures</td>
</tr>
<tr>
<td>Proposition</td>
<td>Firm A has a different management structure to firm B</td>
</tr>
<tr>
<td>Rule</td>
<td>The management structure of firm A should be designed so as to be different to the management structure of firm B.</td>
</tr>
<tr>
<td>Permission</td>
<td>The management structure of firm A may be designed so as to be different to the management structure of firm B</td>
</tr>
<tr>
<td>Definition</td>
<td>If the chain of command within firm A is different to that in firm B, then firm A has a different management structure to firm B</td>
</tr>
</tbody>
</table>

The proposition in the above table has been derived from the propositional function by specifying all of the object and predicate variables. Thus, the non-specific "firms" becomes the specific firms A and B. In a theory of company auditing, it is unlikely that object and predicate variables will be specified. For example, it is unlikely that a theory of company auditing would refer to specific firms of auditors. Rather, propositions would be more likely to be derived from propositional functions by the process of quantification, in which claims are made about specific numbers or a specific proportion of firms of auditors. The process of identifying the theory contained within and implied by the Standards and Guidelines will be based on this assumption and, where necessary, propositions will be derived from propositional functions by the process of quantification.

Although a formal system of company auditing will derive audit practices and provide arguments to support the claim that those
practices are consistent, justifiable and appropriate, the formal system will not be sufficient to enable company audits to be conducted. In order for the derived practices to be applied in appropriate circumstances, for the concepts used to be interpreted as intended and for auditors to be adequately aware of the nature and purpose of derived practices, it will be necessary to introduce an additional system of statements to fulfill three roles.

The first role is to indicate the situations and circumstances in which the theory is held to be valid. In the case of the Standards and Guidelines, for example, the date on which the requirements became effective would constitute an indication of the period in which the theory is held to be valid. The second role is to provide interpretive definitions which express terms and concepts used within the formal system in more familiar terms. Such interpretive definitions would not provide the basis for the derivation of further company audit practices; they would act only to facilitate a consistent understanding of the formal system. The final role is to provide examples of problems, situations, documents, etc., which are referred to in the formal system. That is, additional statements might be necessary to illustrate how the practices derived in the formal system should be interpreted in various practical situations.

Such a system of additional statements will be referred to as an "operational system", and will contain primarily statements of scope, definitions and examples and, as such, will contain very few empirically verifiable statements. The major classes of statement appearing within the operational system can be summarised as follows;
Conceptual form | Example
---|---
Statement of scope | The rules regarding management structure are applicable to the U.K. only.
Interpretive definition | The "management structure" of an audit firm is its chain of command.
Example | An example of a "management structure" is where the audit manager is directly responsible to the senior partner.

To summarise, the formal theoretical system of company auditing will be supported by an operational system. The component parts of these systems are as follows;

<table>
<thead>
<tr>
<th>Formal system</th>
<th>Operational system</th>
</tr>
</thead>
<tbody>
<tr>
<td>Propositional functions</td>
<td>Statements of scope</td>
</tr>
<tr>
<td>Propositions</td>
<td>Interpretive definitions</td>
</tr>
<tr>
<td>Rules</td>
<td>Examples</td>
</tr>
<tr>
<td>Permissions</td>
<td></td>
</tr>
</tbody>
</table>

Definitions

The Lakatosian structure presented in Chapter 2, which is to be used as a model for the identification of the theory underlying extent company audit practices, is applicable to the formal theoretical system. In order to develop a formal system in the terms of the proposed framework, it is necessary to have some means of identifying the component elements of the "hard core" and differentiating them from statements which form the "protective belt". Propositions which are considered to be components of the "hard core" are the subject of the next section of this chapter.
Section 2. Structural Elements in Company Audit Theory.

Fundamental Propositions

The Standards and Guidelines contain numerous propositions, propositional functions and other statements such as rules and definitions. Of the propositions, some will be more central for the Standards and Guidelines, or more distinctive of them than others. These propositions constitute the set of central and distinctive propositions of U.K. company auditing.

Being assumptions, the set of central and distinctive propositions are not derived from others in the Standards and Guidelines. Being central, they express the most important ideas of the Standards and Guidelines and being distinctive, they serve to distinguish the theory implicit in the Standards and Guidelines from other theories. As such, these propositions will be referred to as "fundamental propositions". In terms of the structural considerations introduced in Chapter 2, fundamental propositions will occur in the "hard core" of the theory of company auditing which is represented in the Standards and Guidelines.

Fundamental propositions have a number of important characteristics; 1) Since they are part of the hard core, they are "protected" propositions. That is, efforts will be made by supporters of the theoretical basis of the Standards and Guidelines to protect fundamental propositions by suitable amendments to the "protective belt", or by explaining away refuting evidence as merely apparent.

2) They are the basis of both research and practice. That is, fundamental propositions guide research by indicating which
apparently refuting observations require explanation rather than minor amendments to the Standards and Guidelines. For those who seek to introduce fundamental changes to the professional literature, it is necessary to direct research effort toward the successful refutation of the fundamental propositions contained within or implied by that literature. Similarly, fundamental propositions are the foundation of company audit action. Since refutation of a fundamental proposition in auditing is likely to imply a significant change to accepted audit practices, fundamental propositions play a crucial role in determining what the auditor does.

3) They are presupposed knowledge but are not necessary truths. That is, fundamental propositions are supposed to be true, although at least some of them can be subjected to examination and possible refutation by the collection of empirical evidence.

4) The truth of fundamental propositions is necessary for the continued existence of the theory which underlies the Standards and Guidelines. That is, the successful refutation of a fundamental proposition implies the rejection of the theory within which that proposition occurs and the abandonment of any practices which are prescribed or recommended on the basis of that proposition, unless such practices can be derived in other ways in alternative theoretical frameworks. The changes necessitated by the abandonment of a fundamental proposition could well be so extensive as to amount to the establishment of a new set of standards and guidelines.

It follows from these criteria that what propositions are taken as
fundamental is subject to change through time. Indeed, the emergence of new theories requires the development of new fundamental propositions, for a new theory is one with a new hard core and a new body of fundamental propositions.

To summarise, the fundamental propositions of company auditing
1) are not open to refutation to the same extent that non-fundamental propositions are,
2) guide audit research as well as audit practice,
3) are presumed to be true and are necessarily true if the theoretical system is to survive,
4) are indispensible to the theoretical system.

It is, however, not an easy task to identify the fundamental propositions of U.K. company auditing. As has already been suggested, the theory of company auditing is not highly formalised or well articulated and, as a result, it is extremely difficult to determine the dispensibility, indispensibly or in general the "structural position" of any of its propositions. Similarly, audit research has not been conducted within the framework of a formal theory, so it is difficult to identify those propositions which have guided research in the past.

It is not possible, therefore, to identify the fundamental propositions of U.K. company auditing by examining the structure of the theory of company auditing. Similarly, an examination of the nature of research into company auditing which has been carried out in the past can provide only the vaguest suggestion of the nature of fundamental propositions in company auditing.
In the earlier chapters of this thesis, however, the close links between audit theory, audit practice and the Standards and Guidelines has been emphasised. This link will provide the major means by which the fundamental propositions of U.K. company auditing will be identified in this thesis. A proposition will be treated *prima facie* as a fundamental proposition of U.K. company auditing if:

1. it occurs in an argument which derives the company audit objectives to be found within the Standards and Guidelines,
2. it is not derived from other statements in that argument, and
3. a fundamental change to both the Standards and Guidelines and to company audit practice would be necessary if the proposition were refuted.

**Fundamental Propositions in U.K. company audit theory**

The U.K. literature on company auditing suggests that there are two areas in which propositions fundamental to the existence of the company audit function occur. The first is the area of justification. If U.K. company auditing in its present form is to be justified, it is necessary to present arguments which derive a primary objective of company auditing and which demonstrate that the successful achievement of that objective would be beneficial.

If these arguments were identified and expressed in a formal, explicit manner, their component propositions could be identified. If one or more of those propositions were shown to be false, that argument for the continued justified existence of the company audit function could no longer be sustained, even if the argument were valid.
If a particular argument which justifies company auditing were demonstrated to be invalid, or if propositions contained within the argument were demonstrated to be false, company auditing would have to be justified on other grounds. If no other grounds had been given, or none could be identified, the company audit function would be without justification and those who support the continued existence of that function would be unable to argue convincingly against those, for example, who would press for the removal of compulsory audit from the legislature. Propositions contained within such arguments are fundamental to U.K. company auditing since, if they are shown to be false, company auditing in its present form would be unjustified. Such propositions will be styled "justifying propositions", and the arguments in which they occur "justifying arguments".

The second area containing propositions fundamental to the existence of company auditing consists of arguments which demonstrate that it is possible to achieve the primary objective established within a justifying argument. Such arguments will be called "enabling" arguments.

In order to demonstrate that it is possible to achieve the primary objective, two general classes of claim must be made. Firstly, it must be possible to derive audit practices such that the implementation of those practices will result in the attainment of the primary objective. That is, it must be possible to demonstrate that audit practices exist which will enable the primary audit
objective to be achieved.

Secondly, it must be demonstrated that there are no circumstances which prevent the implementation of derived audit practices. If it were shown that circumstances are such that it is not possible to implement derived practices, then those same circumstances would prevent the achievement of the primary audit objective. Accordingly, it would be necessary either to change the primary objective, or to alter the circumstances which prevent the achievement of that objective if the continued existence of the company audit function were to be justified. Propositions contained within arguments demonstrating the possibility of attaining the primary company audit objective are also fundamental to company auditing since, if those propositions are be shown to be false, successful achievement of the primary objective will be impossible. Were this the case, there would be no point to the conduct of an audit examination, despite the desirability of achieving the stated audit objective. Propositions within such arguments will be referred to as "enabling propositions".

Other propositions in U.K. company audit theory

Within the formal system of company audit theory, the "hard core" consists of justifying and enabling arguments. The remainder of the formal system consists of arguments which derive appropriate audit procedures to be adopted in order to achieve secondary audit objectives and, through those, the primary audit objective. Such procedures will be subject to change at any time, in response to evidence which suggests that a proposition within the argument is
false, to changes in the business environment as a result of which a procedure becomes inappropriate, or to advances in available audit techniques. Since this aspect of the theory is flexible and can be amended without threatening the integrity of the hard core, it constitutes a "protective belt". Procedures can be introduced, withdrawn or amended as circumstances change without threatening either the nature of the primary audit objective or the possibility of achieving that objective.

Arguments which derive appropriate company audit practices will be called "procedural arguments", and propositions contained within such arguments "procedural propositions". The above discussion enables the structure of the two theoretical systems to be diagrammed;
This framework will be used as the basis for analysing the Auditing Standards and Guidelines in order to identify the theory which underlies current company audit practices in the U.K. Before doing so, however, the literature on U.K. company auditing other than the Standards and Guidelines will examined in order to identify the justifying arguments contained therein. This examination will serve two purposes. Firstly, it will provide an extended example of how the above framework could be used in order to identify the "hard core" of different theories of company auditing and, secondly, it
will give an indication of the kind of theory likely to be found in the Standards and Guidelines.
Section 3 Justifying Arguments in the Literature.

Although there is a substantial body of literature concerned with the "principles and practices" of company auditing in the UK, it is difficult to find within that literature clear arguments which explain precisely why the existence of the company audit function is justified. Yet the literature, the Standards and Guidelines and the support given to company audits by the law, suggest acceptance of a general proposition that audit activity and audit reports are useful.

However, most of the literature remains vague as to the precise manner in which company audit reports are useful, apart from suggesting that an audit report, whether qualified or not, provides some indication of the reliability of the financial statements to which that report refers. Why it is necessary to have some indication of reliability, however, is rarely subjected to detailed analysis.

It is apparent from the literature that it is frequently assumed that financial statements are used by shareholders as a basis for decisions concerning either investment in companies or the extent to which directors have discharged their duty of accountability. Further, it is frequently assumed that the presence of an audit report provides shareholders with some guidance as to the extent to which financial statements constitute a reliable basis for these decisions. It is believed that, without an audit report, shareholders will not know whether the financial statements are reliable and might make inappropriate decisions as a result.
An examination of the literature suggests that there are two main propositional systems (arguments) which explain and justify the existence of the company audit function. These two arguments will be styled 1) the accountability argument and 2) the investment decision argument.

The Accountability Argument

This argument is based on the claims that directors are accountable to shareholders and that this duty of accountability is discharged by the provision of financial information. The role of the company auditor is to provide shareholders with an indication of the extent to which the financial statements provided by the directors are sufficiently reliable to be used when judging whether the duty of accountability has been adequately discharged.

It is possible to identify the most important components of this argument and to express them in the form of a structured series of statements. In terms of the concepts developed in this thesis, such a series could be considered to constitute a major part of the formal theoretical system of company auditing. In the formulation which follows, both the type of statement and premises for the statement are indicated in brackets.

1. In circumstances where the power to manage resources is granted by one party to another, the managers of the resources are held to be accountable by those who granted the power of management.

[propositional function]
2. In companies, the power to manage resources is granted by shareholders to directors.
[propositional function]

3. Company directors are held to be accountable by shareholders.
[propositional function, derived from 1,2]

4. Where one party is held to be accountable by another, that duty of accountability should be discharged to the satisfaction of the latter party.
[rule]

5. Company directors should discharge their duty of accountability to the satisfaction of shareholders.
[rule, derived from 3,4]

6. In order for company directors to discharge their duty of accountability to the satisfaction of shareholders, it is necessary that directors prepare and present annual financial statements which are reliable and which are believed by shareholders to be reliable.
[propositional function]

7. Shareholders use annual financial statements to determine whether they are satisfied with the exercise of resource management power by directors.
[propositional function]

8. Shareholders are able to take action against directors if shareholders are not satisfied with the way in which resource management power has been exercised by directors.
[propositional function]
9. It is in the directors' interests to prepare and present annual financial statements which will result in a belief by shareholders that the exercise of resource management power has been satisfactory.

[propositional function, derived from 7,8]

10. Annual financial statements which result in a belief by shareholders that the exercise of resource management power by directors has been satisfactory when in fact that belief is unjustified are "unreliable financial statements".

[definition]

11. It is possible for annual company financial statements to be unreliable.

[propositional function, derived from 9,10]

12. If it is possible for annual company financial statements to be unreliable, and if shareholders are not provided with an explicit indication of whether annual financial statements prepared by directors are reliable, the accountability of directors to shareholders will not be discharged.

[propositional function, derived from 6]

13. Shareholders should be provided with an explicit indication of whether annual financial statements prepared by directors are reliable.

[rule, derived from 5,11,12]

14. If an independent, professionally qualified third party has formed an opinion on the truth and fairness of the annual financial
statements and reported that opinion to the shareholders, they will have an explicit indication of whether those financial statements prepared by directors are reliable.

[propositional function]

15. If an independent, professionally qualified third party has formed an opinion on the truth and fairness of the annual financial statements and reported that opinion to the shareholders, an audit will have been carried out.

[definition]

16. Company annual financial statements should be audited.

[rule, derived from 13,14,15]

The above formulation is by no means the only way in which the accountability argument can be expressed, and it appears in the U.K. company auditing literature in a range of guises, supported by a number of authors\(^{12}\). In all of the formulations, the most important components seem to be:

a) that directors are accountable to shareholders
b) that accountability is discharged by preparing annual financial statements
c) that there is a conflict of interest between the directors' obligation to prepare reliable financial statements and their desire to be seen in a favourable light by the shareholders
d) that the role of the auditor is to provide an indication as to the outcome of that conflict of interest.

We shall return to an examination of these component elements after considering an alternative justification for U.K. company auditing.
The Investment Decision argument

This argument adopts a rather wider view of the function of the company audit than is adopted in the accountability argument. Essentially, the investment decision argument justifies company auditing on the grounds that the audit report is an additional item of information which shareholders will need when faced with an investment decision. The argument depends on the claim that the audit report has an important role to play in ensuring that investment decisions have the outcome which is desired by the shareholder.

Adopting a similar methodology to that of the previous argument, the investment decision argument is formulated as follows:

1. Shareholders invest in companies in order to achieve their own objectives.
   [propositional function]

2. The objectives of individual shareholders differ.
   [propositional function]

3. The abilities of companies to satisfy the objectives of individual shareholders differ.
   [propositional function]

4. A shareholder wishes to invest in those companies which are best able to meet the objectives of that shareholder.
   [propositional function, derived from 1,2,3]
5. Shareholders use financial information about companies when determining which company is best able to meet the objectives of that shareholder.

[propositional function]

6. Financial information about companies is provided by the directors in the form of annual financial statements.

[propositional function]

7. Shareholders will base investment decisions on the content of annual company financial statements

[propositional function, derived from 4,5,6]

8. Annual financial statements which give the impression that a company is able to meet the objectives of a particular shareholder when in fact the company cannot meet those objectives are "unreliable financial statements".

[definition]

9. Shareholder investment decisions based on unreliable financial statements will be unlikely to result in the outcome desired by the shareholder.

[propositional function, derived from 4,7,8]

10. There should be a means of minimising the risk of undesired outcomes of shareholder investment decisions.

[rule]
11. If shareholders are provided with an explicit indication of the reliability of annual company financial statements, shareholder investment decisions will not be based on unreliable financial statements.
[propositional function]

12. There should be a means of providing shareholders with an explicit indication of the reliability of company annual financial statements.
[rule, derived from 9,10,11]

13. If an independent, professionally qualified third party has formed an opinion on the truth and fairness of the annual financial statements and reported that opinion to the shareholders, they will have an explicit indication of whether those financial statements are reliable.
[propositional function]

14. If an independent, professionally qualified third party has formed an opinion on the truth and fairness of the annual financial statements and reported that opinion to the shareholders, an audit will have been carried out.
[definition]

15. Company annual financial statements should be audited.
[rule, derived from 12,13,14]

As with the accountability argument, this formulation is just one of a number of possible formulations of the same or similar arguments. The important components of the investment decision
argument, regardless of the form in which it is expressed, seem to be

a) that annual company financial statements are used in shareholder investment decisions

b) that annual financial statements might not be a reliable basis for shareholder investment decisions.

c) that shareholders require some indication of the reliability of annual company financial statements in order to determine the extent to which reliance upon those statements when making investment decisions is justified.

d) that the role of the auditor is to provide an indication of the reliability of annual company financial statements.

Both of the above arguments conclude with the "rule" that company annual financial statements should be audited, so both provide a justification for the existence of the company audit function. In order to understand the implications of these arguments, it is useful to represent them diagrammatically;
The Accountability Argument

The Investment decision argument

In the above diagrams, "rules" are shown on the right hand side of the dotted line and other statements on the left. In this way, the process of building a set of normative statements is explicated. The abbreviations used are;

PF = Propositional function
D = Definition
R = Rule.

These diagrams suggest a number of important observations which can be made concerning the formulations of the above arguments.
Firstly, although the manner of expression of the arguments appears relatively formal, they are not necessarily complete in a strictly logical sense. For example, concepts such as "accountability", "resources" and "truth and fairness" are introduced without explicit definition. This is primarily because no attempt has been made to specify the operational systems which would support the stated formal systems, although it must be recognised that the arguments presented could still be criticised for a failure to use precisely defined terms.

The form of expression of the arguments suggests the nature of the essential definitions. For example, "accountability" would need to be defined in such a way that an indication of the reliability of financial statements is necessary to the discharge of accountability (accountability argument, statement 6). Similarly, a definition of "truth and fairness" would necessarily provide that financial statements could not be both "true and fair" and "unreliable" (accountability argument, statement 14). A similar analysis of terms and concepts appearing in the investment decision argument could also be undertaken.

The accountability argument, as presented, is also incomplete in that statement 12 is derived only from statement 6. In fact, statement 12 is an extension to the claim made in statement 6, for it suggests that it is possible for directors to present reliable financial statements but still to fail to discharge their duty of accountability (i.e. where no indication of the reliability of those financial statements is provided).
This abbreviation of argument and lack of definition is justified in that the purpose of the present discussion is only to illustrate the manner in which justifying arguments can be formally expressed so as to enable the identification of the component propositions of those arguments. In principle, it would be possible to use symbolic logic to demonstrate the precise derivation of each statement in order to ensure that the argument is complete.

The second important observation regarding the stated arguments is that they both depend upon fundamental normative statements expressed in the form of underived rules. In order to justify the need for company audits, the accountability argument depends upon the (underived) rule that accountability obligations should be discharged (statement 4). Similarly, the investment decision argument depends upon the underived rule that the risk of undesired outcomes of shareholder investment decisions should be minimised (statement 10).

Ultimately, all arguments purporting to justify the existence of company auditing must rest upon one or more similar assertions. Since company auditing is not a science in the same way as the physical sciences, no attempt is made to explain or predict aspects of the real world. As a result, there is no "truth" or "reality" which is the ultimate arbiter of the acceptability of company audit theory.

In the final analysis, justification for the existence of company auditing rests upon a fundamental normative statement which asserts the desirability of some other factor. In turn, the acceptability
of the argument justifying company audits depends upon the acceptability of the fundamental normative statement. Since any justification of company auditing must be based upon a fundamental normative statement, the difficulties of establishing a generally accepted starting point are unavoidable. And since the admissability of any fundamental normative statement depends upon general acceptance, it will be impossible to demonstrate that company auditing is necessary in any absolute sense.

Similarly, both arguments contain premises in the form of definitions. As with the fundamental normative statement, the best that can be hoped for is a consensus regarding the admissability of definitions. Accordingly, justified company audit practices are those derived within a theory which satisfies four criteria; a) there exists a consensus regarding the acceptability of the fundamental normative statement, b) there exists a consensus that stated definitions are acceptable, c) evidence could be adduced to demonstrate that stated propositions are true, and d) the argument which demonstrates the necessity for company auditing is valid.

A third observation based on the above diagrams is that it is possible to identify those propositional functions which satisfy the structural criteria for fundamentality. That is, they are those propositional functions which are not derived from earlier statements. In the accountability argument, they are statements 1, 2, 6, 7, 8 and 14. In the investment decision argument, they are statements 1, 2, 3, 5, 6, 11 and 13. Each of these functions could
be tested in order to determine whether they are true. If found to be false, the argument in which they occur would have to be rejected in its present form.

A further observation based on the representation of the arguments concerns the rules which have been derived. All rules which appear in the arguments are derived from rules presented earlier in the argument, with the exception of that rule assumed to be necessary (i.e. the fundamental normative statement). Ultimately, the purpose of a theory of company auditing is to derive rules for auditor behaviour on the basis of propositional functions, definitions and earlier rules. It is thus clear that all rules must either be assumed to be necessary, or must be based on earlier rules; it will not be possible to derive rules solely on the basis of propositional functions. This observation places the roles of the components of company audit theory in perspective; the purpose of introducing propositional functions and definitions into the argument is to derive rules (or permissions), and any propositional function or definition which is not used for this purpose is superfluous to requirements.

The final important aspect of the above formulations is that they contain no propositions. It is very uncommon to find arguments within the U.K. company auditing literature which are expressed in the form of propositions rather than propositional functions. However, it is possible to derive propositions from the stated propositional functions by quantification or by specification of the variables. For example, statement 6 in the accountability argument is;
In order for company directors to discharge their duty of accountability to the satisfaction of shareholders, it is necessary that directors prepare and present annual financial statements which are reliable and which are believed by shareholders to be reliable.

A proposition derived from this propositional function could be:

There is no shareholder who believes that the directors' duty of accountability will be discharged unless the directors prepare and present annual financial statements which are reliable and which are believed by that shareholder to be reliable.

Such a proposition could be subjected to empirical test. If found to be false (assuming that the proposition properly reflects the content of the propositional function), there would be no way to be sure of the truth of the conclusion of the accountability argument (i.e. that annual company financial statements should be audited).

The above discussion suggests that it is possible to attack arguments purporting to justify company auditing in at least four ways. These attacks would involve demonstrating;

a) a lack of consensus concerning the acceptability of the fundamental normative statement

b) a lack of consensus concerning the acceptability of stated definitions,

c) the existence of evidence which refutes one or more of the propositions in the argument, or

d) the invalidity of the argument itself.

Before any of these attacks can begin, however, it is necessary to organise statements into the form of a deductive argument, specify the fundamental normative statement, identify necessary definitions and state any further introduced propositions. It is also important to realise that the refutation of any argument justifying the existence of company auditing does not necessarily constitute
sufficient grounds for claiming that company auditing is unjustified, for it will often be possible to avoid the source of refutation by inventing other justifications. Indeed, the literature suggests that other justifying arguments have already been presented.

For example, company auditing has been justified on the grounds that the presence or absence of audit has a significant effect on the extent to which the directors of any company are likely to commit fraud\textsuperscript{17}. It should be noted, however, that this justification is almost always presented as an alternative, or secondary argument to either the accountability or investment decision argument\textsuperscript{18}. It is of some importance, though, for if the accountability and investment decision arguments are found to be untenable, it would be possible for proponents of company auditing to retreat to this secondary justification which, it will be noted, does not depend upon claims about the effect of audit on the perception of financial statement reliability.

The literature contains one further justification of company auditing which should, perhaps, be considered to be the justification of last resort. It depends solely on the proposition that company audits are required by legislation and the rule that the provisions of statutes should be adhered to. As with the secondary argument discussed above, a legal justification is most often presented as subsidiary to either the accountability or resource allocation argument\textsuperscript{19}. Also as with the above argument, it does represent a position to which proponents of company audits could retreat if necessary. And it would be very difficult to
present convincing counter-arguments.

It is clearly possible to identify in the literature a number of different justifications for the existence of the company audit function in the U.K. In terms of the concepts adopted in this thesis, the existence of alternative justifications suggests that there exists a number of different theories of company auditing. As indicated earlier, the primary aim of this thesis is to identify the theory which is contained within the Auditing Standards and Guidelines. We are now in a position to describe the methodology by which this objective is to be achieved.
Section 4. Identifying the Theory of Company Auditing within the Standards and Guidelines.

It was argued in Chapter 3 that the appropriate source of the theory underlying extant company audit practice in the U.K. would be the Standards and Guidelines. This chapter has examined the auditing literature in general in order to identify the more common classes of argument justifying company audits. In order to identify the theory which underlies extant company audit practices, the Standards and Guidelines will be subjected to a similar, but substantially more detailed, analysis.

Since the Standards and Guidelines do not contain an explicit formal system, it is necessary to rework the contents of that document if the theory contained therein is to be identified. The major part of this project consists of clarifying concepts, identifying propositions and looking for implicit propositions by which the stated propositions can be connected. As a first step in this process, it is necessary to identify the specific meaning of each sentence in the Standards and Guidelines and to express that meaning as a singular statement. The results of this step are presented as Appendix A. That appendix also indicates the nature of the identified statements which, in turn, suggests the role that they play in a structured theory.

Appendix A is used as the basis for the identification of the theory contained within the Standards and Guidelines. Statements within that appendix have been rearranged according to subject area, relations between them identified and, where necessary, further
statements introduced in order to explain fully the derivation of the statements contained within the Standards and Guidelines. The results of this second stage are presented as Appendix B. Finally, the theory as presented in Appendix B has been represented diagrammatically as Appendix C. As with the accountability and investment decision arguments presented in this chapter, the combination of the stated theory and the diagrammatic representation of that theory facilitates interpretation, analysis and criticism of the theory. Since the three appendices constitute the basic data upon which the remainder of this thesis depends, it is necessary to consider in some detail the methodology by which they have been derived.

Appendix A: Statements within the Standards and Guidelines

There is little difference between the content of the Standards and Guidelines and that of Appendix A. Each paragraph in the Standards and Guidelines has been examined and the component statements expressed as single ideas. In some cases, it has been necessary to express what appears to be a single statement in the Standards and Guidelines in the form of a number of statements in Appendix A. For example, paragraph 8 of the Explanatory foreword states;

The responsibility for the prevention and detection of fraud rests with the management, who may obtain reasonable assurance that this responsibility has been discharged, by instituting an adequate system of internal control.

This statement has been expressed in the form of two propositional functions in Appendix A:

Management is responsible for prevention and detection of irregularities and fraud.

An adequate internal control system provides management with reasonable assurance that its responsibility for prevention and detection of irregularities and fraud will be discharged.
Appendix A is cross-referenced both to the Standards and Guidelines and to Appendix B. As a result, both the derivation of Appendix A from the Standards and Guidelines and of Appendix B from Appendix A can be verified. For an explanation of the cross-referencing codes used, see the contents page of Appendix A.

Perhaps the most important aspect of Appendix A is the classification of each statement according to its type which, in turn, enables the structural position of each statement in the theory proper to be determined. The classification of statements is based on the discussion of statement types presented earlier in this chapter, and seven different types appear in Appendix A:

1) Administrative statements. These statements concern only the structure or administration of the Standards and Guidelines document itself and, therefore, play no role in the theory specified in Appendix B. They provide, for example, that the contents of a particular section "should be read in conjunction with the Explanatory Foreword".

2) Propositional functions. As discussed earlier, these are statements which are truth functional. That is, they are claims made within the Standards and Guidelines which could be either true or false and are used as the basis for the derivation of appropriate company audit practices. Some of these propositional functions will be more central to the theory than others, and the relative importance of these components of the theory is discussed in Chapter 6.
3) Definitions. In general, there are two types of definition to be found within the Standards and Guidelines. One type acts as a premise in the derivation of one or more audit practices and, therefore, plays an important role in the formal theoretical system. The other type of definition is interpretive, expressing concepts used within the formal system in more familiar terms. Accordingly, definitions of this latter type do not play a role in the derivation of audit practices and appear in the operational system of the theory.

4) Rules. These are codes of behaviour to which the auditor is expected to adhere. Rules are expressed in a number of ways within the Standards and Guidelines, and the following phrases have all been interpreted as expressing rules;

"the auditor should"
"the auditor must"
"the auditor needs to"
"the auditor will"
"...must be maintained"
"it is improper to"
"the auditor may not"
"the auditor is not entitled to"
"...will be appropriate"
"the audit report should"
"...will be described...
"...should be reported by"
"the auditor is unable to"
"...are relevant to the work of an auditor"
"the decision...will be kept under review"
"...might be based on questions..."
"the greater the...the more...must be..."
"is particularly appropriate..."
"the decision...will have to be made"
"...is particularly required"
"...should be carried out by..."
"...should be introduced by..."
"the audit report does not..."
"...should not be regarded"

It will be apparent from the above list that the term "rule" is used to describe audit actions which vary from those apparently intended to be compulsory to those intended as merely desirable. In translating the content of Appendix A into a form suitable for expression as a theory (i.e. in Appendix B), the phrase "the auditor should..." has been adopted for all rules of audit behaviour, with no distinctions between rules apart from those distinctions brought about by the nature of the argument or, as will be discussed in more detail later, the structural position of the rule. The relative importance of audit rules can be determined by examining their structural position in general and the extent to which they form the basis of further derived rules in particular.

5) Permissions. Occasionally, the Standards and Guidelines permit the auditor to carry out an action if he so wishes, but do not actually require that the action be carried out. An example of this is paragraph 7 of the Guideline on internal control, which gives the auditor permission to reduce substantive testing in circumstances
where an adequate system of internal control exists.

In some cases, it is difficult to distinguish between "desirable rules" and "permissions". For example, paragraph 12 of the Guideline on internal control states that documentation which helps to identify internal controls "might be based on" certain types of questions. It is unclear whether the intention here is to give the auditor permission to ask certain questions if he so desires, or to indicate the kinds of questions which ought to be asked. Where such ambiguities exist, statements were expressed in a form which required auditors to consider whether the stated procedure should be implemented. Thus, a rule is developed, but the procedure itself is not treated as a recommended practice. For example, the above statement was reformulated as "the auditor should consider whether" to ask certain types of questions. In short, only where codes of behaviour cannot be considered to be rules of any kind, have they been treated as permissions. As a result, Appendix B contains relatively few permissions, although it must be emphasised that it is still necessary to show how permissions have been derived if audit actions are to be justified. Permissions are expressed in Appendix B in the form "the auditor may...".

6) Examples. Statements which relate concepts and circumstances described within the Standards and Guidelines to those which have been, or might be, encountered in practice are classed as examples and included in the operational system of the theory. For example, the appendix to the Guideline on internal control provides a number of examples of different types of internal controls. These examples play no role in the derivation of specific company audit practices
and are not part of the formal system. Rather, the purpose of these examples is to provide the practitioner with an indication of the kinds of controls to which the Guideline refers. In Appendix B to this thesis, these examples of internal controls have been included in the operational system of the theory.

7) Statements of scope. The final class of statement to be found in the Standards and Guidelines consists of those which describe the circumstances under which the provisions of the Standards and Guidelines are held to apply. For example, paragraph 12 of the Guideline on planning, controlling and recording states that the guideline has been written "on the basis that the audit is carried out by a reporting partner and his staff". This has been interpreted as a statement that the provisions of that guideline are only applicable to such audits. That is, that the scope of the pronouncement is limited to audits carried out by a reporting partner and his staff. This statement has been interpreted in Appendix B as specifying the circumstances under which the propositions in the Guideline on planning, controlling and recording are asserted to be true. As a result, it is a statement of the scope of the theory, and is included as a component of the operational system.

In a few cases, statements within the Standards and Guidelines have been taken as containing more than one of the above classes. For example, paragraph 13 of the Guideline on review of financial statements contains a statement to the effect that the auditor should review the financial statements in order to ensure compliance with the requirements of statutes, SSAP's and other applicable
regulations. This has been taken firstly as part of the rule that auditors should conduct an overall review of financial statements and secondly as a component of the definition of an "overall review". These two aspects are reflected as statements 12.1 and 12.2 in Appendix B.

Appendix B: A theory of company auditing

This appendix specifies the formal theoretical system of company auditing which has been identified on the basis of the content of the Standards and Guidelines. In order to construct this formal system, the statements contained in Appendix A were analysed according to the class of statement within which they fell and were classified according to broad subject areas. Appendix A statements were rearranged to reflect, as far as possible, a consistent, logical argument. Where it was not possible to identify a complete stream of argument in Appendix A, additional statements were introduced in order to link the statements already identified.

The process of rearrangement of Appendix A statements resulted in the identification of thirteen sections within the formal system. These are;

1: Company audits, in which the nature and objectives of the company audit function are established,

2: Auditor judgement, in which the need for, and importance of, auditor judgement is derived

3: Materiality, in which materiality is derived as an important area in which the auditor should exercise judgement,

4: Truth and fairness, in which the nature of truth and fairness is
established and a series of criteria by which company auditors can judge truth and fairness is derived,

5: Evidence, in which the nature and purpose of audit evidence is considered,

6: Consultation with other auditors, in which the circumstances for consultation and the precautions to be taken when consulting another auditor are examined,

7: Planning

8: Controlling

9: Recording,

in which a derivation of and justification for the need to plan, control and record the audit is provided. These three sections also describe the procedures which should be adopted by company auditors at these stages of the audit.

10: Internal control

11: Accounting systems,

in which company audit practices appropriate to the examination and evaluation of internal control and accounting systems are derived,

12: Review of financial statements, in which the need for an overall review is specified and appropriate procedures identified,

13: Audit Reporting, in which the nature of the audit report is examined.

There is also an additional section, identified in Appendix B as section 14, which contains those elements of the operational system which are to be identified in the Standards and Guidelines.

In rearranging the statements identified in Appendix A, the
intention was to create a flow of argument which derives increasingly specific company audit practices. Thus, audit procedures which are applicable in a wide range of circumstances appear in earlier sections of the theory.

Within Appendix B, statements are identified by a code which reflects both the section of the theory in which they appear and their position in the argument. Thus, statement 6.8 is the eighth statement in section 6 of the theory. These reference codes appear in Appendix B to the left of the statement to which they refer.

Appendix B also contains a cross-reference to Appendix A, which facilitates a verification of the link between the theory and the content of the Standards and Guidelines. This cross-reference appears in Appendix B immediately underneath the statement code. An examination of this appendix will reveal that there are a large number of statements which are not cross-referenced to Appendix A. These are statements which, although not appearing in the Standards and Guidelines, were found to be necessary in order to specify the logical relations between those statements which had been identified therein and which constitute Appendix A.

It will be clear that the construction of Appendix B required the exercise of judgement in both the classification of statements by subject area and the introduction of additional statements. Accordingly, the claim that Appendix B reflects the content of the Standards and Guidelines must be interpreted with this need for judgement in mind. However, in order to make the structure of the arguments contained in the Standards and Guidelines explicit, the
responsible exercise of judgement in these areas was unavoidable, and it was essential to explicate the argument so that the theory could be identified.

Appendix B also specifies the manner in which particular statements were derived. Since the intention is to develop a deductive argument, those statements which are conclusions will depend on earlier statements which are premises. The premises for each conclusion are indicated in square brackets after that conclusion in Appendix B. For example, statement 1.18 is derived from statements 1.14, 1.15, 1.16 and 1.17. It is also evident that statements which are conclusions can act as premises in the derivation of subsequent statements. Statement 1.18, for example, acts as a premise in the derivation of statements 2.5 and 13.67.

Although many of the statements which appear in Appendix B are cross-referenced to Appendix A, it is not always the case that the statements in the two appendices are identical. As indicated in the discussion of Appendix A, the Standards and Guidelines contain a range of phrases which might or might not be interpreted as indicating a "rule". In order to avoid introducing those same ambiguities into the identified theory, a number of conventions have been adopted in the preparation of Appendix B as follows;

1) since the subject of this thesis is the audit of companies, all references to "the enterprise" in the Standards and Guidelines have been stated as "the company" in Appendix B.

2) for similar reasons, references to "management" have been replaced, where appropriate, by reference to "directors", and "users" has been replaced by "shareholders"
3) all rules are expressed in the form "the auditor should..", and all permissions in the form "the auditor may.."

For example, Appendix A contains the following statement;

QS11 The auditor needs to obtain the same degree of assurance in order to give an unqualified opinion on the financial statements of both large and small enterprises.

This statement has been reformulated and expressed in Appendix B as;

5.67 The auditor should obtain sufficient relevant and reliable evidence to give him a reasonable basis for his opinion regardless of the size of the company concerned.

Statement QS11 has been amended for a number of reasons. Firstly, the phrase "the auditor needs to" has been translated to the general rule form "the auditor should" in order to ensure consistent form of expression of rules. Secondly, the phrase "the same degree of assurance in order to give an unqualified opinion on the financial statements" has been translated to "sufficient relevant and reliable evidence to give him a reasonable basis for his opinion" in order to use a phraseology which is consistent with statement 4.21, from which statement 5.67 is derived. It is believed that this change does not alter the nature of the requirement expressed in QS11 and does enable statement 5.67 to be derived within the theory as a logical consequence of earlier statements. Thirdly, the phrase "of both large and small" has been amended to "regardless of the size of" in order to allow for the existence of a company of intermediate size. Finally, the reference to "enterprises" has been amended to "companies" since the theory developed in Appendix B is intended only to apply to the audit of companies.
Appendix C: Diagrammatic representation of the formal system.

This appendix is a diagrammatic representation of the content of Appendix B, and is intended to serve primarily as an aid to the interpretation and criticism of the formal theoretical system. It fulfills this role by achieving a number of objectives;

a) it clearly distinguishes between derived audit practices and the statements upon which those practices depend,

b) it shows the derivation of all conclusions by facilitating the process of tracing back through the argument,

c) it shows the role of all premises in the subsequent argument by identifying the statements which depend upon those premises, and

d) it shows the extent to which it has been necessary to introduce statements in addition to those contained within the Standards and Guidelines in an attempt to ensure that the argument is complete and consistent.

The ways in which these objectives are achieved is best discussed in the context of an example. Since Section 6 of Appendix C is the shortest, it has been chosen for this purpose. That section is diagrammed as follows (the components in red are those appearing on the transparent overlay);

The distinction between statements of practice (i.e. rules and permissions) on the one hand and other, non-practical statements (i.e. propositional functions, propositions and definitions) on the
other is achieved by segregating each diagram into two sections. The right hand half of each diagram contains only statements of practice. All other classes of statement appear on the left hand side of each page. In section 6, for example, statements 6.3 and 6.5, as well as the earlier statement 1.14 and later statement 9.27 are all statements of practice. Statements 6.1, 6.2 and 6.4, as well as later statement 9.2 are other kinds of statement.

Such a segregation enables the general role of any statement to be identified and its place in the theory to be established. Since the purpose of the theory is to be to derive company audit practices and, thereby, to demonstrate that those practices are consistent, justifiable and appropriate, the theory is subject to criticism if there are statements of practice which have not been derived in terms of earlier statements, or if there are non-practical statements which do not lead to derived practices. The identification of such conditions is greatly facilitated by the segregation between statements of practice and other classes of statement.

The derivation of each statement, and the role of each statement in the subsequent argument is shown by arrows linking related statements. In Section 6, for example, statements 6.1, 6.2 and 6.4 act as premises only. That is, they are assumptions which are not derived from earlier statements in the theory, reflected by the absence of any arrows linking into these statements. Similarly, statement 6.5 acts as a conclusion only, since there is no arrow linking out of that statement. On the other hand, statement 6.3 is both a conclusion (of statements 6.1, 6.2 and 1.14) and a premise
(of statement 6.5) and, accordingly, has arrows which both enter into and exit from that statement.

Statements from earlier sections which act as premises are shown in circles, with the segregation between statements of practice and other classes of statement being maintained. In section 6, for example, statement 1.14 is a statement of practice which acts as a premise for statement 6.3. The derivation of statement 1.14 may be examined by turning to the diagram of section 1.

Where statements act as premises for later statements, arrows to the extreme left or right of the page are shown and the latter statements indicated. In section 6, statement 6.1 acts as a premise for statement 9.2 and statement 6.4 acts as a premise for statement 9.27. The identification of other premises for statements 9.2 and 9.27 may be found in the diagram of section 9.

The final role of Appendix C is to indicate both statements and logical relationships which have been introduced in Appendix B. All introduced statements and relationships appear on the transparent overlays, and when that overlay is lifted those components of the theory which exist in the Standards and Guidelines will remain. In section 6, statements 6.2 and 6.4 have been introduced in order to derive statements 6.3 and 6.5 which appear in the Standards and Guidelines. Statement 1.14 has also been introduced and the extent to which that statement depends upon earlier introduced statements can be seen by examining the diagram for section 1. Since each of statements 6.3 and 6.5 depend on one or more introduced statements, the logical links have also been treated as introduced
relationships. Thus, all arrows appear on the transparent overlay.

Similarly, since statements 9.2 and 9.27 depend upon at least one introduced statement, the arrows from 6.1 and 6.4 to those statements also appear on the transparent overlay.

There is one additional symbol appearing in Appendix C. It is a blocked arrow (явление), and is used to show the derivation of later statements within the same section, where one section of Appendix B extends over more than one page in Appendix C. Section 5, for example, contains one such symbol.

Together, Appendices B and C contain a statement of the theory which apparently underlies present company audit practices in the U.K., as reflected in the content of the Auditing Standards and Guidelines. Much of the remainder of this thesis depends upon the content of these two appendices.
CHAPTER 5

THE THEORY OF COMPANY AUDITING.

In this chapter, the major components of the identified theory are discussed and the derivation of the more important company audit practices is explained. The chapter considers each section of the theory separately, highlighting those practices which are the basis for the derivation of a substantial proportion of later practices and explaining how those former practices relate to basic company auditing objectives.

The objective of this chapter is to explain the theory and, thereby, to establish a basis for a detailed critical analysis to be undertaken in the following chapter. In the course of this explanation, some of the more important logical relationships within the theory will be highlighted.
Overview

Although the subject matter of this chapter is the theory of company auditing which has been identified on the basis of the content of the Standards and Guidelines, it must be emphasised that a substantial number of the statements which are elements of that theory have been introduced solely on the grounds that they are implied by the Standards and Guidelines. It is quite possible that different, equally implicit statements could have been identified in order to build the theory. Accordingly, the derivations of practices discussed in this chapter are not necessarily the only possible derivations which are consistent with the content of the Standards and Guidelines.

Where, however, additional statements have been introduced, they have been chosen with the intention of building a theory which is not only consistent with the Standards and Guidelines but is also as complete as possible. As has been argued earlier, the role of a formalised theory of company auditing is to derive practices from earlier derived practices together with other statements. Ultimately, all practices will be founded upon one or more fundamental normative statements. In the theory presented in this thesis, additional statements have been introduced in order to ensure that all of the recommended practices are derived from a single fundamental normative statement. To the extent that the derivations are valid, the identified theory is both complete and consistent.

As described in the previous chapter, the formal theoretical system has been constructed in thirteen sections which are arranged in an order deriving increasingly specific audit practices. In this way,
the practices derived earlier in the theory are more general in nature and, accordingly, are applicable in a wide range of circumstances. The thirteen sections of the theory are:

Section 1: Company audits
Section 2: Auditor judgement
Section 3: Materiality
Section 4: Truth and fairness
Section 5: Evidence
Section 6: Consultation with other auditors
Section 7: Planning
Section 8: Controlling
Section 9: Recording
Section 10: Internal control
Section 11: Accounting systems
Section 12: Review of financial statements
Section 13: Audit Reporting

In each section, practices are derived which relate to the particular subject area in question and which constitute the basis for the derivation of practices in subsequent sections. An examination of each section will reveal which practices are required of company auditors with respect to a particular subject area, and will also enable the relative importance of those practices to be established in terms of the extent to which they are necessary to the derivation of subsequent practices.

One of the most important structural aspects of the theory is that every derived practice can be traced back through earlier derived practices to the single fundamental normative statement identified
in Section 1 of Appendix B. A description of the theory should, therefore, begin with that section.
Section 1. Company audits

The purpose of this section is to state the fundamental normative statement of company audits and, having done so, to derive general classes of procedure necessary as a result of that statement. In the specified theory, the fundamental normative statement is that the auditor should adopt those practices necessary in order to achieve primary and secondary audit objectives (statement 1.0).

This statement has been introduced on the grounds that, in the absence of lengthy arguments, it is the only one which is consistent with all of the practices specified in the Standards and Guidelines. By relating this statement to the objectives identified in the Standards and Guidelines, it is possible both to specify that company auditors should adopt certain general classes of audit action (referred to hereafter as "basic requirements") and, subsequently, to derive increasingly specific audit procedures. It should be recognised, however, that by adopting this fundamental normative statement, it is implicitly assumed that the achievement of company audit objectives is desirable, whatever those objectives might be. Whether this is a reasonable assumption will be considered in the next chapter.

Before it is possible to derive specific company audit practices from the assumption that audit objectives ought to be achieved, it is necessary to specify those company audit objectives which are to be achieved. Two different approaches to identifying the objectives of company auditors could be adopted on the basis of the Standards and Guidelines.
The first would be to take the definition of an audit (Statement 1.12 in Appendix B) and to assume that that definition contains an exhaustive list of company audit objectives. If this approach were adopted, company audit objectives would be established by definition. As such, the desirability of those objectives would be established by consensus, rather than by argument, and the desirability of the company audit function would be assumed rather than demonstrated. As a result, the entire theoretical edifice of company auditing would be built upon a definition which, since it does not have truth value, would be untestable.

An alternative approach which also seems justified by the content of the Standards and Guidelines would be to state the objectives of company auditors in the form of propositions or propositional functions and to derive the definition of company auditing from those statements. By adopting this approach, the objectives of company auditors would be expressed as empirically verifiable propositions rather than as consequences of an arbitrarily established definition of the company audit function. Thus, the attention of researchers could be focussed upon the validation of those propositions and, thereby, upon the justification for practices derived on the basis of identified objectives. If the available evidence supported the propositions, the theory could be said to have a more secure foundation than if it depended solely upon definition. Since this second approach seems more fruitful, it has been adopted in constructing the theory presented in Appendix B.

One primary objective and four secondary objectives of U.K. company
audits have been identified on the basis of the Standards and Guidelines. They are (the numbers refer to statements in Appendix B);

1.1 The primary objective of the auditor is to:
   a) form an opinion, and
   b) report
   on the financial statements of a company.

1.5 A secondary objective of the auditor is to comply with statutory regulations governing the audit.

1.7 A secondary objective of the auditor is to comply with the terms of his engagement unless to do so would contravene statutory regulations.

1.9 A secondary objective of the auditor is to provide an effective, economic and efficient service within an appropriate time-scale.

1.13 A secondary objective of the auditor is to ensure that it is possible to conduct a successful defence if a legal action is brought against him in which his judgement is questioned.

If it is assumed that the above list of objectives is exhaustive, it is possible also to conclude that

1.21 To search specifically for fraud is not an objective of the auditor unless required by statute or the specific terms of his engagement.

Since the five identified objectives are stated in the form of propositions, it would be possible to undertake a research project to determine whether company auditors do, in fact, have those objectives. Although this does enable the claim that the theory is grounded upon empirical statements to be made, it does not in any way support the claim that the identified objectives are justified.

Additionally, no reason or justification is given for the claim that company auditors do not have an objective of fraud detection, and no support is offered for the assumption made above that the five
identified objectives are exhaustive. This absence of support for the fundamentals of the theory identified on the basis of the Standards and Guidelines is subjected to a detailed analysis in the next chapter.

The relationship between primary and secondary objectives also warrants further discussion. As will become evident during this chapter, a large majority of company audit practices have been derived from one or more of the "secondary objectives" rather than from the "primary objective". This casts doubt, firstly, on the relative importance of the primary objective and, secondly, on whether a distinction between primary and secondary objectives is appropriate.

These doubts are, however, ameliorated to some extent by the clear implication within the Standards and Guidelines that action to attain secondary objectives is only to be undertaken so long as to do so is consistent with the attainment of the primary objective. For example, the "service" referred to in the secondary objective of providing an effective, economic and efficient service within an appropriate time scale is, undoubtedly, the formation and expression of an opinion by the auditor. Thus, this secondary objective could be restated as an objective to attain the primary objective in an effective, economic and efficient manner and within an appropriate time-scale. As a consequence of this implication, any company audit practices derived from this secondary objective must also promote the attainment of the primary objective.

Since no statements concerning the relationship between company
audit objectives appear within the Standards and Guidelines, no similar statements have been included in any of the provisions in the identified theory. It does seem likely that, were such statements to be included, they would properly constitute part of the operational system.

In this first section, the fundamental normative statement that objectives should be achieved is combined with the identified objectives of company auditors in order to derive seven basic audit requirements which constitute the basis of all practices derived later in the theory. These seven basic requirements are:

1.3 The auditor should conduct an independent examination of the financial statements.

1.4 The auditor should report on the financial statements of a company.

1.6 The auditor should comply with statutory regulations governing the audit.

1.8 The auditor should comply with the terms of his engagement unless to do so would contravene statutory regulations.

1.10 The auditor should provide an effective, economic and efficient service within an appropriate time-scale.

1.14 The auditor should adopt procedures which will ensure that it is possible to conduct a successful defence if a legal action is brought against him in which his judgement is questioned.

1.22 The auditor should not search specifically for fraud unless required by statute or the specific terms of his engagement.

Each of these basic requirements is derived from one of the company audit objectives (or the "non-objective" regarding detection of fraud), together with the assumption that company auditors should undertake actions necessary to achieve those objectives.
A detailed examination of Appendix C also reveals that all other rules for auditor behaviour which are to be found within the Standards and Guidelines can be traced back to one or more of the above seven basic requirements and, through them, to the fundamental normative statement and the identified objectives. All company audit practices specified in the theory are justified by the argument that they are necessary in order to attain one or more of the company audit objectives.

In order to derive a definition of an "audit" from the identified objectives, it is necessary to establish the link between the audit process and the attainment of audit objectives. This is afforded by the statement that an "audit" is the adoption of procedures by the auditor to achieve primary and secondary audit objectives (statement 1.11). Thus, the definition of auditing which appears in the Standards and Guidelines (specified as statement 1.12 in the theory) is derived;

An "audit" is an independent examination of and expression of opinion on the financial statements of a company by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation.

Although seven "basic requirements" have been derived from audit objectives, only four are included in the definition contained in statement 1.12. Accordingly, the definition must be said to be incomplete. However, since the definition itself does not play an important role in the construction of the theory (in that it leads to no additional company audit practices or objectives), its incompleteness is not critical. Moreover, the definition could more properly be considered as a component of the operational, rather
than formal, system and has been shown in Section 1 of the theory only because it is given considerable emphasis in the Standards and Guidelines.

Two other audit practices are derived in this first section, both of which depend upon the practices discussed above. The requirement for the auditor to comply with auditing standards (statement 1.18) is justified on the grounds that to do so will assist him to conduct a successful defence if his judgement is questioned (statement 1.14). This argument can be diagrammed as follows:

\[ \begin{array}{c|c|c}
1.16 & 1.17 & 1.14 \\
\hline
1.15 & & 1.18 \\
\end{array} \]

The requirement to comply with auditing standards is justified on the grounds that auditing standards constitute "good practice" (statements 1.16 and 1.17) and that "good practice" is necessary in order to conduct a successful defence if the auditor's judgement is questioned (statement 1.15). Accordingly, compliance with auditing standards is required in order to achieve the secondary objective of ensuring that it is possible to conduct a successful defence if the auditor's judgement is questioned.

The second practice derived in this section is the requirement to adopt the personal standards contained in ethical guides (statement 1.20). This requirement is derived from two basic requirements;
Statement 1.19 simply asserts that in order to conduct a successful defence and to provide an effective, economic and efficient service it is necessary to adopt the personal standards contained in Ethical Guides.

The relative importance to the theory of the seven basic audit actions is indicated by the number of subsequent practices to which they lead. This is reflected in the following table;

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Table 1: The number of subsequent practices derived from the seven basic requirements.

It is apparent from the table that statement 1.10, which requires the provision of an effective, economic and efficient service within an appropriate time-scale, is by far the most important in terms of subsequently derived audit procedures. Of the 194 separate practices derived within the theory, 185 are derived within arguments which include statement 1.10 as a premise.
The next most important requirement is for the auditor to report on the financial statements (statement 1.4), which justifies thirteen practices in Section 12 (review of financial statements), forty-two practices in Section 13 (audit reporting) and sixty-four practices in the entire theory. Although the requirement to report on the financial statements is the second most important basic requirement (judged in terms of the number of practices derived from it), the requirement for an effective, economic and efficient service acts as a premise in the derivation of nearly three times as many practices. This extensive reliance on statement 1.10 is a matter which receives considerable attention in this and the next chapter.

Section 2. Auditor judgement.

This section establishes the important rule that it is necessary for company auditors to exercise judgement when complying with approved auditing standards (statement 2.5). This rule is derived from the basic requirement for the auditor to adopt procedures which will ensure that it is possible to conduct a successful defence if his judgement is questioned (statement 1.14). The chain of argument establishing this link can be diagrammed as follows;

![Diagram]

Statement 1.18 is the requirement to comply with auditing standards,
the derivation of which has been discussed in the previous section. Statements 2.3 and 2.4 assert that auditing standards do not cater for all situations and that, under these circumstances, judgement must be exercised. Thus, the need to comply with auditing standards plus the non-universal nature of those standards results in the need for the auditor to exercise judgement when complying with the standards (statement 2.5), and is ultimately justified in terms of the basic requirement to ensure that it is possible to conduct a successful self-defence (statement 1.14).

It will be noticed in Appendices B and C that the Standards and Guidelines contain a clear implication both of the need to comply with auditing standards in order to adopt good practice (Explanatory foreword, paragraph 7) and the need to exercise judgement when complying with the standards (Explanatory foreword, paragraph 4). This chain of argument seems to be the most obvious (if not the only) way of deriving the need for auditor judgement. As with other practices derived within the theory, the content of the Standards and Guidelines has been used, as far as possible, to establish links between stated audit practices and the identified objectives.

The only other company audit practice derived in this second section is the need for the auditor to consider the content of auditing guidelines, explanatory notes and existing pronouncements when exercising judgement (statement 2.7). This requirement is derived as a direct consequence of the need to exercise judgement and, accordingly, can be traced back through statement 2.5 to the basic requirement to ensure that it is possible for the auditor to conduct a successful defence if his judgement is questioned (statement 1.14).
Section 3 Materiality

Within this section, three rules of audit behaviour are established, one of which leads directly to five subsequent rules. This is the requirement that the auditor should be concerned only with material matters (statement 3.6). As a result of this rule, the auditor is required to consider the materiality of a matter when determining (a) the sources and amount of evidence required (statement 5.37), (b) what action to take when explanations for unusual events indicate misstatements in the financial statements (statement 5.66) (c) what action to take with regard to matters disclosed in an overall review of the financial statements (statement 12.23) (d) whether to issue a qualified audit report (statement 13.38) and (e) what to refer to in a qualified audit report (statement 13.59).

The requirement to be concerned only with material matters is derived within the theory from the basic requirement to provide an effective, economic and efficient service (statement 1.10), and the argument can be diagrammed as follows;

Statement 3.2 is the requirement to ensure that the audit report is useful, derived on the grounds that it is not possible to provide an
effective audit service without ensuring that the audit report is useful (statement 3.1). Statements 3.3 and 3.4 together establish that in order to ensure that the audit report is useful, it is necessary to be concerned only with matters which are likely to influence shareholders. Such matters are defined in statement 3.5 as "material" matters. Accordingly, the requirement for the company auditor to be concerned only with material matters, in order to ensure that the audit report is useful, is derived.

Two further company audit procedures are then derived from statement 3.6. The first requires the auditor to judge the materiality of a matter (statement 3.7) and is a logical consequence of the requirements to exercise judgement (statement 2.5) and to be concerned only with material matters (statement 3.6). Statements 3.8 and 3.9 are based on provisions within the Standards and Guidelines which specify those factors likely to influence the shareholder when using financial statements. These provisions amount to a specification of those items which could be material. Statement 3.10, derived from 3.5, 3.8 and 3.9 then requires the company auditor to consider those specific factors when judging materiality.

Section 4 Truth and fairness

Although the Standards and Guidelines do not contain a specific definition of truth and fairness, there are a number of statements which do provide a clear indication of the criteria which a company auditor should take into account when forming an opinion on the financial statements. Accordingly, those statements have been taken
collectively to imply a definition of truth and fairness. Those criteria, their location in the Standards and Guidelines and in the identified theory are indicated in Table 2.

<table>
<thead>
<tr>
<th>Quality necessary for a &quot;true and fair&quot; view</th>
<th>S&amp;G</th>
<th>Theory</th>
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<tbody>
<tr>
<td>1. Acceptable accounting policies must be used</td>
<td>RFS2</td>
<td>12.1</td>
</tr>
<tr>
<td></td>
<td>RFS6</td>
<td>12.4</td>
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<tr>
<td></td>
<td>RFS7</td>
<td></td>
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<tr>
<td>2. Accounting policies must be consistently applied</td>
<td>RFS2</td>
<td>12.1</td>
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<tr>
<td></td>
<td>RFS6</td>
<td>12.4</td>
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<tr>
<td>3. Accounting policies appropriate to the business must be used</td>
<td>ARS6</td>
<td>13.15</td>
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<td></td>
<td>RFS2</td>
<td>12.1</td>
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<tr>
<td>4. Disclosure must be adequate</td>
<td>RFS2</td>
<td>12.1</td>
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<tr>
<td>5. Classification and presentation of information must be suitable</td>
<td>RFS2</td>
<td>12.1</td>
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<tr>
<td>6. Statutory and other regulations must be complied with in presenting the financial statements</td>
<td>RFS2</td>
<td>12.1</td>
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<tr>
<td></td>
<td>QS1</td>
<td>12.19</td>
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<td></td>
<td>RFS13</td>
<td>13.33</td>
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<tr>
<td>7. Financial statements must not be misleading</td>
<td>QS22</td>
<td>13.34</td>
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<td>8. Financial statements must not be meaningless</td>
<td>QS22</td>
<td>13.34</td>
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<td>9. Financial statements must be complete, accurate and valid</td>
<td>GT9</td>
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<td></td>
<td>AE8</td>
<td>5.24</td>
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<tr>
<td></td>
<td>RFS3</td>
<td>12.1</td>
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<td>10. The results of operations, state of affairs and all other information contained within the financial statements must be compatible with each other and with the auditor's knowledge of the company</td>
<td>RFS2</td>
<td>12.1</td>
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<td>RFS8</td>
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Table 2: Identification of a definition of "true and fair".

The combination of these ten criteria have been expressed as statement 4.5 in order to provide the theory with a basic definition of truth and fairness. From that basic definition, a number of recommended practices are derived which govern both the type of
evidence which should be referred to by company auditors and the nature of the audit report appropriate under differing circumstances.

One of the difficulties with the definition, as it is formulated in statement 4.5, is that the concept of "truth and fairness" is replaced by a number of other concepts which are not defined within the theory. For example, the definition provides that financial statements which are "misleading" or "meaningless" are not true and fair. Yet the nature of "misleading" or "meaningless" financial statements is not discussed within the Standards and Guidelines and, as a result, does not appear in the theory. This issue of problems with definition is discussed more fully in Chapter 6, although it must be pointed out at this stage that the theory does contain additional statements which elaborate some of the criteria included in the definition of truth and fairness.

For example, statements 4.7, 13.14 and 13.15 provide that statements of Standard Accounting Practice constitute "acceptable" accounting policies, unless those statements are inapplicable or inappropriate. Thus, these statements provide a criterion by which "acceptability" of accounting policies can be judged. Similarly, statement 12.15 provides that "adequate disclosure" and "suitable classification and presentation of information" can be interpreted in terms of whether a reader of financial statements would draw conclusions therefrom which are justified and consistent with the circumstances of the business of the company.

Section 4 also specifies the rule which establishes the requirement for the auditor to report in terms of the truth and fairness of the
financial statements (statement 4.4). This requirement is derived in two ways. Firstly, it depends both upon the basic requirement to report on the financial statements (statement 1.4) and upon the basic requirement to comply with statutory regulations (statement 1.6). This derivation is diagrammed as follows:

Statement 4.2 requires the auditor to comply with statutory reporting requirements, and statement 4.3 specifies that an opinion as to "truth and fairness" is, normally, a statutory reporting requirement. Compliance with this requirement establishes the need to report on truth and fairness. As can be seen from Appendix C, each of statements 4.2, 4.3 and 4.4 are to be found within the Standards and Guidelines. Accordingly, there can be little doubt that this argument deriving the requirement to report on truth and fairness is supported by the U.K. profession.

The second derivation depends upon the basic requirement to provide an effective, economic and efficient service (statement 1.10), and is diagrammed as follows:
Statement 3.2 is the requirement to ensure that the audit report is useful, the derivation of which has been discussed in the previous section. Statement 4.1 asserts that it is necessary to report on truth and fairness in order to ensure that the audit report is useful, thus enabling the derivation of the requirement expressed in statement 4.4. The requirement for the auditor to report on truth and fairness leads to the specification of the content of the audit report (statement 13.2) and to the nature of the evidence which should be consulted by the company auditor (statement 4.6).

This fourth section of the theory contains one other statement which is of importance in terms of the number of subsequent practices to which it leads. This is the rule that the auditor should obtain sufficient relevant and reliable evidence to give him a reasonable basis for his opinion (statement 4.21).

As with statement 4.4, this requirement is based upon the need to provide a useful report. Its derivation is as follows:

Statements 4.14 and 4.16 assert that it is necessary for the auditor to have a reasonable basis for his opinion in order for the audit report to be useful. Thus, the requirement for a reasonable basis to the audit opinion (statement 4.17) is established. Statement
4.20 then defines a "reasonable basis" as sufficient, relevant and reliable evidence, which then enables the derivation of the requirement to collect sufficient relevant and reliable evidence (statement 4.21).

Thus, the requirement for the auditor to obtain sufficient relevant and reliable evidence to give him a reasonable basis for his opinion is ultimately derived from the basic requirement to provide an effective economic and efficient service (statement 1.10). In addition, that former requirement becomes the basis for a substantial proportion of the next section.

Section 5. Evidence

Of the twenty six practices derived in this section, four are particularly important to the remainder of the theory. These four practices relate to the type of evidence the auditor should collect and play a role in the derivation of forty seven subsequent practices. They are;

1. The auditor should collect evidence which will enable him to determine whether;
   a) acceptable accounting policies, consistently applied and appropriate to the business have been used,
   b) the results of operations, state of affairs and all other information contained within the financial statements are compatible with each other and with the auditor's knowledge of the company,
   c) disclosure is adequate, classification and presentation of information is suitable, and
   d) statutory and other regulations have been complied with in
presenting financial statements (statement 5.6).

2. In some companies the auditor should collect evidence about the quality of internal control (statement 5.17).

3. In some companies the auditor may collect evidence about the quality of internal control (statement 5.18).

4. The auditor should collect evidence about the adequacy of the accounting system (statement 5.23).

The first of these practices is the basis of Section 12 of the theory, which is concerned with the review of financial statements. Of the fifteen practices specified in Section 12, thirteen are derived from the requirement to collect evidence of the kind specified in statement 5.6. The requirement for the auditor to collect the evidence specified in statement 5.6 has been derived by two different chains of argument which include four different basic requirements.

The first of these chains of argument is based primarily on the requirement for the auditor to collect evidence which will enable him to form an opinion on the truth and fairness of the financial statements (statement 4.4), and is diagrammed as follows:
As discussed in the previous section, the requirement to form an opinion on truth and fairness (statement 4.4) is justified by two arguments, one of which depends upon the basic requirements to report on the financial statements and to comply with legislation (statements 1.4 and 1.6) and the other of which depends upon the basic requirement to provide an effective, economic and efficient service (statement 1.10).

Developing the argument further, statement 4.6 requires the auditor to conduct an independent examination (in terms of statement 1.3) in order to determine whether the criteria for a true and fair view (established by definition in statements 4.5) have been met. Statement 5.5 then provides that the independent examination consists of collecting evidence which will enable the auditor to
determine whether a true and fair view has been given. Accordingly, statement 5.6 requires the auditor to collect that evidence.

To summarise this argument, the auditor is required to conduct an independent examination in order to collect evidence which will enable him to form an opinion on the truth and fairness of the financial statements. In turn, this opinion will result in compliance with statute, the provision of an effective, economic and efficient service and the provision of a report on the financial statements.

The alternative derivation of the requirement to collect evidence of the kind specified in statement 5.6 is based on the need for "sufficient" evidence. It is diagrammed as follows:

In the previous section, the derivation of the requirement to collect sufficient relevant and reliable evidence (statement 4.21) from the basic requirement to provide an effective, economic and efficient service (statement 1.10) was discussed. As an extension of this argument, statement 5.5 asserts that if the auditor does not collect evidence of the kind specified in statement 5.6, he will
have failed to collect sufficient evidence for his opinion. Accordingly, statement 5.6 is established as one of the actions necessary in order to ensure that an effective, economic and efficient service is provided.

To summarise, the requirement for the company auditor to collect evidence which will enable him to determine whether
a) acceptable accounting policies, consistently applied and appropriate to the business have been used,
b) the results of operations, state of affairs and all other information contained within the financial statements are compatible with each other and with the auditor's knowledge of the company,
c) disclosure is adequate, classification and presentation of information is suitable, and
d) statutory and other regulations have been complied with in presenting financial statements,
is justified on the grounds that by so doing, the auditor will satisfy the requirements to
a) conduct an independent examination of the financial statements
b) report on the financial statements
c) comply with statutory requirements, and
d) provide an effective, economic and efficient service within an appropriate time-scale.

The next two important practices in Section 5 provide the basis for the collection of evidence about internal control and as such provide the justification for much of Section 10 of the theory. Thirty-four separate practices are specified in Section 10,
twenty-seven of which are direct consequences of statements 5.17 and 5.18.

These two statements concerning the evaluation of internal control are interesting in that one (statement 5.17) specifies that in some companies auditors should collect evidence about the quality of internal control, whereas the other (statement 5.18) specifies that in some companies auditors may collect evidence about the quality of internal control if they wish. Thus, in respect of some companies, many of the practices derived in Section 10 are optional, depending upon whether or not the auditor has chosen to collect evidence about internal control. The provisional aspect of these practices is indicated in the appropriate statements by the use of phrases such as "where the auditor wishes to rely on internal control, he should...".

This ambiguous nature of the requirement to evaluate internal control comes about because of specific provisions in the Standards and Guidelines. Paragraph 9 of the Guideline on Internal Control provides that in some companies the auditor might be unable to determine whether all the transactions have been reflected in the accounting records unless there are effective internal controls (statement 5.15). This clearly suggests that under these circumstances the auditor should evaluate the quality of internal control. That same paragraph implies that, for other companies, sufficient relevant and reliable evidence might be obtained without collecting evidence about the quality of internal control (statement 5.16), suggesting that the evaluation of internal control is a permitted, rather than required, audit action.
Both of these statements are derived from the requirement for the company auditor to obtain sufficient relevant and reliable evidence to give him a reasonable basis for his opinion (statement 4.21) which, as discussed in the previous section, is derived from the basic requirement to provide an effective economic and efficient service (statement 1.10). These derivations are diagrammed as follows:

Derivation 1

Statement 5.14, which appears in both chains of argument, provides that evidence about the quality of internal control is relevant to the formation of the auditor's opinion, thus bringing such evidence within the ambit of the requirement to collect sufficient relevant evidence. The rule that in some cases the auditor should collect evidence about the quality of internal control (statement 5.17) is then derived in terms of statement 5.15, and the permission for the auditor to collect evidence about the quality of internal control if he so wishes (statement 5.18) is derived in terms of statement 5.16.

The final relatively important company audit practice derived in this section is the requirement for the auditor to collect evidence about the adequacy of the accounting system (statement 5.23). This
statement is the basis for fifteen of the sixteen practices derived in Section 11 of the theory and, like statements 5.17 and 5.18 discussed above, is derived from the requirement for the auditor to collect sufficient relevant and reliable evidence (statement 4.21). The derivation is as follows:

Statement 5.21 establishes the relevance of evidence about the adequacy of the accounting system, and statement 5.22 asserts that if the auditor does not collect evidence about the adequacy of the accounting system, he will have failed to collect sufficient evidence. Thus, the requirement to collect evidence about the adequacy of the accounting system is justified ultimately in terms of the basic requirement to provide an effective, economic and efficient service (statement 1.10).

Section 6. Consultation with other auditors

The company audit practices derived in this small section do not have significant implications for the remainder of the theory in that they do not lead to the derivation of later practices. However, one rule which could be considered to be important from the point of view of ethical behaviour is established. It is the requirement that, when another accountant is consulted, the auditor should ensure that confidentiality is maintained (statement 6.5).

This practice is derived from a requirement that the auditor should consider consulting another practitioner when difficult questions of
principle or judgement arise (statement 6.3), together with the propositional function that the details of the audit are confidential (statement 6.4). Ultimately, both of the practices in this section are justified in terms of the basic requirement to ensure that it is possible to conduct a successful defence if the auditor's judgement is questioned (statement 1.14), on the grounds that consultation with another auditor will assist in satisfying that requirement (statement 6.2).

Although the company audit practices derived in this section do not lead to subsequently derived practices, the claim that the auditor's judgement could be questioned in areas of the audit where difficult questions of principle or judgement have arisen (statement 6.1) does lead to a number of requirements regarding audit working papers. As is apparent from the diagram of Section 9 in Appendix C, statement 6.1 plays a role in the justification of six of the eleven practices specified in that section.

**Section 7: Planning**

In many ways, this section most clearly illustrates the way in which a theory of company auditing can be constructed by a careful analysis and restructuring of statements to be found within the professional literature. As can be seen from the diagram of Section 7 in Appendix C, the only practice which is not based directly on a specific statement found within the Standards and Guidelines is the requirement for the auditor adequately to plan a joint audit (statement 7.5). Similarly, the definition of an "adequately planned audit" (statement 7.2), which plays a role in the derivation
of every practice in this section is based upon paragraph 5 of the Auditing Guideline on planning, controlling and recording. By introducing a number of propositional functions it has been possible to tie together the statements which appear within the Standards and Guidelines and, thereby, to provide a justification for each of the specified company audit practices.

As in previous sections, the basic requirement for an effective, economic and efficient service (statement 1.10) plays a major role in the derivation of practices in this section. As will be observed from the diagram of Section 7 in Appendix C, the requirement adequately to plan the audit (statement 7.4) provides a justification for each of the practices in this section. The derivation of this requirement is diagrammed as follows:

Statement 7.3 is based on paragraph 2 of the Guideline on planning, controlling and recording, and asserts that in order to provide an effective, economic and efficient service within an appropriate time-scale, it is necessary to conduct an "adequately planned audit". Thus, the requirement adequately to plan the audit is justified.

In order to derive additional company audit practices, an "adequately planned audit" is defined as one in which

a) intended means of achieving objectives are established
b) the direction and control of the audit work is assisted
c) means are adopted which help to ensure that attention is devoted
to critical aspects of the audit
d) means are adopted which help to ensure that the work is completed expeditiously (statement 7.2).

Further specification of these aspects of an adequately planned audit leads to specific practices. For example, the derivation of the requirement for the auditor to determine the nature of audit tests (statement 7.10) is as follows:

Statement 7.9 elaborates the first aspect of an adequately planned audit by asserting that determination of the nature of audit tests will establish the intended means of achieving objectives, thus justifying the requirement for the auditor to determine the nature of audit tests (statement 7.10).

Of all the rules derived within this section, just one does not depend solely upon the requirement to conduct an adequately planned audit. It is the requirement for the company auditor, when planning the audit, to consider the extent to which reliance can be placed on analyses and summaries prepared by the company's employees (statement 7.30). This rule is justified not only in terms of the requirement to conduct an adequately planned audit, but also in terms of the basic requirement to provide an effective, economic and efficient service (statement 1.10) together with assertions that

(a) In order to provide an effective, economic and efficient service within an appropriate time-scale, it is necessary to minimise the work carried out by the auditor (statement 7.28), and
(b) Work carried out by the auditor will be minimised by seeking to place reliance on documents and evidence generated by others and tests carried out by others (statement 7.29). These two propositional functions which play a role in the derivation of the requirement to consider the extent to which reliance can be placed on work carried out by others are also important in later sections of the theory. In particular, they provide one justification for the auditor's reliance on internal control (statement 10.6).

Section 8 Controlling

This section is concerned with the derivation of company audit practices relating to the control of the audit. Its structure and the derivation of practices is similar to the previous section in that the requirement for the auditor adequately to control the audit is established (statement 8.6), and an "adequately controlled audit" is defined (statements 8.4 and 8.8). These three statements provide the justification for each of the practices in section 8, with only one exception (statement 8.31, discussed below). A further similarity with the previous section is that all practices are justified ultimately in terms of the basic requirement for an effective, economic and efficient service (statement 1.10). To illustrate, the derivation of the requirement adequately to control the audit is as follows:

where statement 8.5 provides that it is necessary to conduct an
adequately controlled audit in order to provide an effective, economic and efficient service. Thus, the need adequately to control the audit is justified.

As mentioned above, there is one practice in this section which is not derived from the need to conduct an adequately controlled audit. This is the requirement for the auditor to exercise judgement to determine how the overall quality of audit work can be monitored and maintained within his firm (statement 8.31). This requirement involves both the exercise of judgement and the determination of how the overall quality of audit work can be monitored and maintained. The exercise of judgement is justified in terms of the necessity for judgement in the absence of a precise code of rules (statement 2.4) and the assertion that there are no precise rules for the control of an audit (statement 8.30). The second aspect of the rule is justified by the assertion that monitoring the quality of audit work is necessary in order to provide an effective, economic and efficient service (statement 8.1).

Section 9. Recording

Five of the company audit practices specified in this section are derived in a fashion similar to the sections on planning and controlling. That is, a requirement for the auditor to prepare an adequate record of audit work is derived (statement 9.11) and a definition of an "adequate record" is specified (statement 9.3). These two statements result in the specification of requirements for the auditor to

a) prepare adequate working papers (statement 9.13),
b) record certain details concerning the audit (statement 9.17),
c) prepare working papers as the audit progresses (statement 9.26),
d) ensure confidentiality of working papers (statement 9.30), and
e) record the audit whatever the size of the company concerned (statement 9.31).

Three different reasons are presented in support of the need to prepare an adequate record of audit work (statement 9.11). They are as follows:

**Derivation 1**

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9.4 \downarrow 1.14
\downarrow 9.11
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**Derivation 2**

```
9.7 \downarrow 1.10
\downarrow 9.11
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**Derivation 3**

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8.5 \downarrow 1.10
\downarrow 8.6
8.8 \downarrow 8.9
\downarrow 9.8
9.10 \downarrow 9.11
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Derivation 1 is based on the claim that an adequate record will enable the auditor to defend himself if his judgement is questioned.
(statement 9.4). So the need to maintain an adequate record is justified in terms of the basic requirement to adopt procedures which will ensure that it is possible to conduct a successful defence if a legal action is brought against the auditor (statement 1.14).

Derivation 2 is based on the claim that without an adequate record of audit work, it is not possible to provide an effective, economic and efficient service (statement 9.7). This argument is similar to the derivation of requirements to conduct an adequately planned and controlled audit, discussed in the previous two sections.

The final derivation of the need to prepare an adequate record is through the previous section on control. Here, it is argued that in order to conduct an adequately controlled audit it is necessary for the auditor to satisfy himself that audit work is adequately performed (statements 8.9 and 9.8). Statement 9.10 then asserts that an adequate record of work done will enable the auditor to determine whether audit work is adequately performed, thus justifying the need for an adequate record of work done. Since the need for adequate control has already been established in terms of the basic requirement to provide an effective, economic and efficient service (statement 1.10), the need for adequate recording follows from that same requirement.

Within this section, four statements are derived other than as a result of the need to keep an adequate record. Three of these statements (9.20, 9.23 and 9.24) are concerned with the use of standardised working papers, and the fourth (statement 9.31) is
concerned with safe custody of working papers.

Statement 9.20 gives the company auditor permission to use standardised working papers on the grounds that the use of standardised working papers could improve the extent to which the auditor provides an effective, economic and efficient service (statement 9.19). Note that statement 9.19 only asserts that there might be a link between standardised working papers and the effectiveness, efficiency and economy of the audit. Accordingly, there are no grounds for stating that the auditor should use standardised working papers, and statement 9.20 is a "permission" rather than a "rule".

The requirement for the company auditor to ensure safe custody of working papers is justified on the grounds that by so doing, the auditor is able to gain access to those papers (statement 9.29) and that access is necessary in order to provide an effective, economic and efficient service as well as to ensure that it is possible to conduct a successful defence if the auditor's judgement is questioned (statement 9.28). This requirement is also justified on the grounds that safe custody of working papers is necessary in order to ensure confidentiality (statement 9.30).

Section 10. Internal control

This is the most complex section of the formal system, consisting of 102 separate statements. The majority of the practices derived in this section are implementations of the permission for the auditor to rely on adequate, relevant internal controls together with reduced substantive testing when collecting evidence for his opinion (statement 10.6).
This permission is justified through three different chains of argument, two of which depend on the requirement for the auditor to obtain sufficient relevant and reliable evidence to give him a reasonable basis for his opinion (statement 4.21). The first of these arguments depends upon the assertion that it is possible that reliance upon adequate relevant internal controls and reduced substantive testing will provide the auditor with a reasonable basis for his opinion (statement 10.5). This argument can be diagrammed as follows:

Statement 10.5 is based upon paragraph 9 of the Auditing Guideline on audit evidence, which provides that it is possible for the auditor to obtain sufficient relevant and reliable evidence either by conducting substantive tests or by relying upon adequate, relevant internal controls together with reduced substantive tests. In this argument, the latter of these alternatives results in the permission to rely on internal control specified in statement 10.6.

The second derivation of statement 10.6 (which is also a result of
the requirement to collect sufficient evidence) is based on the provision that the auditor should collect evidence about the adequacy of the accounting system. The argument, from statement 4.21, is as follows:

Statement 5.23 provides that the auditor should collect evidence about the adequacy of the accounting system, and statement 10.3 (which is implied by paragraph 6 of the Auditing Guideline on accounting systems), asserts that an adequate internal control system constitutes such evidence. Thus, permission to place reliance upon an adequate control system is granted.

The third derivation of the permission for the auditor to place reliance upon internal control is based on the reduction in audit work which will accrue from so doing. The argument is as follows:

Statement 10.4 asserts that audit work will be minimised by placing reliance upon internal controls, and statement 7.28 asserts that audit work must be minimised in order to provide an effective, economic and efficient service within an appropriate time-scale. Thus, reliance upon internal controls is justified in terms of the
requirement for an effective economic and efficient service.

It is important to note in this case that a claim that audit work will be minimised by placing reliance upon internal controls is a conclusion of a detailed argument, part of which is shown in the above diagram. This argument is based on descriptions of the nature of assurances provided by internal control, together with the (underived) assertion that work carried out by the auditor will be minimised by seeking to place reliance upon documents and evidence generated, and tests carried out, by others (statement 7.29).

Although permission to rely on internal controls has been derived in these three separate ways, it ultimately depends only on the basic requirement to provide an effective, economic and efficient service (statement 1.10), since each of these three chains of argument begins with that requirement.

An additional important company audit practice specified in this section is the requirement for the auditor to identify and evaluate relevant internal controls if he wishes to rely on those controls (statement 10.12). This requirement is derived in two ways, both of which depend on the permission to rely on internal controls (statement 10.6). These two derivations are:

Derivation 1
The first derivation is in the context of the auditor placing reliance upon internal controls in order to obtain evidence about the adequacy of the accounting system. Statement 10.11 provides that the adequacy of the accounting system can be determined by identifying and evaluating relevant internal controls. Since a requirement to determine the adequacy of the accounting system has been established earlier (statement 5.23), a requirement to identify and evaluate relevant internal controls, if reliance is to be placed upon such controls, is justified.

The alternative derivation of the requirement to identify and evaluate internal controls is a direct result of the permission to place reliance upon "adequate and relevant" controls (statement 10.6) and the requirement under some circumstances to collect evidence about the "quality" of internal controls (statements 5.17 and 5.18). Statements 10.7, 10.9 and 10.10 provide that adequacy, relevance and quality of controls can be determined by identification and evaluation, thus resulting in statement 10.12.

Of the thirty-four statements of practice in Section 10, only one is not justified in terms of the permission to rely on internal controls (statement 10.6). This is the requirement for the auditor to move directly to substantive tests if he either fails to identify
relevant controls or does not wish to rely on internal controls (statement 10.20).

Although not derived from the permission to place reliance upon internal controls, this rule is clearly related to that permission, in that it provides for audit actions when permission to rely on internal controls is ignored or is inappropriate. This requirement is necessary because of the nature of statement 10.5, which provides that it is possible for the auditor to collect evidence either by reliance upon internal controls together with reduced substantive tests, or by conducting substantive tests only. In the absence of reliance upon internal controls, substantive tests are the only means of collecting audit evidence.

The remainder of the rules and permissions derived in Section 10 relate to the identification and evaluation of internal controls. This section provides relatively detailed guidance as to the procedures to be adopted in the evaluation of controls and includes, for example, provisions for the evaluation of the internal audit function on the grounds that internal audit is an element of the internal control system (statement 10.58).

Section 11. Accounting systems.

Contrary to the previous section, the audit practices in the section dealing with accounting systems are derived from a rule rather than from a permission. The rule was established in section 5 and provides that the auditor should collect evidence about the adequacy of the accounting system (statement 5.23). Thus, the company auditor has no choice but to evaluate the accounting system. This
requirement, together with a definition of an "adequate accounting system" (statement 11.6), enables the derivation of a requirement for the auditor to determine whether the accounting system provides orderly assembly of accounting information, appropriate analyses and complete and accurate information (statement 11.7). Once again, this requirement is derived ultimately from the basic requirement to provide an effective, economic and efficient service (statement 1.10).

Having established both the requirement to evaluate the accounting system and the terms within which that evaluation is to be carried out, increasingly specific practices are derived. For example, the auditor is required to record the accounting system (statement 11.20) on the grounds that it is necessary to do so in order to determine whether the accounting system provides orderly assembly of accounting information, appropriate analyses and complete and accurate information (statement 11.18).

Only one rule in Section 11 is not a consequence of the need for the auditor to collect evidence about the adequacy of the accounting system (statement 5.23). It is the requirement for the auditor to consider his specific duties relating to accounting records in audits governed by legislation (statement 11.4). This rule is derived directly from the basic requirement to comply with statutory provisions (statement 1.6) and is based on the assertion that statutes often give auditors specific duties in relation to the accounting records (statement 11.3).

Although the theory is limited to U.K. company audits, the above
statements have not been confined to companies legislation in order to allow for the possibility that other statutes could impose obligations on company auditors in respect of company accounting records. For similar reasons, the requirement to comply with statute has been expressed in broad terms. By so doing, the theory will remain valid even during periods of legislative change.

Section 12. Review of financial statements

Thirteen of the fifteen practices derived in this section depend upon the rule established in section 5 that the auditor should collect evidence which will enable him to determine whether;

a) acceptable accounting policies, consistently applied and appropriate to the business have been used,

b) the results of operations, state of affairs and all other information contained within the financial statements are compatible with each other and with the auditor's knowledge of the company,

c) disclosure is adequate, classification and presentation of information is suitable, and whether

d) statutory and other regulations have been complied with in presenting financial statements (statement 5.6).

The requirement to conduct an overall review (statement 12.2) is established simply by defining the process of collecting evidence referred to in statement 5.6 as an "overall review". Since statement 5.6 constitutes the basis for the justification of audit practices concerning the overall review, neither the definition of an "overall review" nor the requirement to conduct such a review plays any further role in the derivation of audit practices.
The derivation of statement 5.6 was discussed at some length in section 5 of this chapter, where it was indicated that the requirements of that statement are justified in terms of the basic requirements to conduct an independent examination (statement 1.3) and to provide an effective, economic and efficient service (statement 1.10). Accordingly, audit practices concerned with an overall review of financial statements are intended to implement those same requirements.

Of the two practices not entailed by statement 5.6, one is the requirement for the auditor to consider the materiality of matters under review (statement 12.23). This is a direct consequence of the requirement that the auditor be concerned only with material matters (statement 3.6) and is, therefore, a consequence of the requirement to provide an effective, economic and efficient service.

The other practice not intended to implement the requirements of statement 5.6 is the requirement for the auditor to ensure that the overall review is carried out by someone who has adequate experience and skill (statement 12.31). This requirement is derived from provisions in Section 8: Controlling, which establish that the auditor should adopt procedures to ensure that the audit is conducted by adequate staff who have an adequate understanding of the work involved (statement 8.12). This requirement is a consequence of the need for the auditor adequately to control the audit (statement 8.6). Both of these practices which are not dependent upon statement 5.6 are, as are all of the practices derived in this section, derived from the basic requirement to
provide an effective, economic and efficient service (statement 1.10).

Section 13. Audit Reporting

This last section of the formal system deals with the final phase of the company audit process; the audit report. Practices related to the reporting function depend primarily on the requirement for the company auditor to provide a report which is not misleading (statement 13.4). This rule is derived both from the basic requirement to report (statement 1.4) and from the requirement to ensure that the audit report is useful (statement 3.2). The latter requirement depends, in turn, on the basic requirement to provide an effective, economic and efficient service (statement 1.10). The argument is as follows:

In this argument, statement 13.3 provides simply that if the audit report is misleading, it will not be useful. Thus, the requirement for the auditor to ensure that the audit report is not misleading is established.

Of the forty-three statements of practice in Section 13, just five do not depend upon the requirement to provide an audit report which is not misleading (statement 13.4). Two of these depend upon the
basic requirements to provide a report (statement 1.4) and to comply with statutory regulations (statement 1.6). They specify that the auditor should provide a report in which he refers expressly to any matters prescribed by legislation or other requirements (statement 13.1) and, consequently, that he should provide a report which refers to the truth and fairness of the financial statements (statement 13.2).

The former rule (statement 13.1) also justifies the requirement for the auditor to consider whether the circumstances which give rise to a qualification impinge upon his statutory duty to report (statement 13.83). Since this requirement is concerned also with the basic requirement to report, it is related to the implementation of three basic requirements; to provide a report (statement 1.4), to comply with legislation (statement 1.6) and to provide an effective, economic and efficient service (statement 1.10).

Two further rules which are not dependent upon the need to ensure that the audit report is not misleading are similarly derived from the legal requirement for an opinion as to truth and fairness and to the definition of a "true and fair view". They are, firstly, that the auditor should satisfy himself that all relevant SSAP's have been complied with (except where inappropriate) before giving an unqualified opinion (statement 13.14) and, secondly, that the auditor should satisfy himself that any significant accounting policies not covered by SSAP's are appropriate before giving an unqualified opinion (statement 13.15).

Both of these rules are derived from the requirement for the auditor
to form an opinion and report on the truth and fairness of the financial statements (statement 4.4). As discussed in Section 4 above, this rule is concerned with the implementation of three basic requirements; to report on the accounts (statement 1.4), to comply with statute (statement 1.6) and to provide an effective, economic and efficient service (statement 1.10).

The final statement not justified in terms of the requirement for a report which is not misleading is the permission, under certain circumstances, for the auditor to rely on management assurances when preparing his report (statement 13.81). This permission has been justified on the grounds that it is possible for management assurances to constitute reliable evidence (statement 13.80). Accordingly, reliance upon management assurance is intended to result in the collection of sufficient relevant and reliable evidence (statement 4.21). Like the great majority of audit practices specified in this section, permission to rely on management assurances is derived from the basic requirement to provide an effective, economic and efficient service (statement 1.10).

Section 14. Operational.

As discussed in the previous chapter, the operational system contains statements which are necessary for a proper interpretation and implementation of the formal system. Since there is no argument within the section, it is not diagrammed in Appendix C, although its importance to the formal theoretical system ought not be underestimated.
Little attempt has been made within Section 14 to ensure that it contains every statement which would be necessary to an understanding of the formal system. Rather, it contains those statements which appear within the Standards and Guidelines and which have been considered to be "operational", together with some additional statements judged to be necessary in order to explain some of the statements to be found within the Standards and Guidelines. An example of the latter group concerns the agreement by the U.K. profession to consider the content of international pronouncements on auditing;

14.11 An objective of the U.K. auditing profession is to avoid the introduction of inconsistent international company audit practices.

14.12 If U.K. Auditing Standards conflict with Auditing Standards in other countries, inconsistent international company audit practices could be introduced.

14.13 The U.K. auditing profession has agreed to incorporate the principles on which the UEC Auditing Statements and IFAC Auditing Guidelines are based into its own Auditing Standards.

Statement 14.13 appears within the Standards and Guidelines as paragraph 16 of the Explanatory Foreword. Statements 14.11 and 14.12 have been introduced in order to present a possible explanation for statement 14.13. As in the formal system, this has been done by positing an audit objective (in this case, an objective of the profession) and the means of achieving that objective.

Section 14 consists almost exclusively of examples, definitions, statements of scope and statements of practice concerned with the way in which the Standards and Guidelines are to be interpreted. The only statements which do not fall into these categories are the
three propositional functions listed above (statements 14.11, 14.12 and 14.13) and one other propositional function concerned with failures to observe the auditing standards;

14.18 Apparent failures by members of the U.K. auditing profession to observe Auditing Standards could be enquired into and disciplinary action could result.

Summary

The discussion in this chapter has been concerned only with painting a broad picture of the more important company audit practices and their derivation within a theoretical framework. Although it would have been possible to consider the identified theory in much more detail and to examine the derivation of each separate audit practice, this has been felt unnecessary since such information is available by closely analysing the content of Appendices B and C.

In considering the content of the theory in broad terms, a number of important observations can be made;

1. Every practice (both rules and permissions) has been derived from one or more of the identified company audit objectives and the related basic audit requirements. It is apparent from the discussion that the great majority of practices are considered to implement the basic requirement to provide an effective, economic and efficient service within an appropriate time scale. The reason for this is simply that it would be quite possible to form and report an opinion without adopting very many recommended practices and that, as a result, the primary objective does not, by itself, justify many of the practices to be found within the Standards and
Guidelines. When, however, the service must be provided with effectiveness, economy and efficiency, the stated practices become essential.

2. Some practices have been justified in more than one way. Thus, the refutation of one derivation will not necessarily mean that the practice is unjustified. Similarly, if a practice can be derived from more than one objective, evidence that auditors do not (or ought not) have one of those objectives will not mean that the practice is unjustified.

3. There is a definite hierarchy of audit practices. The most general is the rule in statement 1.0 that auditors should adopt practices necessary in order to achieve the stated objectives. As the theory develops, practices become increasingly specific and, therefore, less critical to the development of subsequent practices. If it were demonstrated that a relatively general practice is unjustified, a substantial portion of the theory could well collapse.

4. The discussion in this chapter has undoubtedly emphasised company audit practices, to the exclusion of propositional functions, definitions and other theoretical (i.e. non practical) statements which occur within the theory. Although this emphasis is justified on the grounds that the purpose of the theory is to derive company audit practices, it is essential to realise that the only way in which practices are linked to objectives is through the operation of theoretical statements such as propositional functions. Accordingly, such statements are of critical importance to the theory, and where those statements constitute a complex argument,
the validity of that argument is critical to the justifiability of any derived practices.

5. There is one aspect of the theory which is important in the light of the methodology adopted in its derivation. This concerns the relationship between those practices known as "standards" and those derived within the theory. Section 1 contains the rule that the auditor should comply with approved Auditing Standards whenever an audit is carried out, unless otherwise indicated in Section 14: Operational (statement 1.18). It is therefore necessary to be able to identify those statements which are "approved Auditing Standards". Section 14 defines "standards" and "approved Auditing Standards" in the following terms:

14.4 "Auditing Standards" are prescriptions of basic principles and practices which auditors are expected to follow in the conduct of an audit. They are indicated within this theory by an asterisk.

14.5 "Approved Auditing Standards" are those Standards approved by the U.K. profession which are effective for the period covered by the financial statements on which the auditor is reporting.

Statement 14.4 indicates that the requirement to adhere to standards (statement 1.18) is to be interpreted only as a requirement to adhere to those statements identified within the presented theory by an asterisk. It is noteworthy that no justification is offered within the Standards and Guidelines (and therefore does not appear in the theory) for identifying such statements as "standards".

There are many implications of the theoretical structure presented in the appendices to this thesis. The purpose of this chapter has been to describe in general terms the more important of these
implications and to outline the relationships which exist between statements within the structure. The remainder of this thesis is concerned with a closer analysis of the theory and a consideration of the steps necessary in order to ensure that it is valid. The final objective will be to describe how the theory could be extended and improved in order to provide a framework for the derivation of all company audit practices.
CHAPTER 6

AN EVALUATION OF THE THEORETICAL FRAMEWORK

As discussed in Chapter 4, it is possible to attack arguments deriving company audit practices in at least four ways. They are:
1) demonstrating a lack of consensus concerning the acceptability of the fundamental normative statement
2) demonstrating a lack of consensus concerning the acceptability of stated definitions,
3) presenting evidence which refutes one or more of the propositions in the argument, or
4) showing that the argument is logically invalid.

The first three of these possible attacks involve the collection of empirical evidence. Since this thesis is concerned with theoretical issues, the collection of such empirical evidence is left to other researchers, although Chapter 9 does examine some of the issues involved in the validation or refutation of propositions by the collection of empirical evidence. The primary concern in this chapter is with the fourth possible area of criticism: invalidities in the argument.

In evaluating the argument in these terms, the concept of "validity" is interpreted in its very broadest sense. It is not solely a matter of whether the conclusions follow logically from the premises. Rather, the evaluation is a wide-ranging critique of the theory in terms both of its internal structure and its relationship to extant company audit practices. The purpose of this critique is not to demonstrate that the theory is invalid and should therefore
be rejected, but to provide an indication of the directions in which future research could proceed in order to develop and improve the theory, in much the same way that the theory herein is a development and, hopefully, an improvement on the content of the Standards and Guidelines.

By subjecting the identified theory to evaluation, one is open to a "straw man" criticism. That is, much of this thesis has been concerned with building the theory, and to subject it now to criticism and evaluation could lead to a belief that it has been constructed in such a way as to facilitate that criticism. It is therefore essential to distinguish clearly between inadequacies which arise as a result of the introduction of additional statements and those which are inherent in the Standards and Guidelines. The intention in this chapter is to consider primarily those inadequacies of the latter type. For this reason, Appendix C has been constructed so as to enable the removal of all statements which have been added in the process of constructing the theory and, thereby, to focus attention on the content of the Standards and Guidelines. Despite the format of Appendix C, there are occasions when it is difficult to delineate criticisms of the Standards and Guidelines from those of the theory. Where this occurs, a suitable comment appears in the text.

The critique is undertaken in five sections. In the first, the nature of the adopted fundamental normative statement is examined; in the second, the identified objectives are considered; in the third, some comments concerning the derivation of the theory on the basis of the Standards and Guidelines are made; in the fourth some
implications of the role of definition are examined and in the fifth the derivation of company audit practices is considered.

The objective of this chapter is to present a theoretical analysis of the Standards and Guidelines in order to identify possible weaknesses therein and to suggest areas in which future research into the theory of company auditing could be undertaken.
Section 1: The Foundation of the Theory

A fundamental criticism of the Standards and Guidelines is that they contain no examination of the role of the company audit or discussions of the benefits which accrue as a result of the existence of the company audit function. In terms of the concepts adopted in this thesis, the theory as suggested by the Standards and Guidelines contains no explicitly stated fundamental normative statement and no hard core of justifying and enabling arguments. In other words, the Standards and Guidelines indicate only the nature of the "protective belt" of procedural arguments.

Since it has been argued earlier that a theory is identifiable by the existence of a hard core, it must be concluded that the Standards and Guidelines do not specify a fully developed theoretical framework of U.K. company audit practices. However, statements within the Standards and Guidelines do suggest a series of audit objectives from which a wide range of audit practices can be derived. Accordingly, the Standards and Guidelines provide an excellent basis for the identification of procedural arguments and, subsequently, for the development of a suitable hard core. Indeed, the next chapter of this thesis is concerned with extending the theory presented in Appendix B by the provision of a hard core.

Although there is no explicitly stated fundamental normative statement in the Standards and Guidelines, it is possible to impute such a statement on the basis of the content of that document. Perhaps the most obvious would be a statement to the effect that "auditors should form and report an opinion on the financial
statements", a requirement based on the identified primary objective (statement 1.1), and specified in Paragraph 2 of the Explanatory Foreword to the Standards and Guidelines. A major difficulty with this as a fundamental normative statement, however, (and, incidentally, the reason it was not adopted in Appendix B) is that the Standards and Guidelines contain no indication of arguments which could be developed in order subsequently to derive audit practices, and it is not an easy matter to identify arguments which would enable such derivations to be made.

For example, to derive the requirement for the auditor to adhere to statutory regulations (Statement 1.6), it would be necessary to explain how adherence to those regulations is necessary in order to form and report an opinion on the financial statements. Although this link could simply be asserted by introducing a propositional function such as; "in order to form an opinion on the financial statements, it is necessary for the auditor to adhere to statutory regulations", it must be remembered that this statement would subsequently be subjected to empirical investigation. In order for the statement to be accepted, evidence must reveal that it is not possible to form an opinion on financial statements without adhering to statutory regulations. Yet audits of unincorporated bodies suggest that it is quite possible to form an opinion other than within a framework of statutory obligations. Thus, it the available evidence would be unlikely to support the suggested propositional function.

Since there is no discussion within the Standards and Guidelines of the purpose to be served by an audit, whatever statement is adopted
as a fundamental normative statement on the basis of that document must assume the existence (and desirability) of the audit function. This is reflected in the fundamental normative statement in the theory presented in Appendix B to this thesis. That statement asserts that company audit objectives, whatever they are, should be attained (statement 1.0). No argument is presented which justifies this claim or explains precisely why an audit of company accounts is desirable. This statement has been introduced as the only obvious means of ensuring that the objectives identified with the Standards and Guidelines result in the derivation of the specified company audit practices.

It is interesting to compare the fundamental normative statement developed in the theory based on the Standards and Guidelines with those presented in the accountability and investment decision arguments discussed in Chapter 4. The accountability argument depends upon the general rule that "where one party is held to be accountable by another, that duty of accountability should be discharged to the satisfaction of the latter party". This statement acts as the basis of a justification for the existence of company auditing and, in a fully developed theory, would constitute a premise in the derivation of all recommended company audit practices. Similarly, the investment decision argument is based on the rule that "there should be a means of minimising the risk of undesired outcomes of shareholder investment decisions".

Neither of these rules relates specifically to company auditing, and neither assumes the existence of the company audit function. This is particularly important in that it prevents labelling the
arguments in which they appear as circular. That is, these justifications of company auditing do not assume the existence of that function.

This is not the case with the argument developed on the basis of the Standards and Guidelines. Both the fundamental normative statement on which that theory depends and the identified primary objective assume the existence of the company audit function. There is thus no basis within either the Standards and Guidelines or the theory presented in Appendix B by which the existence of the company audit function is explained.

A second general criticism of the fundamental normative statement on which the identified theory is based concerns some of its implications. A statement that company auditors should do whatever is necessary to achieve their objectives is a licence for auditors to do, literally, whatever they want. It is apparent that such a statement could ultimately result in the specification of any audit action by the identification of an appropriate objective. In these circumstances, the theory imposes no limits to audit behaviour.

In other words, the only way in which a particular audit action could be said to be inappropriate, given the foundation of the theory specified in Appendix B, would be to demonstrate that there is no possible objective which could be attained by that action. As a result, the theory does little to enable the identification of inappropriate company audit procedures, unless the list of objectives specified in Section 1 of the theory is assumed to be exhaustive.
Although this last comment cannot be considered to be a criticism of the Standards and Guidelines, it is relevant to what is the most serious deficiency of that document, assuming that the Standards and Guidelines contain the most explicit statement by the profession of the theoretical framework of U.K. company auditing practices. That deficiency is that there is no explanation in the Standards and Guidelines of what useful purpose the company audit function is intended to serve.
Section 2: Objectives

Four important criticisms of the Standards and Guidelines can be made on the basis of the objectives identified in Section 1 of Appendix B. The first concerns the extent to which those objectives are merely implied by, rather than explicitly stated in, the Standards and Guidelines.

Of the five objectives identified in Section 1, only two are based directly on statements contained within the Standards and Guidelines. The first is the primary objective of forming an opinion and reporting on the financial statements (statement 1.1). Paragraph 2 of the Explanatory Foreword is the basis for the reporting aspect of this objective. It states; "The auditor's responsibility is to report on the financial statements". The objective of forming an opinion is based on paragraph 2 of the Auditing Guideline on review of financial statements, which provides that "the auditor is required to form an opinion on the... financial statements as a whole".

Perhaps the clearest statement of objective is that contained in paragraph 4 of the Auditing guideline on planning, controlling and recording, which states that "the auditor should aim to provide an effective and economic service within an appropriate time-scale". This is the basis of the secondary objective specified in statement 1.9. As discussed in the previous chapter, this objective is extremely important to the remainder of the theory in that it acts as a premise in the justification of a wide range of company audit practices.
The remaining objectives have been introduced into the theory on the grounds either that they are implied by the definition of an audit or that there are practices specified in the Standards and Guidelines which can be justified only in terms of those objectives.

For example, paragraph 7 of the Explanatory Foreword provides that "a court of law may, when considering the adequacy of the work of an auditor, take into account... Auditing Standards and Guidelines". This is the only statement contained with the Standards and Guidelines which suggests a reason for adherence to auditing standards. And the reason would only have any force if auditors had an objective of ensuring that it is possible to conduct a successful defence if their actions were questioned in a court of law. Hence the objective specified in statement 1.13 is introduced into the theory.

The substance of this first criticism of the objectives in the Standards and Guidelines is similar to that discussed in the previous section; as a source for the specification of the theoretical framework of U.K. company audit practices, the Standards and Guidelines are incomplete. As a result, a number of practices specified within the Standards and Guidelines are not justified in terms of explicit audit objectives. Accordingly, the Standards and Guidelines provide little guidance to the identification of inappropriate company audit practices.

Woolf levied a similar criticism against the Standards and Guidelines when he said that

the definition [of an audit] makes no reference to the party or
parties to whom the opinion is addressed, and hence to whom responsibility is owed.

Without a recognition of the group(s) to whom the auditor is to report, there can be no identification of audit objectives in terms which justify company auditing as a useful function. And without the expression of objectives in those terms, it is not possible to determine whether company audit practices ultimately result in the provision of a useful service.

A second comment on the identified objectives is related to the absence of justification for those objectives presented in the Standards and Guidelines. Since no explanation of the purpose to be served by the company audit function is presented, it is impossible to determine why company auditors have, or ought to have, those objectives specified in Section 1 of the theory. If no single purpose is specified by which objectives can be unified, it is quite possible for derived practices to be inconsistent.

For example, it might be argued that in order to comply with the requirement to ensure that a successful defence could be conducted if the auditor's judgement were questioned (statement 1.14), it is necessary to keep extremely detailed records. However, the need to keep such records could act against the basic requirement to provide an "economic service" (statement 1.10). Similarly, the auditor is likely to be in a stronger legal position if he refuses to place substantial reliance upon internal control. Yet a failure to place reliance upon internal control could result in a failure to provide an effective, economic and efficient service (statements 7.28 and 10.4).
The third possible criticism of the objectives identified on the basis of the Standards and Guidelines is that it could be argued that not all of the seven basic requirements specified on the basis of those objectives are strictly necessary to the derivation of audit practices. As indicated in Table 1 of Chapter 5, 185 of the 194 practices specified in the theory are derived from the basic requirement to provide an effective, economic and efficient service. If the theory could be amended such that some or all of the remaining nine practices were also derived from the requirement for an effective, economic and efficient service, it would be possible to argue that other basic requirements are redundant.

For example, the requirement to ensure that it is possible to conduct a successful defence (statement 1.14) provides the only justification for just five practices, derived within two streams of argument. These streams of argument are as follows:

**Argument 1**

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  1.14
  |     |
  1.16
  |     |
  1.15

  2.4
  |     |
  2.3

  2.6
  |     |
  2.5

  2.7
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Argument 1 relates to the requirement to comply with auditing standards (statement 1.18). As discussed earlier, it appears that the only justification given within the Standards and Guidelines for complying with auditing standards is so that the auditor will be in a better position to conduct a successful defence if his judgement is questioned in a court of law. It could be argued, however, that the phrase "good practice", as a description of the standards, suggests that the requirement to comply with those standards could also be justified in terms of the basic requirement to provide an effective, economic and efficient service.

Argument 2 concerns the requirement for the auditor to consider consulting another practitioner when difficult questions of principle or judgement arise (statement 6.3). This requirement is justified on the grounds that the auditor's judgement could be questioned in areas of the audit where difficult questions of principle or judgement have arisen (statement 6.1) and that consultation with another experienced accountant will assist the auditor to defend himself if his judgement is questioned (statement 6.2).

Since statement 6.1 is based on paragraph 20 of the Auditing
Guideline on planning, controlling and recording, the Standards and Guidelines suggest that the "self-defence" requirement provides an explanation of the requirement for the auditor to consider, under certain circumstances, consulting another experienced accountant. The content of the Standards and Guidelines does not suggest that the practice of consulting other practitioners is to be justified on other grounds.

As with argument 1 above, however, it could be suggested that the requirement to consider consulting another practitioner is justifiable in terms of the need to collect sufficient evidence (statement 4.21), which is explained in terms of the basic requirement to provide an effective, economic and efficient service.

It could therefore be suggested that the basic requirement for the auditor to ensure that it is possible to conduct a successful defence is not strictly necessary. With minor modifications to the theory, practices derived on the basis of that requirement could be justified in terms of the implementation of other basic requirements. If the Standards and Guidelines were similarly changed (in particular, paragraph 7 of the Explanatory Foreword and paragraph 20 of the Guideline on planning, controlling and recording), there would be no need for the secondary objective of ensuring that it is possible to conduct a successful defence.

Since there are only nine practices derived within the theory which are not derived from the requirement to provide an effective, economic and efficient service, it is quite probable that with minor modifications to the theory, all practices could be derived from the
primary objective together with the one secondary objective of providing an effective, economic and efficient service within an appropriate time scale. This suggests that with minimal effort, the majority of the secondary objectives could be removed from the theory and problems of conflict between practices based on those objectives avoided.

The final possible criticism of the identified objectives is that the Standards and Guidelines provide no indication of how any conflict between objectives is to be resolved. This could be achieved, for example, by specifying the objectives in order of precedence. If this were done, the structure of the theory would enable auditors to decide on the appropriate course of action if a conflict occurs.

Unfortunately, the only indication of the rank of any objective in the Standards and Guidelines is that compliance with statute takes precedence over compliance with the terms of the engagement (statement 1.7). In the absence of a precise indication of the relative importance of secondary objectives, and given the possibility of conflict between practices derived from those objectives, company auditors are provided with no guidance by which a decision between objectives in the case of conflict can be made.
Section 3: Derivation of the theory

As discussed in Chapter 4, the derivation of the theory presented in Appendix B involved a two stage process. Firstly, the Standards and Guidelines were analysed in order to identify statements therein which could conceivably be re-organised so as to construct a series of arguments which explain and justify company audit practices. Secondly, any gaps which were left after the re-organisation of these statements were filled by the introduction of additional statements. This section is concerned with an examination of introduced statements in order to determine more precisely the areas in which the Standards and Guidelines can be said to be incomplete as a source of a theoretical framework of U.K. company audit practices.

The general classes of introduced statements, and the sections in which they appear is analysed in Table 3 below.
Table 3 The relative importance of introduced statements.
A: Total statements of practice  
B: Introduced statements of practice  
C: B as a percentage of A  
D: Total theoretical statements  
E: Introduced theoretical statements  
F: E as a percentage of D

As Table 3 reveals, 26% of the statements of practice appearing in the theory and 54% of other classes of statement have been introduced rather than identified in the Standards and Guidelines. In total, 42% of the statements in Appendix B have been introduced in order to link together the provision of the Standards and Guidelines.

In all but sections 1 and 3, the majority of introduced statements are theoretical. This suggests that the greatest gaps in the Standards and Guidelines occur in the area of propositional functions and other statements which explain the derived practices. It has been necessary to introduce more than half of such statements which appear within Appendix B².
Introduced Theoretical Statements

Theoretical statements have been introduced in order to fulfill one or more of three roles:

a) to enable a company audit practice to be derived from earlier statements in the theory,

b) to draw a conclusion from earlier statements in the theory, or

c) to enable a later theoretical statement to be derived.

For example, part of the argument which results in the requirement for the auditor to satisfy himself that audit work is adequately performed (statement 8.9) can be diagrammed as follows (introduced statements shown in red):

In this argument portion, three statements have been introduced into the theory in order to link four statements which appear in the Standards and Guidelines. Statement 8.6 is the requirement for the auditor to conduct an adequately controlled audit. In order to derive statement 8.9 from that earlier requirement, it was necessary to specify that an audit would not be adequately controlled unless the auditor satisfied himself that audit work is adequately performed. Since no statement to this effect could be found in the Standards and Guidelines (despite the presence of both 8.6 and 8.9 in that document), statement 8.8 was introduced. That introduced statement provides, inter alia, that an audit in which audit work is
adequately performed is an adequately controlled audit. In enabling
the derivation of statement 8.9, statement 8.8 is introduced to
fulfill role (a) above.

Earlier in the theory, statement 8.4 had been included on the
grounds that it appears within the Standards and Guidelines. That
statement provides that an audit in which mistakes and omissions are
prevented is an adequately controlled audit. Since both statements
8.4 and 8.8 dealt with adequately controlled audits, it was possible
to establish a link by asserting that mistakes and omissions can be
caused by inadequately performed audit work. This assertion appears
in statement 8.7, which has been introduced to fulfill role (c)
above. After the introduction of 8.7, statement 8.8 becomes a
conclusion drawn from earlier statements in the theory, fulfilling
role (b) specified above.

Like statement 8.4, statement 8.14 appears within the Standards and
Guidelines and deals with an aspect of an adequately controlled
audit. In this case, it provides that direction and supervision are
important elements of adequate control. Since statement 8.8
provides that an adequately controlled audit is one conducted by
adequate staff, it is possible to link statements 8.8 and 8.14 by a
statement asserting that direction and supervision will ensure that
the audit is conducted by adequate staff. Statement 8.13 makes this
assertion. Thus, both statements 8.8 and 8.13 fulfill role (c)
above; that of enabling a later theoretical statement to be derived.

It will be apparent from the above example that introduced
statements can fulfill more than one of the roles specified above.
In fact, statement 8.8 fulfills all three. The roles of all introduced theoretical statements are analysed in table 4 below.

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Table 4 Roles played by introduced theoretical statements.
N: Number of statements introduced in section
A: To enable the derivation of statements of practice.
B: To draw a conclusion from theoretical statements.
C: To enable the derivation of theoretical statements.

The 165 introduced statements play a total of 224 different roles. Of the 224 roles, 128 (57%) are to enable the derivation of statements of practice, thirty seven (17%) are to enable the drawing of conclusions from earlier theoretical statements, and fifty nine (26%) are to enable the derivation of theoretical statements. It appears that the major area in which the Standards and Guidelines could be said to be incomplete is in the provision of sufficient theoretical statements completely to justify the recommended practices.

An examination of the opaque pages of Appendix C reveals that there are 150 statements of practice contained within the Standards and Guidelines which are reflected in the formal theoretical system of Appendix B. Of those 150 statements, just thirty (20%) are derived
solely on the basis of statements contained within the Standards and Guidelines. Of those thirty, only eight (5% of the total) are derived from one or more of the basic audit requirements without the need to rely upon introduced statements. The extent to which practices within the Standards and Guidelines are fully justified by other statements in that document is analysed in Table 5.

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Table 5: The extent to which practices in the Standards and Guidelines are fully justified by other statements in that document.

A: Statements of practice in the Standards and Guidelines
B: Fully justified statements of practice in the Standards and Guidelines
C: B as a percentage of A
D: Fully justified statements of practice in the Standards and Guidelines which are also traceable to a basic audit requirement.

Table 5 reveals a surprisingly consistent picture of the gaps which exist in the Standards and Guidelines. In the first four sections of the theory, only one practice is fully derived within the Standards and Guidelines. These sections are the more conceptual of those which appear in the theory. The lack of justification at a conceptual level is consistent with the observations in the previous
two sections of this chapter.

When dealing with the more procedural level of company audits (i.e. with the protective belt of the theoretical framework of company audit practices) the Standards and Guidelines fairly consistently justify about 20% of the practices recommended. This further supports the argument that the Standards and Guidelines provide a reasonable basis for the specification of procedural arguments, but are sorely lacking in the provisions of justifying or enabling arguments.

Table 4, which was concerned with the roles played by introduced statements, revealed a similar picture. In that table, introduced theoretical statements in the first four sections of the theory were indicated to play a total of thirty one roles. Of these, twenty one (71%) were to enable the justification of an audit practice. In the remaining sections, the percentage of introduced statements playing this role decreased to 55%. The evidence suggests that the more fundamental the company audit practice (i.e. the earlier it is derived in the theory), the less likely it is to be justified by the content of the Standards and Guidelines.

**Introduced Practical Statements**

Table 3, which specified the nature of introduced statements, indicated that 26% of the statements of practice appearing in Appendix B were not to be found in the Standards and Guidelines. This suggests that the Standards and Guidelines could be criticised for a failure to specify practices which are quite justified by other statements within that document.
Introduced statements of practice fulfill one or both of two roles;
a) to specify a requirement (or permission) which is justified by earlier statements in the theory, and/or
b) to enable the derivation of later requirements or permissions.
These roles are analysed in Table 6.

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Table 6: Roles played by introduced statements of practice.
A: To specify a statement of practice which is justified by earlier statements in the theory.
B: To enable the derivation of later statements of practice.

Only one practice has been introduced solely to enable the derivation of later practices. It is statement 1.0, the fundamental normative statement which provides that auditors should adopt procedures necessary to achieve objectives, and from which all other practices are derived. Since compliance with this requirement is assumed to be desirable, statement 1.0 is neither derived nor justified.

However, every other practice in the theory is a derived practice (ultimately from the fundamental normative statement), and some also
act as the basis for the derivation of later practices. Of the eighty four roles played by introduced statements of practice, fifty two (62%) are conclusions from earlier statements, and thirty two (38%) are to enable the derivation of later statements.

For example, part of the argument resulting in the requirement for the auditor to consider using documentation designed to identify internal controls which meet specified overall control objectives or which prevent or detect particular specified errors or omissions (statement 10.18) can be diagrammed as follows (introduced statements in red):

```
  10.14
   ^
  10.15
   |
  10.17
   |
  10.18
```

In this argument, two introduced statements link together three statements to be found in the Standards and Guidelines. Statement 10.14 requires the auditor, if he wishes to rely on internal controls, to ascertain and record the internal control system. Statement 10.15 asserts that ascertaining and recording the internal control system are facilitated by using documentation designed to identify relevant controls. It follows from these statements that, if the auditor wishes to rely on internal controls, he should consider using documentation designed to identify relevant controls. Although this is not specifically stated within the Standards and Guidelines, it is quite justified by other statements therein.

Having introduced statement 10.16 to play role (a) above, it then
becomes possible to derive statement 10.18 by introducing a
definition of "relevant controls" as those which meet specified
overall control objectives or which prevent or detect particular
specified errors or omissions. This definition is provided in
statement 10.17. As a result, statement 10.16 then fulfills the
role of enabling a later requirement to be derived.

Table 6 suggests that the Standards and Guidelines are incomplete in
that they do not specify all of the company audit practices which
are justified by other statements therein. In order to determine
the extent to which this is a justified criticism, it is instructive
to compare those occasions when a justified practice is specified in
the Standards and Guidelines with those occasions when a justified
practice is not specified. This comparison appears in Table 7. 7

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Table 7: The extent to which practices justified by the Standards
and Guidelines appear within that document.
A: Practices justified by, and in, the Standards
and Guidelines.
B: Practices justified by, but not in, the Standards
and Guidelines.
C: Total practices justified by the Standards and Guidelines.

Table 7 reveals that on forty nine occasions, the content of the
Standards and Guidelines provides full justification for the recommendation of a company audit practice. However, on nineteen occasions (39%), the practices are not recommended. The table also indicates that the Standards and Guidelines are quite complete in the area of Audit Reporting (Section 13); of the eleven practices concerned with audit reporting which are justified by the content of the Standards and Guidelines, ten are in fact specified in that document. If this area is eliminated from Table 7, the proportion of practices justified but not recommended, as compared to total justified practices, jumps to 47%. Thus, it is reasonable to claim that the Standards and Guidelines fail, on a significant number of occasions, to specify quite justified company audit practices.

The role of theoretical statements

As discussed earlier in this section, non-practical statements play one or more of three roles in a theory of company auditing; (a) to justify practices, (b) to draw conclusions from earlier theoretical statements and/or (c) to justify subsequent theoretical statements. If the argument in Chapter 2 that the purpose of a theory of company auditing is to derive company audit practices is accepted, then non-practical statements which do not ultimately lead to practices are irrelevant. Seen in this light, the roles of drawing conclusions from earlier theoretical statements, and of justifying subsequent theoretical statements are only intermediate roles played by statements in chains of argument leading to the specification of practices.

If any statements which appear in the Standards and Guidelines do
not lead to practices specified in Appendix B, then either justified practices have not been specified (lending further support to the criticism in the previous section) or those statements are irrelevant. An analysis of Appendix C in order to identify such statements appears in Table 8.

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Table 8: Theoretical statements not leading to audit practices
A: Introduced theoretical statements not leading to practices.
B: Theoretical statements in the Standards and Guidelines not leading to practices.

Table 8 reveals that there are a total of thirty six theoretical statements to be found in Appendix B which do not lead to audit practices and are, in terms of the theory as specified, irrelevant. Ten of these statements have been introduced in order to link together statements which are to be found within the Standards and Guidelines and to enable as many statements as possible to be specified in the identified theory. The remaining twenty six are statements to be found within the Standards and Guidelines which do not lead to audit practices and which, as a result, are irrelevant to the theory as specified.
The most obvious area where statements in the *Standards and Guidelines* do not lead to the specification of practices is internal control (section 10). Of the twenty six statements in the *Standards and Guidelines* which do not lead to company audit practices, fifteen (58%) are to be found in section 10. In broad terms, those statements deal with matters such as the directors' responsibility for internal control, factors which influence internal control design, and the need for internal controls in companies of different sizes.

It appears that such statements have been included as matters of information for auditors. However, whether a document on Auditing Standards and Guidelines is an appropriate place to provide such information is open to question. In any case, statements which do not lead to the specification (and, therefore, justification) of audit practices have no role to play in a theory of company auditing. This suggests that fifteen of the thirty eight theoretical statements to be found in the Auditing Guideline on internal control are not relevant to a theoretical framework of U.K. company audit practices.

Some statements contained within the *Standards and Guidelines* have been excluded from Appendix B on the grounds that they can play no role in a theory of company auditing. Such statements are identified in Appendix A by the letter "N" appearing after the statement type. Exclusion of these statements has been on one of two grounds;
a) they are administrative, dealing with the structure of the *Standards and Guidelines* document itself, or
b) since they are neither premises on which later statements depend nor conclusions drawn from earlier statements, they play no role in the theory. In Chapter 2 it was established that the term "theory" is being used in this thesis in a narrow sense, so that no statement in the theory can remain isolated; "every statement is either an assumption or a conclusion". Thus, statements identified within the Standards and Guidelines which are neither assumptions nor conclusions in the context of a theory of company auditing, can play no role in that theory.

Of the thirty one statements in Appendix A which do not appear in Appendix B, twenty four (77%) are administrative, dealing with such matters as how the Standards and Guidelines are structured and how they are to be read. Such statements are classified as "administrative" and indicated by the letter "A" in Appendix A.

Seven other statements in the Standards and Guidelines have been excluded from the theory even though they are not administrative statements. Six of these statements are propositional functions and the other is a rule. The propositional functions have been excluded on the grounds that there is no explicit or implicit link between the excluded statement and other statements in the Standards and Guidelines. Without such a link, the statement can be neither a premise nor a conclusion.

For example, paragraph 24 of the Auditing guideline on planning, controlling and recording provides that:

Working papers are the property of the auditor and he should adopt appropriate procedures to ensure their safe custody and confidentiality.
As will be seen in Appendix A, this paragraph contains one propositional function (that working papers are the property of the auditor) and two rules (that appropriate procedures should be adopted to ensure (a) safe custody and (b) confidentiality of those papers). Although the wording of the paragraph suggests that the auditor should ensure safe custody and confidentiality of working papers on the grounds that they are his property, this link cannot be established in terms of the theory presented in Appendix B.

A rule that the auditor should ensure safe custody and confidentiality of working papers might be derived from an assertion that such papers are his property by establishing a more general rule that the auditor should ensure safe custody and confidentiality of all documents which are his property.

There are two difficulties with this more general rule. Firstly, there is the implication that the auditor need not ensure safe custody of documents which are the property of his clients, an implication which is unlikely to be acceptable to the profession. Secondly, there is nothing in the Standards and Guidelines to suggest how the more general rule could be derived from one or another of the basic audit requirements. That is not to say that such a derivation is impossible, only that to specify such an argument would be to impose a degree of judgement which could expose one to the charge that the specified theory is not based on the Standards and Guidelines. And since it is possible to derive the rules for safe custody and confidentiality on other grounds which are specified in the Standards and Guidelines and which have been
derived from the basic audit requirements, the assertion that working papers are the property of the auditor is unnecessary and has not been included in Appendix B.

The one rule that has been excluded is contained in paragraph 10 of the Auditing Standard on the audit report, which provides that:

It should be noted that the Companies Act of Great Britain, Northern Ireland and the Republic of Ireland contain different reporting requirements.

This rule does not appear in Appendix B since it is implied by the rule that the auditor should comply with reporting requirements (Statement 4.2). It appears that the reason for including the requirement to note differences between legislative provisions is to avoid the possibility of an inadvertent failure to comply with the legislation. The rule in statement 4.2 provides for unconditional compliance with reporting requirements, and other provisions concerning adherence to statute allow for differences between the requirements of different countries. In short, the rule to note such differences has been excluded as redundant.

Summary

This section has been concerned with the adequacy of the Standards and Guidelines as a basis for the identification of a theoretical framework of U.K. company auditing. The analysis has been based on the extent and nature of the judgement exercised when deriving the theory in Appendix B from the Standards and Guidelines. In general terms, it was found necessary to introduce a large number of additional statements in order to link together the provisions of the Standards and Guidelines. On a much smaller number of
occasions, it was necessary to exclude statements found in the Standards and Guidelines from the theory in Appendix B.

To summarise, if the Standards and Guidelines are interpreted as more than a listing of interesting observations and recommended practices, then they have a number of inadequacies. In the first place, there are insufficient statements adequately to justify the recommended practices, particularly in the earlier sections of the theory. As table 5 showed, in the first four sections of the theory only one practice was fully derived within the Standards and Guidelines. This suggests that the Standards and Guidelines provide an inadequate basis for the identification of a hard core, or conceptual foundation, for U.K. company audit practices. If the argument presented in Chapter 3 that the Standards and Guidelines are the most appropriate source for the identification of the theoretical framework of U.K. company audit practices is accepted, then these practices have not been established on the basis of a conceptual foundation, since none appears within the Standards and Guidelines.

A second criticism of the Standards and Guidelines is that they stop short of recommending practices which are quite justified by other statements in the document. This further indicates that, as a basis for the identification of a theory of company auditing, the Standards and Guidelines are incomplete.

A final criticism of the Standards and Guidelines is that they contain a number of statements which seem superfluous to the justification or explanation of recommended practices. Thus, from
the point of view of establishing a theoretical framework of company audit practices, a number of statements within the Standards and Guidelines are redundant.
Section 4: Definitions

As discussed in Chapter 4, definitions play two roles in a theory of company auditing. Firstly, definitions which appear in the operational system provide the means of interpreting statements within the formal theoretical system. Such definitions are necessary in order to secure understanding of, and agreement about, the terms used. In the absence of an understanding of the terms used, it is possible that statements of practice derived within a theory could be misinterpreted. If this occurs, actions taken could be inconsistent or inappropriate.

It is very important, therefore, that interpretive definitions which appear in the operational system are both unambiguous and complete. That is, not only must the definitions be successful in eliminating ambiguities, but they must refer to all of the important concepts in the theory, since until those terms have unique and defined referents, it will neither be possible to ensure that they are used consistently throughout the theory nor to discover all of their implications and draw inferences therefrom. In short, without definition, there is no way to be sure that the theory is valid or leads to consistent, justifiable and appropriate company audit practices.

It follows that it is quite appropriate to criticise the Standards and Guidelines for containing ambiguous definition, if that document is accepted as a basis for the identification of a theory of company auditing. Furthermore, it is likely that the identification and elimination of ambiguous definition will facilitate the
identification of inconsistent, unjustified or inappropriate company audit practices.

A different role is played by definitions which appear in the formal theoretical system. Such definitions enable concepts to be interpreted such that audit practices are derived. For example, the derivation of the rule that the auditor should determine the nature of audit tests when planning the audit (statement 7.10) is as follows:

In this argument, statement 7.4 provides that the auditor should conduct an adequately planned audit. The concept of an "adequately planned audit" is defined in statement 7.2 to include, inter alia, the establishment of intended means of achieving objectives. Statement 7.9 then asserts that determination of the nature of audit tests will establish the intended means of achieving objectives. Thus, the requirement for the auditor to determine the nature of audit tests is derived on the basis of the definition of an adequately planned audit.

It was recognised in Chapter 4 that definitions are not empirically verifiable and that, as a result, empirical evidence cannot be presented in support of the claim that a definition may properly remain in a theory. Instead, the only possible grounds for retention of a definition in the formal theoretical system is that it commands general acceptance. Accordingly, definitions may
properly remain within a theory of company auditing only so long as they are acceptable to those who wish to evaluate or act upon that theory. Since definitions remain within the theory only so long as they remain acceptable, they are subject to withdrawal at any time.

If definitions are a component part of the formal system of a theory of company auditing and form the basis of the derivation of company audit practices, withdrawal of such definitions will mean withdrawal of the justification for derived practices. The greater the number of practices derived from definition, the less stable is the theoretical structure. A second possible source of criticism of the Standards and Guidelines, therefore, concerns the extent to which definition is relied upon in the derivation of practices. The greater the reliance upon definition, the less secure will be the basis of recommended company audit practices.

Definition in the Operational System

The research effort in this thesis has been primarily directed towards building the formal theoretical system. As a result, no claim is made that the Operational System (Appendix B, Section 14) is complete. In fact, that system consists of little more than the interpretive definitions, examples and statements of scope which appear in the Standards and Guidelines. However, it does provide the basis for some comment on the extent to which definition in the Standards and Guidelines is unambiguous and complete, and, therefore, on the extent to which statements within the Standards and Guidelines are likely to be interpreted consistently.

The terms and concepts which appear within a theory of company
auditing are frequently qualitative. For example, reference is made to "relevant and reliable evidence", a "reasonable basis" for the auditor's opinion, an "adequate accounting system" and "true and fair" financial statements. In practice, difficulties are likely to be encountered in providing unambiguous definitions for such concepts. Indeed, it has been suggested that some concepts (e.g. that of "true and fair view") cannot, and should not, be defined unambiguously, in order that scope for auditor judgement may be retained.

Despite this argument for subjectivity it must be remembered that, unless important concepts are defined, there will be scope for misinterpretation of required practices and misunderstanding of the basis on which those practices are justified. If this occurs, the objectives inherent in building a theoretical framework of company audit action will be unlikely to be achieved.

Section 14 contains twenty definitions which are apparently intended to enable interested persons to interpret the Standards and Guidelines. The terms so defined are specified in Table 9.
<table>
<thead>
<tr>
<th>Statement</th>
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</tr>
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<td>14.2</td>
<td>financial statements</td>
</tr>
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<td>14.3</td>
<td>company</td>
</tr>
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<td>14.4</td>
<td>auditing standards</td>
</tr>
<tr>
<td>14.5</td>
<td>approved auditing standards</td>
</tr>
<tr>
<td>14.6</td>
<td>auditing guidelines, explanatory notes and existing pronouncements on auditing</td>
</tr>
<tr>
<td>14.19</td>
<td>audit evidence</td>
</tr>
<tr>
<td>14.21</td>
<td>inspection</td>
</tr>
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<td>14.22</td>
<td>observation</td>
</tr>
<tr>
<td>14.23</td>
<td>enquiry</td>
</tr>
<tr>
<td>14.24</td>
<td>computation</td>
</tr>
<tr>
<td>14.25</td>
<td>analytical review procedures</td>
</tr>
<tr>
<td>14.26</td>
<td>joint audit</td>
</tr>
<tr>
<td>14.27</td>
<td>audit staff</td>
</tr>
<tr>
<td>14.29</td>
<td>reporting partner</td>
</tr>
<tr>
<td>14.33</td>
<td>internal control</td>
</tr>
<tr>
<td>14.34</td>
<td>exception</td>
</tr>
<tr>
<td>14.40</td>
<td>qualified audit report</td>
</tr>
<tr>
<td>14.41</td>
<td>uncertainty</td>
</tr>
<tr>
<td>14.42</td>
<td>disagreement</td>
</tr>
</tbody>
</table>

Table 9: Concepts for which interpretive definitions are provided in the Standards and Guidelines

The majority of terms defined in the Standards and Guidelines and included in the operational system of the theory are not qualitative and do not relate to fundamental concepts such as "reliability" of evidence, "truth and fairness" of financial statements or "reasonable basis" for the auditors' opinion. This suggests either that the Standards and Guidelines fail to define such concepts or that the definitions are the basis for deriving audit practices and are therefore, included in the formal system of the theory. To the extent that the former is the case, the Standards and Guidelines will not provide the means for unambiguous interpretation of important company auditing concepts. To the extent that the latter is the case, the theory can be criticised for reliance on (unverifiable) definitions and for a failure to establish a secure framework for company audit practices.
Since a theory is structured such that increasingly specific practices are derived, the conclusions will be the most specific practices in the theory. Thus, practices which play a role only as conclusions in a theory (i.e. which do not result in the derivation of subsequent practices) will in general contain terms which are defined in the operational system of that theory. That is, where definitions appear in the formal system, their role is to specify a term in a statement of practice in order to enable the derivation of increasingly specific practices. Although it is possible to derive ever more specific practices by the introduction of definitions into the formal theoretical system, the fact that no such practices are derived from concluding practices indicates that definitions of terms appearing in those practices have not been introduced into the formal system.

While the observation that terms in concluding statements of practice are defined in the operational system would certainly be true in respect of a theory developed according to a Lakatosian structure which did not refer to the Standards and Guidelines, it is not always true in Appendix B for two reasons. Firstly, concluding practices are not necessarily the most specific in the theory. Thus, they could contain terms defined earlier in the formal system.

For example, Statement 7.20 specifies four audit practices to be carried out when planning the audit. Statement 7.21 then defines "preparatory procedures" as these four practices. Accordingly, the requirement in the Standards and Guidelines for the auditor to consider preparatory procedures is derived and specified in
Statement 7.22. As a consequence, the concluding Statement 7.22 contains the term "preparatory procedures" which is defined in an earlier statement in the formal system. In fact, although statement 7.22 is derived from statement 7.20, the latter is the more specific statement of practice. Accordingly, an investigation into whether the most specific practices in the theory contain undefined terms should consider statement 7.20 rather than 7.22.

A second reason for the invalidity of the general claim that concluding statements of practice contain terms which are defined only in the operational system is that the argument in Appendix B is incomplete. That is, more specific practices could have been specified on the basis of a concluding statement and definitions contained elsewhere in the formal system of the theory. Thus, it is possible that terms which appear in concluding statements are defined in other streams of argument.

For example, Statement 5.8 requires the auditor to consider whether evidence is relevant to the formation of an opinion as to truth and fairness. Although this is a concluding statement of practice, it would have been possible to specify a range of more specific practices by establishing a link between statement 5.8 and the definition of truth and fairness provided in statement 4.5. In a sense, it could be argued that statement 5.8 is not a "concluding" statement in that more specific statements could be derived without introducing additional statements.

Despite these difficulties, an analysis of concluding statements which appear in both Appendix B and the Standards and Guidelines
will provide some guidance as to the extent to which sufficient definition is provided. The following Table 10 specifies the number of concluding statements in each section of the theory which are also in the Standards and Guidelines, together with some concepts appearing in those statements not defined elsewhere in the theory.

<table>
<thead>
<tr>
<th>Section</th>
<th>A</th>
<th>Undefined Concepts</th>
</tr>
</thead>
<tbody>
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<td>personal standards</td>
</tr>
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<td>2</td>
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</tr>
<tr>
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<tr>
<td>4</td>
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</tr>
<tr>
<td>5</td>
<td>13</td>
<td>adequate approach, proper disclosure, reliability, independence</td>
</tr>
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<td>6</td>
<td>1</td>
<td>confidentiality</td>
</tr>
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<td>7</td>
<td>13</td>
<td>outline approach, significant phase of preparation of financial statements, nature of business, irregularities</td>
</tr>
<tr>
<td>8</td>
<td>4</td>
<td>quality of audit work</td>
</tr>
<tr>
<td>9</td>
<td>4</td>
<td>safe custody</td>
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<tr>
<td>10</td>
<td>11</td>
<td>independence</td>
</tr>
<tr>
<td>11</td>
<td>7</td>
<td>accounting records</td>
</tr>
<tr>
<td>12</td>
<td>7</td>
<td>authoritative support, substance of underlying transactions, adequate reflection of information, factors which affect presentation or accounting policies, adequate experience and skill</td>
</tr>
<tr>
<td>13</td>
<td>23</td>
<td>relevant SSAP's, significant accounting policies, appropriate disclosure, measures of last resort, management assurance</td>
</tr>
</tbody>
</table>

Table 10: Concluding practices and undefined concepts in the Standards and Guidelines. A: Number of concluding practices in section.

If nothing else, Table 10 gives a flavour of those concepts which are not defined in the Standards and Guidelines. A total of twenty four concepts are specified in the above table, all of which are subjective in nature and open to different interpretations. Since these requirements refer to concepts which could be interpreted differently by different auditors, adherence to a requirement will not necessarily result in different auditors undertaking similar audit actions. For example, although auditors are required to
consider the adequacy of the audit approach (Statement 5.65), no
definition of an "adequate audit approach" is given. Thus, no
criteria are established by which the auditor can judge the adequacy
of his audit approach.

The above comments should be interpreted in the light of the
requirement for auditor judgement (Statement 2.5) and the assertion
that the Standards and Guidelines do not (and probably cannot) cater
for all situations (Statement 2.3). Thus, the Standards and
Guidelines cannot be criticised for a failure to provide objective
definitions of every concept appearing in that document. However,
it is appropriate, firstly, to identify those concepts which are
undefined and, secondly, to criticise the Standards and Guidelines
for a failure to minimise the possibility of conflicting
interpretations of recommended practices. At the very least, the
Standards and Guidelines can be criticised for a failure to specify
those areas in which judgement is necessary and, hence, for a
failure to indicate those areas in which it is possible for
practices to be inconsistent or inappropriate as a result of the
exercise of faulty judgement by the auditor.

Definition in the formal system

Definitions have been included in the formal system of the theory
when they are essential to the derivation of audit practices. In
general, such definitions will provide a link between practices
specified earlier in a theory and more specific practices specified
later in that theory.

For example, statement 4.5 lists ten criteria necessary for
financial statements to be considered to be "true and fair", and is expressed in the form of a definition. That definition plays a role in the derivation of eighty seven separate audit practices concerned with the collection of evidence, evaluation of internal control, evaluation of accounting systems, analytical review of financial statements and audit reporting. These practices are derived from the general requirement for the auditor to form an opinion on the truth and fairness of financial statements, together with the definition of truth and fairness provided by Statement 4.5.

Since Statement 4.5 constitutes a premise in the derivation of eighty seven practices, anything which suggests that Statement 4.5 is unacceptable will cast doubt on whether those eighty seven practices are appropriate to the attainment of identified audit objectives or are justified by the argument on which they depend. As suggested earlier, acceptability of definitions depends on concensus rather than empirical evidence. Since concensus can be changed by emotive, as well as rational argument, all definitions must be considered tentative at best and liable to be withdrawn at any time.

The extent to which the theory in Appendix B relies on definition is analysed in Table 11.
As shown in Table 11, eleven percent of the theoretical statements in the formal system are definitions. Section 4 contains the highest proportion of definitions, dealing with matters such as truth and fairness (statements 4.5 and 4.8), acceptable accounting policies (statements 4.7 and 4.12) and reasonable basis for the auditor's opinion (statement 4.20). These definitions play an important role in the derivation of later practices.

The extent to which practices depend on definition is shown by columns D, E and F. A total of 77% of all of the practices in the theory are conclusions of arguments which contain at least one definition as a premise. There can be little doubt that much of the theory as presented in Appendix B depends on definition.

The construction of section 7 provides an illustration of the role of definition in Appendix B. Statement 7.4 provides that the

<table>
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<tr>
<th>Sect.</th>
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<th>C</th>
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</table>

Table 11: The role of definition in Appendix B
A: Total theoretical statements (including definitions)
B: Definitions
C: B as a percentage of A
D: Total statements of practice
E: Practices derived from definitions
F: E as a percentage of D
auditor should adequately plan the audit, on the grounds that if the audit is not adequately planned, it will not be possible to provide an effective, economic and efficient service within an appropriate time scale (Statement 7.3). A definition of an "adequately planned audit" is provided (Statement 7.2) such that the provision of an adequately planned audit requires that:
a) intended means of achieving objectives are established
b) direction and control of audit work is assisted
c) means are adopted which help to ensure that attention is devoted to critical aspects of the audit, and
d) means are adopted which help to ensure that the work is completed expeditiously.

Thus, all practices related to audit planning are derived from the requirement to conduct an adequately planned audit, together with the definition of such an audit. That definition acts as a premise in the derivation of each of the practices which have been stated in Section 7. If, for any reason, the definition of an "adequately planned audit" were to change, practices required in order to provide an adequately planned audit would also change.

Although the above discussion has referred to the theory presented in Appendix B, similar comments can be made concerning the Standards and Guidelines. Table 12 analyses the reliance upon definition in the Standards and Guidelines by extracting from Table 11 those statements which do not appear in the Standards and Guidelines.
Table 12: The role of definition in the Standards and Guidelines

<table>
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<tr>
<th>Sect.</th>
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</table>

Whereas 11% of the theoretical statements in Appendix B are definitions (see Table 11), the proportion in the Standards and Guidelines is 14%. This suggests that the theoretical statements which have been introduced into the theory are primarily of classes other than definitions.

A comparison of Tables 11 and 12 reveals that the theory in Appendix B relies more heavily on definition than do the Standards and Guidelines. This is due primarily to the fact that the Standards and Guidelines fail to define important concepts, particularly in the early sections of the theory. Thus, it is necessary to introduce definitions at an early stage of the argument in order to derive later practices.
Of the nine definitions contained in the first four sections of the theory in Appendix B, only three are to be found in the Standards and Guidelines. Introduced definitions relate to the concepts of audit (statement 1.11), truth and fairness (statement 4.5), acceptable accounting policies (statements 4.7 and 4.12) and reasonable basis for the auditors' opinion (statement 4.20). As discussed above, each of these concepts (apart from that of the "audit") plays an important role in the derivation of later practices and, although not specifically identified within the Standards and Guidelines, have been introduced in order to enable the derivation of practices which are to be found therein. If Table 12 is amended to show practices in the Standards and Guidelines which are derived from definitions in the theory (including introduced definitions), it becomes as shown in Table 13.

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| 5       | 18| 17| 94
| 6       | 2 | - | - |
| 7       | 16| 16| 100
| 8       | 10| 9 | 90
| 9       | 7 | 6 | 86
| 10      | 26| 26| 100
| 11      | 10| 9 | 90
| 12      | 10| 10| 100
| 13      | 40| 22| 55
| Total   | 150| 117| 78

Table 13: The derivation of practices in the Standards and Guidelines
A: Practices in the Standards and Guidelines
B: Practices in the Standards and Guidelines derived from definition
   (including introduced definition)
C: B as a percentage of A

When all definitions are considered, 78% of the statements of
practice in the Standards and Guidelines contain a definition in the chain of argument from which they are derived. There can be little doubt that both the theory in Appendix B and the Standards and Guidelines rely heavily upon definition to provide at least part of the justification for a wide range of company audit practices.

Summary

An examination of the role and nature of definition in the Standards and Guidelines and in the theory identified on the basis of that document reveals that two major criticisms are justified. Firstly, there are insufficient definitions within the operational system to ensure that the risk of misinterpretation of recommended practices is minimised. Thus, a very wide range of practices depend fundamentally on the judgement of the company auditor. Although it is not suggested here that scope for such judgement should be eliminated, it is argued that the greater the guidance given to the auditor in the exercise of his judgement, the more likely will audit practices be to satisfy the requirements of consistency and appropriateness. Definition of terms used in specified company audit practices will provide the auditor with such guidance.

A second criticism of the Standards and Guidelines, and of the theory contained in Appendix B, is that the formal system in which practices are derived relies too heavily on definition. The majority of derived practices are justified by arguments which contain one or more definitions. It has been argued that definitions cannot be supported or refuted by empirical evidence and that, accordingly, they are assumptions to be included in a theory
of company auditing only on the grounds of general acceptance. Since definitions, particularly of technical terms, are subject to amendment at any time, a theoretical framework which depends on definition will be subject to change at any time. Similarly, practices derived within that theoretical framework will be subject to change solely as a result of changes to definitions. Under these circumstances, a theory cannot be said to provide a secure framework for the derivation of audit practices. Since the evidence suggests that the Standards and Guidelines rely heavily on definition (either explicit or implicit) in the specification of practices, that document provides only an insecure framework within which company audit practices are derived.
Section 5. Derivation of practices

This section examines some specific attributes of practices which have been derived within the theory and which are specified in the Standards and Guidelines. In particular, it is concerned with ambiguities, inconsistencies and other factors which make it difficult to interpret the requirements of the Standards and Guidelines under certain circumstances. If company auditors find it difficult to interpret required practices, it is possible that actions undertaken are not those contemplated by the profession when drawing up the Standards and Guidelines. As such, company audit practices might not be appropriate to the attainment of recognised objectives.

In general, three factors could cause the implementation of inappropriate company audit practices. Firstly, if there are cases in which practices, although justified, are not specified, the body of stated practices will fail to provide auditors with adequate guidance. For example, within the context of a particular theory, a number of practices will be justified which could be specified as required practices. If, however, one or more of those justified practices are not specified, the body of required practices will be incomplete, and will provide inadequate guidance to the auditor concerning the methods available for the achievement of audit objectives.

Implementation of inappropriate practices could also occur where rules are expressed in non-specific terms, such that a range of different practices comply with the stated requirement. An extreme
example would be a requirement to the effect that company auditors should undertake actions appropriate to the formation of an opinion. If the nature of "appropriate actions" is not further specified, the theory would justify any action felt by auditors to be "appropriate". Such actions would not necessarily be consistent with the attainment of specified audit objectives. The subjective nature of the phrase "appropriate actions" results in the possibility of inconsistent interpretations of rules which require such actions.

A final cause of possibly inappropriate audit practices arises if there are situations in which derived practices are in conflict, and no additional statement is provided by which this conflict might be resolved. For example, a theory could require an auditor to adhere both to statutory provisions and to the terms of the engagement. If the terms of engagement contradict statutory provisions, and if there is no additional rule specifying whether statutory provisions or the terms of engagement take precedence, the theory will provide no guidance to audit action. Under such circumstances, whatever action is undertaken will be in conflict with required practices. It could well be that the choice of rule to be followed is based on criteria other than the attainment of audit objectives.

Unspecified Practices

The general issue of the failure of the theory in Appendix B and of the Standards and Guidelines to specify all justified practices has been addressed earlier in this chapter. The present discussion is concerned with the possibility that such a failure to specify
justified practices will not provide the auditor with guidance in all situations contemplated by other statements in the theory and could, as a result, fail to prevent inappropriate actions.

An example of a situation in which all justified practices are not specified in the theory in Appendix B concerns the relevance of audit evidence. Statement 5.7 asserts that "evidence which has no relation to the attainment of any audit objective is not relevant", implying that relevance of evidence is to be judged in terms of whether it relates to the attainment of any audit objective. This implication is supported by statements which relate the relevance of audit evidence to the objectives of forming an opinion (statement 4.20) and of ensuring that it is possible to conduct a successful defence if a legal action is brought against the auditor (statement 9.1).

Statement 4.23 requires the auditor to judge the relevance of audit evidence. Together with statement 5.27, this implies that the auditor should consider whether evidence is relevant to the attainment of any audit objective. However, practices derived within the theory only require the auditor to consider whether evidence has any relation to the objective of forming an opinion on the truth and fairness of the financial statements (Statement 5.8). Thus, the auditor is not required to consider whether evidence might be relevant to the attainment of other audit objectives, despite that requirement being completely justified by statements 5.7 and 4.23.

These observations have important implications for practices derived
later in the theory. If the auditor fails to consider whether evidence is relevant to the attainment of objectives other than the formation of an opinion, he could fail to comply with other requirements. For example, if he fails to consider whether evidence is relevant to the likelihood of being able to conduct a successful defence if his judgement is questioned, the auditor could fail to maintain an adequate record of his work.

In fact, both the Auditing Guideline on Audit Evidence and Section 5 of Appendix B specify practices relating only to evidence which will be used as the basis of the audit opinion. As a consequence, no guidance at all is given to the auditor with respect to the collection of evidence relevant to the attainment of other audit objectives. For example, Statement 5.10 lists a number of classes of evidence which are relevant to the formation of an opinion as to truth and fairness. There is no corresponding statement by which relevance to other audit objectives can be judged, despite the fundamental normative statement that company auditors should adopt those procedures necessary to attain all audit objectives.

Non-specific phraseology

A second factor which could result in the implementation of inappropriate practices is the use of non-specific phraseology. As has been emphasised, the role of a theory of company auditing is to derive increasingly specific company audit practices. The degree of specificity of derived practices will depend upon judgements made by those responsible for the development of the theory concerning the extent to which procedural arguments will be developed. In general,
the greater the development of procedural arguments, the more specific will be derived practices. The more specific the derived practices, the more specific will be the guidance given to auditors and the less likely will be difficulties in interpreting derived practices.

For example, Chapter 2 contained a brief example of the derivation of company audit practices which illustrated the way in which derived practices become increasingly specific as the argument develops. The procedural argument in that example began with a requirement for the auditor to seek to minimise audit work and concluded with the rule that the auditor should record the company's system of internal control. Had a decision been taken not to develop the procedural argument, the requirement for the auditor to seek to minimise audit work could well have been the most specific requirement. The difficulty with such a requirement is that it provides only very general guidance to auditors by requiring only that auditors have an intention. Under these circumstances, specific actions to be carried out will be matters for auditor judgement. In the absence of guidance for that judgement, it is possible that procedures implemented do not result in the attainment of the objective from which the requirement was derived. In the context of the example in Chapter 2, audit procedures judged to be necessary in order to minimise audit work might not in fact result in the provision of an efficient service.

A number of rules which do not require specific audit action can be identified in the Standards and Guidelines and in Appendix B. These rules require that
the auditor should consider...
the auditor should take into account...
the auditor should judge...
the auditor should reconsider...
the auditor should not use... without regard to...
To the extent that rules containing such phrases are the conclusions of chains of argument, the theory is open to the criticism that guidance to auditors is insufficient to maximise the likelihood that identified objectives will be achieved.

For example, paragraph 3 of the Guideline on audit evidence requires the auditor to "take into account" cost and time factors in determining sources and amount of evidence necessary to provide a reasonable basis for the audit opinion. Within Appendix B, this is justified on the grounds that in order to provide an economic service within an appropriate time-scale it is necessary to take cost and time factors into account (Statement 5.39).

However, it could be argued that it is necessary to do more than "take cost and time factors into account" in order to provide an economic service within an appropriate time-scale. For example, it could be suggested that it is necessary to determine and quantify those factors. A requirement to "determine and quantify factors" is more specific than one to "take factors into account" and could well lead to more specific practices to be undertaken in order to enable appropriate factors to be determined and quantified. These more specific practices would have the advantage both of reducing the likelihood of an uneconomic or untimely audit service and of enabling the beneficiaries of the company audit process to ensure
that specific audit actions are directed toward the attainment of company audit objectives.

The extent to which non-specific practices appear as conclusions in chains of argument in Appendix B is detailed in Table 14.

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Table 14: Nature of concluding statements of practice
A: Concluding statements of practice
B: Non-specific concluding statements of practice
C: B as a percentage of A
D: Concluding statements of practice in the Standards and Guidelines
E: Non-specific concluding statements of practice in the Standards and Guidelines
F: E as a percentage of D

There are one hundred and six statements of practice (rules and permissions) which are the conclusions of the arguments presented in Appendix B. None of these statements lead to the derivation of other practices and they are, in general, the most specific statements of practice to be found in the theory. Of these, forty-four or 41% are expressed in terms which do not require specific audit action.

A similar picture emerges with respect to the Standards and Guidelines. In that document, thirty-three (i.e. 39%) of the most
specific practices (i.e. practices from which no subsequent practices have been derived in Appendix B) are expressed in terms which do not require specific audit action. There can be no doubt that the Standards and Guidelines do not develop the procedural arguments implicit therein to any great extent. As a result, they provide only a very general framework of audit action within which the company auditor is free to exercise his judgement.

Inconsistent practices

The final, and most serious, criticism of company audit practices derived within the theory concerns the extent to which those practices are inconsistent. If any inconsistencies can be identified, there will be good grounds for arguing that some audit practices might be inappropriate to the attainment of audit objectives, despite being apparently justified by the theoretical structure within which they are derived. An examination of the theory presented in Appendix B suggests that there are at least five areas in which inconsistencies occur. They are; audit reports on funds statements, evaluation of internal controls, responsibility for fraud detection, requirements for confidentiality and compliance with standards.

Funds statements

The first example of an inconsistency, which is in fact recognised within the Standards and Guidelines, concerns the absence of a funds statement. Paragraph 6 of the auditor’s reporting standard (and statement 13.14 in Appendix B) require that the auditor should satisfy himself that all relevant Statements of Standard Accounting
Practice (SSAP's) have been complied with before giving an unqualified opinion, unless those SSAP's are inappropriate. However, paragraph 18 of the auditing standard on Qualifications in Audit Reports, and statement 13.75 in Appendix B, provide that "omission of a funds statement does not justify, on this ground alone, a qualified report on the profit and loss account and the balance sheet", despite the fact that failure to provide a funds statement is contrary to SSAP10.

Although this conflict is resolved within Appendix B and the Standards and Guidelines by providing a specific form of report to be used where SSAP10 is not followed, the inconsistency remains. Specifically, the theory in Appendix B provides that;

a) the auditor's opinion is expressed on the financial statements (Statement 1.4)
b) "financial statements" consist of all statements within the scope of the audit opinion (statement 14.2)
c) the audit opinion refers to the funds statement (statement 14.49)
d) an unqualified opinion can only be given where relevant SSAP's, if appropriate, have been followed (statement 13.14)
e) SSAP10 requires funds statements to be presented (statement 13.74)

If the above statements are all true, the audit opinion must refer to the funds statement and the absence of a funds statement must result in a qualified audit report. To assert that the omission of a funds statement does not justify a qualified audit report (statement 13.75) is clearly inconsistent with earlier statements.
Although the assertion that a qualified audit report is not justified refers only to the profit and loss account and balance sheet, earlier statements within the theory clearly require the audit opinion to refer to the funds statement. If it is acceptable to claim that the omission of a funds statement does not justify a qualified report on the balance sheet and the profit and loss account, it should be equally acceptable (given the content of the theory) to claim that the omission of a balance sheet does not justify a qualified report on the profit and loss account and the funds statement. It is unlikely that this is contemplated by those who drafted the Standards and Guidelines.

Inconsistencies caused by the funds statement provisions have at least been recognised within the Standards and Guidelines, and guidance given for the resolution of the conflict in practices caused by those inconsistencies. Other inconsistencies occur however, in respect of which little or no guidance is given for the resolution of conflicts between company audit practices. The first of these concerns internal control.

Internal controls
The Standards and Guidelines give the auditor permission to evaluate the internal control system, depending on whether he wishes to rely on that system (statements 5.18, 10.12). The Standards and Guidelines also provide that the accounting system should be evaluated; no choice is given to the auditor (statement 5.23). An inconsistency arises as a result of the relationship between internal controls and the accounting system.
When deriving the propositional function that the evaluation of internal controls and the accounting system will normally be carried out concurrently (statement 11.30), reference is made to the assertion that there is frequently a need for internal control systems in accounting systems (statement 10.88) as well as to the definitions of "internal control" (statement 5.12) and "accounting system" (statement 5.19). These definitions, and statement 10.88, clearly suggest that internal control is a part of the accounting system. This conclusion is further supported by the requirements regarding the nature of evidence which is to be collected in order to evaluate both internal control and the accounting system. For example, statement 10.3 provides that adequate internal control is evidence of the adequacy of the accounting system.

If internal control is part of the accounting system, the requirement to evaluate the accounting system would imply that the internal control system (at least as far as it affects the accounting system) should be similarly evaluated; there are no provisions for evaluating some parts of the accounting system and ignoring others. The company auditor is in a dilemma; since it is necessary to rely on the accounting system it is necessary to evaluate that system. Since the internal control system is part of the accounting system, it is necessary to evaluate internal control. Yet the Standards and Guidelines and the theory do not require the evaluation of internal control.

This inconsistency might be unimportant in practical terms, but it does suggest some logical difficulties in the theory. These difficulties could be overcome by redefining "internal control",
"accounting system", or both. Alternatively, the rule regarding evaluation of internal control could be made a necessary requirement with regard to controls within the accounting system. Whatever the case, some changes are necessary to resolve the inconsistency.

Another difficulty is also apparent with respect to internal controls. Auditors are required to decide the extent to which they intend to rely on internal controls (statement 10.55) and to keep that decision under review (statement 10.56). They are therefore entitled to place more or less reliance on internal controls as circumstances dictate (statement 10.57). These provisions imply that reliance on internal controls is not an "either-or" decision. That is, internal control is not seen to be only reliable or unreliable, but to possess degrees of reliability varying from totally reliable to totally unreliable.

However, provisions regarding the evaluation of internal control state that internal control is unreliable if compliance tests reveal exceptions which are representative of many departures from internal controls and/or which suggest errors in the accounting records (statement 10.38). Alternatively, internal controls are reliable if tests indicate only isolated departures (statement 10.40). These provisions suggest that internal control is either reliable or unreliable; there is no "partly reliable". Accordingly, there is no clear indication of the degree to which the presence of partly reliable controls (which is possible according to statements 10.55, 10.56 and 10.57) is likely to lead to financial statements which are true and fair (statement 5.13).
Fraud detection

Further difficulties are also apparent with regard to the role of the company auditor in the detection of fraud. The Standards and Guidelines contain two explicit provisions concerning the auditor's duty to detect fraud. Paragraph 9 of the Explanatory Foreword provides that "the auditor's duties do not require him specifically to search for fraud", and the next paragraph provides that "the auditor should ...plan his audit so that he has a reasonable expectation of detecting material misstatements... resulting from... fraud". These two provisions are reflected in Appendix B as statements 1.21 and 7.45.

An inconsistency arises as a consequence of statement 5.11 in Appendix B, which provides, in effect, that the auditor should obtain evidence to enable him to determine whether the financial statements have been affected by fraud. This is supported by Paragraph 5 of the Guideline on Audit Evidence in the Standards and Guidelines. That paragraph, taken together with others (eg. statements 4.4 and 7.43) imply that the auditor should undertake a specific search for all factors which materially affect the truth and fairness of financial statements. If fraud is such a factor (as is asserted in statement 7.42), then the auditor should search specifically for fraud. This is clearly inconsistent with the statement that the auditor need not search specifically for fraud.

A related problem might be said to arise as a result of the terms in which the auditor's duty with respect to fraud is expressed. The Auditor's Operational Standard requires the auditor to obtain evidence sufficient "to draw reasonable conclusions therefrom"
(statement 4.21) and goes on to specify a wide range of procedures which are to be implemented in a specific search for such evidence. Paragraph 10 of the Explanatory Foreword (statement 7.45) requires a similar test of "reasonableness" to the expectation of detecting fraud.

This suggests that the auditor is to have a "reasonable expectation" of detecting any factor which could result in financial statements which are not true and fair. To require an explicit search for some of those factors and not for others (i.e. fraud) is inconsistent with the imposition of a single standard for the likelihood of detection of those factors.

Confidentiality

A further possibility of inconsistent audit practices arises from the confidentiality provisions introduced in Section 6 of Appendix B, where statement 6.4 provides that details of an audit are confidential. Although "confidentiality" is not defined within the Standards and Guidelines, common usage of the word suggests that, if details of an audit are confidential, the client company provides information to the auditor on condition that the auditor discloses that information to no other party without the client's permission. Thus, information given in confidence is to be kept secret between the auditor and his client.

If confidentiality is intended to prevent disclosures to others, company auditors could encounter problems when consulting other auditors in cases where difficult questions of principle or judgement arise (statement 6.3). Although some degree of
confidentiality could be retained by not naming the client, the auditor would be in the difficult position of ensuring sufficient information is given for the consultation to be of use, and yet sufficient information is withheld to ensure confidentiality is maintained. In any case, it is not at all clear that the Standards and Guidelines propose that confidentiality be maintained when another practitioner is consulted, or whether it is permissable to take that practitioner into full confidence.

Similar problems arise when information concerning one client is relevant to the audit of another client. For example, client A could be a debtor of client B and in financial difficulties. If it is likely that client A will become insolvent, that information is relevant to the truth and fairness of the financial statements of client B (according to the provisions of statement 5.10). The requirement for confidentiality (statement 6.4) would imply that the auditor should not use his knowledge of client A's situation in the audit of client B, in case he is called upon to explain his reasons for believing that the financial statements are not true and fair.

Yet he would be unable to give an unqualified opinion if that information was not taken into account (according to the provisions of statements 4.5 and 13.13). Since there is nothing within the Standards and Guidelines or the theory in Appendix B to suggest that the auditor can ignore evidence, the auditor could be placed in a difficult situation in respect of which neither the Standards and Guidelines nor the theory offer any guidance.
Compliance with standards

One further point can be raised concerning company audit practices as derived within the theory. The Standards and Guidelines and statement 1.18 require that company auditors comply with "standards". The definition of "standards" in the operational system of the theory (statement 14.4) further supports the requirement to comply with those practices called "standards". Thus, although company auditors are required to comply with standards, there is no specific requirement to comply with other practices derived within the theory or described within the Standards and Guidelines.

Yet the nature of the argument, and the purpose of the theory, is to derive justified company audit practices, and neither the content of the theory nor of the Standards and Guidelines suggests any reason for claiming that the "standards" are better justified than other practices. There is therefore no reason for optional compliance with some derived practices and compulsory compliance with others.

Furthermore, practices identified as standards are often derived from earlier statements of practice within the theory which are not themselves standards\(^1\). It has been argued that the theory is structured such that compliance with specific practices is intended to result in the implementation of the earlier practices from which those later practices are derived. Thus, compliance with a standard which depends on earlier non-standard practices implies necessary compliance with those earlier practices. In short, it is nonsense to claim that a "standard" practice is compulsory but that the practices which that standard is intended to implement are optional.
Summary

By expressing the content of the Standards and Guidelines as a formal theoretical system, it has been possible to specify the way in which recommended practices have been derived. An examination of those derivations suggests that the theory contained in Appendix B, and the Standards and Guidelines from which it is derived, have failed to provide the company auditor with sufficient guidance. That is, adherence to recommended practices is not sufficient to ensure that practices adopted are appropriate to the attainment of company audit objectives. This criticism is based on three observations.

Firstly, the theory fails to specify all practices which are justified by statements within the theory. Thus, although situations are contemplated or implied by statements within the theory, derived practices do not necessarily provide the auditor with guidance as to appropriate actions under those circumstances. If the failure to specify justified practices occurs at a high level of generalisation in the theory (i.e. at an early stage of procedural arguments), the theory will fail to provide guidance over a wide range of audit practices.

Secondly, evidence suggests that even some of the concluding practices contained within the theory and the Standards and Guidelines are expressed in non-specific terms. That is, it is possible for the most specific statements of practice to require no specific audit action, requiring only that the auditor "consider", or "take into account" some factor. Even if auditors do take such
factors into account (and, thereby, comply with the requirements of the theoretical framework), there can be no assurance that specific audit actions taken will be appropriate to the attainment of audit objectives.

Finally, there are a number of examples of contradictory audit practices which occur in the theory and in the Standards and Guidelines. Where contradictory requirements appear within the theoretical framework, it will not be possible to ensure that all audit actions are appropriate to the attainment of audit objectives. That is, if contradictory practices are present, an audit action which complies with one requirement will violate a contradictory requirement.
Section 6: Conclusions

A range of important criticisms can be levied against the Standards and Guidelines if that document is considered to be the basis upon which a theoretical framework of U.K. company audit practices is to be built. The purpose of this chapter has been to present some of those criticisms in order to demonstrate the nature of the research effort which should be undertaken to improve the logical qualities of the identified theoretical framework of U.K. company auditing practices.

The chapter has considered five different areas of criticism. The first substantial criticism was that the Standards and Guidelines offer no justification of, or explanation for the existence of the company audit function. This is a most important criticism in terms of the success of the theory in explaining and justifying company audit practices. In the absence of an explanation of the purpose of the company audit, any arguments deriving company audit practices could be rejected as unfounded. That is, unless the fundamental normative statement upon which the theoretical framework is built has been drawn from outside the field of company auditing, that framework will be based on an assumption that the company audit serves a useful purpose. If this assumption is rejected, for whatever reason, the entire theoretical framework will collapse. In terms of the concepts which have been adopted in this thesis, the "theory" in Appendix B, and the Standards and Guidelines, are without a hard core.

The second area of criticism concerned the nature of the objectives
specified in Appendix B. In the first place, it was argued that the Standards and Guidelines contain insufficient specific recognition of company audit objectives. As a result, the practices specified in that document were not obviously derived within the context of achieving audit objectives. Secondly, it was argued that no justification was given in the Standards and Guidelines for those objectives which could be identified. This criticism is related to the first general area of criticism concerning the lack of justification for the existence of the company audit process. Thirdly, it was argued that, with minor changes, the Standards and Guidelines could be based on fewer objectives than is apparently the case at the moment. With fewer objectives, the possibility of conflicts between objectives would be reduced. Finally, it was argued that there is little provision within the Standards and Guidelines for resolving those conflicts which do occur between objectives.

The third area of criticism of the Standards and Guidelines was that they are incomplete in three important ways. Firstly, there are insufficient theoretical statements fully to justify the practices recommended therein. Secondly, there are theoretical statements which would justify practices but those practices are not specified. Thirdly, there are statements which are neither practices nor justifications for practices and which are therefore superfluous to a theoretical framework of U.K. company audit practices.

The fourth area of criticism concerned the role of definition in the Standards and Guidelines. Two points were made. Firstly, there are a number of concepts in the Standards and Guidelines which are
undefined. As a result, the operational system of the theory is incomplete and it is difficult to interpret some of the practices recommended within the Standards and Guidelines because they contain undefined terms. The second point made was that the formal system of the theory depends heavily upon definition for the justification of a range of company audit practices. Since definitions cannot be validated by recourse to empirical evidence, they remain in the theory only by consensus. Practices which are based upon those definitions also remain justified only so long as the definitions remain acceptable. In effect, those practices are justified by consensus, which does not provide a secure foundation for the development and improvement of the company audit function.

The final area of criticism was a development of the previous two. That is, for a number of reasons including insufficient development and inadequate definition, a number of practices specified within the Standards and Guidelines will not necessarily be appropriate to the attainment of company audit objectives. Of particular importance is the occurrence of cases in which derived practices are contradictory.

In the light of the observations made in this chapter, a number of possible research projects can be identified. For example, the theory could be restructured so as to minimise the number of company audit objectives. Attempts could be made to reduce the reliance upon definition in the formal system. Attempts could be made to ensure that company audit practices are expressed only in properly defined terms, and are sufficiently specific to maximise the likelihood that implementation of those practices will result in the
attainment of identified objectives.

Of all the possible research projects suggested by the contents of this chapter, perhaps the most important is the provision of a theoretical foundation which does not assume the desirability of the company audit function. Only by justifying the existence of the audit function will it be possible to argue that the specification of a formal theoretical system (such as that in Appendix B) is at all necessary. If the audit function itself remains unjustified, efforts to derive specific practices will be carried out without foundation.

For these reasons, the next two chapters of this thesis represent an attempt at identifying a hard core for the theoretical system presented in Appendix B. As such, they propose certain justifying and enabling arguments by which the basic audit requirements specified in Section 1 of Appendix B can be derived. These justifying and enabling arguments are specified in Chapter 7.

In Chapter 8, specific fundamental propositions of U.K. company auditing are identified on the basis of the arguments presented in Chapter 7. It will be argued that in order to determine whether the identified arguments are acceptable, it is necessary to determine whether the fundamental propositions identified in Chapter 8 are supported by the available evidence. Some of the issues concerning such empirical verification are discussed in Chapter 9.
CHAPTER 7

THE IDENTIFICATION OF JUSTIFYING AND ENABLING ARGUMENTS

In Chapter 2, a theoretical structure was established based on the philosophy of Lakatos. The essential aspect of this structure as applied to company auditing was that it consisted of a "hard core" of arguments establishing the nature and objectives of the company audit function, and a "protective belt" of assumptions on the basis of which specific company audit practices were derived. It was argued that, in respect of a particular theory, the hard core was placed beyond dispute by proponents of the theory and evidence which suggested faults in the hard core was, as far as possible, to be redirected so as to result in changes to the protective belt. So long as the hard core remained intact, the theory survived. When it became no longer possible to support the hard core, the theory was to be rejected and replaced by another.

Chapter 4 examined in some detail the component elements of such a theory of company auditing and suggested that the hard core would consist of arguments which justify the existence of the company audit function ("justifying arguments"), together with arguments demonstrating that achievement of company audit objectives is possible ("enabling arguments"). The remainder of the theory (i.e. the protective belt) would consist of arguments deriving appropriate specific company audit practices ("procedural arguments").

Chapters 5 and 6 were concerned with extant company audit theory, insofar as it can be identified within the Auditing Standards and Guidelines issued by the U.K. profession. It is clear from that
identified theory that there is very little in the way of justifying or enabling arguments which might be identified within the Standards and Guidelines. In terms of the concepts developed within this thesis, it could therefore be suggested that the identified theoretical structure has no hard core and cannot, therefore, be said to constitute a fully developed theory.

This present chapter is concerned with the hard core of U.K. company auditing theory. In the first section, a methodology by which a hard core can be identified on the basis of the Standards and Guidelines is considered. In the second section, some proposals concerning a justifying argument for U.K. company auditing are made. The third section addresses the issue of enabling arguments, and the final section presents a brief evaluation of the proposed hard core, especially insofar as it effects the theoretical structure specified in Appendix B.

In summary, the objectives of this chapter are:
1. to consider the means by which the hard core of U.K. company auditing theory can be identified,
2. to suggest justifying and enabling arguments which could constitute the hard core of U.K. company auditing theory, and
3. to evaluate the suggested hard core, emphasising in particular the effect of its introduction on the theory specified in Appendix B.
Section 1. The Identification of a Hard Core

The discussion of theoretical structure in Chapter 2 established that the "hard core" of a theory had two important attributes. Firstly, the hard core was to be considered by supporters of the theory as inviolate. That is, research carried out by supporters of the theory intended to result in refutation of statements contained in the hard core was to be discouraged, and any apparently refuting evidence presented by opponents of the theory was to be accounted for, if possible, by changes to a protective belt of auxiliary hypotheses. Thus, one way of identifying a hard core would be to determine which statements are considered to be beyond dispute by supporters of the theory.

A second attribute of a hard core, which also suggests a means of determining the extent of the hard core, is related to the way in which changes to a hard core are to be viewed. Since the hard core of a theory is considered by its supporters to be inviolate, any changes to the hard core will constitute the creation of a new theory. Thus, the hard core is that part of a theory which, if changed, would result in supporters of the theory believing that a new theory had been created.

In Chapter 4, it was suggested that the hard core of company audit theory would consist of two classes of argument; justifying and enabling. The grounds for this suggestion were that an attack against either of these arguments would constitute an attack against the existence of company auditing. If justifying arguments were shown to be invalid, the reason for the existence of the company
audit function would be unfounded. If enabling arguments were shown to be invalid, achievement of the primary audit objective by the adoption of recommended practices would be impossible. In both cases, amendments to the arguments would result in the introduction of a new primary audit objective or fundamental changes to the way in which the primary objective was to be achieved. If no new justifying or enabling arguments could be constructed, there would be no grounds for the continued existence of the company audit function.

Although it is clear from the discussion in Chapter 6 that nothing within the Standards and Guidelines could be identified as a hard core in the sense in which that term has been used in Chapter 2, the definition of "auditing standards" presented in the Standards and Guidelines and in Appendix B suggests a possible criterion for identifying the hard core of U.K. company audit theory. Auditing standards are defined as "basic principles and practices" and are to apply "whenever an audit is carried out"\(^1\). Standards are also distinguished from guidelines, which "do not prescribe basic principles and practices"\(^2\). These definitions clearly suggest a heirarchy of concepts similar to that implicit in the concepts of hard core and protective belt. Similarly, the definition of "standards" might reasonably be taken to imply that the U.K. auditing profession intends that standards and the arguments by which they are derived, be placed beyond dispute.

These observations suggest that all arguments leading to the establishment of standards constitute the hard core of U.K. company audit theory, and arguments deriving practices contained within the
guidelines constitute the protective belt. However, two reasons can be given for rejecting this suggestion, the first of which concerns the way in which standards have been derived within the theory presented in Appendix B.

By defining standards as "basic principles and practices", both the Standards and Guidelines and Section 14 of Appendix B imply that such practices would be derived at a high level of generality in the formal theoretical system and would constitute the basis for the derivation of a substantial proportion of later practices. At the very least, the definition implies that standards would be more "basic" than other practices and that, as a result, a "standard" would not be derived from a "non-standard".

There are 28 statements in Appendix B which are identified as standards. The derivation of the standards is summarised in Table 15.

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Table 15: Derivation of standards
A: Number of standards in section
B: Number of separate chains of argument leading to standards
C: Number of separate chains of argument which include non-standard practices.
D: Number of separate chains of argument which do not include non-standard practices.
Table 15 reveals that there are a total of forty-two distinct chains of argument which lead to the twenty-eight standard practices. Of the forty-two chains of argument, thirty-eight include non-standard practices in the derivation of standard practices. If a practice is to be considered "basic", then practices derived earlier in the theory which form part of the justification of the "basic" practice must be considered to be even more "basic". It appears from the theory presented in Appendix B that there are a number of practices which ought to be considered as "standards" despite not being identified as such in the Standards and Guidelines, since those practices constitute the basis for the derivation of later practices identified as "standards".

It should also be pointed out that Table 15 summarises the chains of argument between basic requirements and identified standards. Accordingly, it does not include the basic requirements themselves. If basic requirements are included as statements in the derivation of standards, not one standard can be derived without reliance on non-standard practices, since none of the basic requirements are identified as "standards" in the Standards and Guidelines.

For example, twenty-five of the twenty-eight identified standards are derived by arguments which include as a premise the basic requirement for an effective, economic and efficient service within an appropriate time scale. Yet the rule that the auditor should provide such a service is not a "standard". Under circumstances where standards depend on practices contained only within the
Guidelines, a claim that the standards are more fundamental than practices within the Guidelines is unjustified, at least in the context of the theory as it has been formulated in Appendix B.

A second reason for rejecting the claim that standards constitute the hard core is that there are few grounds for suggesting that a change to a standard or to the argument deriving a standard would constitute either the introduction of a new theory or a suggestion that the continued existence of the company audit function is unjustified. It would be possible to argue against a particular standard without implying that company auditing is unjustified or that achievement of the primary audit objective is not possible. As has been illustrated in Appendix B, standards are part of a wide range of company audit practices which are derived in order to achieve company audit objectives. A change to the standards would constitute the introduction of new methods of achieving objectives, but would be unlikely to constitute a threat to the existence of company auditing.

On the basis of the foregoing arguments, the hard core of U.K. company audit theory cannot be taken to extend to the establishment of those practices described as standards in the Standards and Guidelines. Since there have been no empirical studies to determine the extent of the hard core by an examination of auditors' beliefs, the criteria suggested in Chapter 4 will be adopted in order to delineate the hard core of U.K. company audit theory. That is, the hard core will be taken to consist of the derivation of company audit objectives and the demonstration that achievement of those objectives is possible.
As was argued in the previous chapter, the evidence suggests that the theory identified on the basis of the Standards and Guidelines contains no "hard core" (as defined) in that it provides no arguments which derive company audit objectives or which demonstrate that the achievement of those objectives is possible. It is the purpose of the remainder of this chapter to suggest arguments which constitute a hard core for the theory in Appendix B and, thereby, which enable the identification of the fundamental propositions of U.K. company auditing.
Section 2. Justifying arguments in the hard core

The theory presented in Appendix B contains no justifying arguments which would explain why company auditors have (or ought to have) the stated primary objective. However, a number of statements within the theory do suggest that company auditing exists in order to provide shareholders\(^3\) with some indication as to the quality of the information contained in company annual financial statements. Perhaps the clearest indication of this is contained in Section 4 of Appendix B, which is concerned with truth and fairness.

In this section, a number of aspects of truth and fairness are identified. Statement 4.5 defines truth and fairness as a quality possessed by financial statements which are "not misleading", "not meaningless", "complete, accurate and valid", in which disclosure is "adequate" and classification and presentation of information is "suitable". Use of such descriptive terms, especially that of "not misleading" implies that financial statements are conceived as being prepared for some purpose.

As has been argued extensively in the early parts of this thesis, there is much to commend the argument that a company's annual financial statements are relied upon when decisions concerning that company are being made, particularly by shareholders. It may therefore be proposed that the auditor's opinion as to truth and fairness amounts to an opinion as to whether annual company financial statements are misleading and, accordingly, as to whether shareholders are justified in relying upon the information contained in those statements when making decisions. This view is further
supported by the contents of Section 13 of Appendix B, which requires that the audit report is to be qualified if the financial statements are not "true and fair" (statement 13.33). In other words, the evidence suggests that company audit reports are conceived within the Standards and Guidelines as reports which indicate to shareholders the reliability of annual company financial statements, even though this is not explicitly stated in the Standards and Guidelines.

Section 3 of Appendix B provides further evidence that company auditors are concerned with the extent to which financial information will be relied upon by shareholders when making decisions. It is apparent from the content of this section that company auditors are concerned only with matters which would be likely to influence shareholders when relying upon the financial statements (statements 3.5 and 3.6). The content of Section 3 implies, firstly, that auditors are aware that company annual financial statements will be relied upon by shareholders and, secondly, that the audit examination is to be conducted with the information needs of shareholders in mind.

Although it is impossible to determine from the content of the Standards and Guidelines whether it is assumed that annual company financial statements will be relied upon by shareholders for any specific class of decision (e.g. for investment decisions or decisions concerning possible action against the directors), it is certainly implied that an unqualified audit report provides shareholders with an explicit indication that the financial statements to which it refers are reliable. This is true regardless
of the type of decision to be made by the shareholder.

These considerations enable a "primary audit requirement" (i.e. a rule which specifies a primary objective) to be established by presenting a justifying argument which is at least consistent with the contents of both Appendix B and the Standards and Guidelines. This argument is as follows:

1. Company directors are responsible for the preparation of annual company financial statements and the presentation of the information included therein to shareholders.
   [propositional function - see also Appendix B statement 10.85]

2. It is possible for company directors to prepare annual company financial statements which are misleading, meaningless, incomplete, inaccurate, invalid, in which disclosure is inadequate or in which classification and presentation of information is unsuitable.
   [propositional function]

3. Shareholders rely upon annual company financial statements in their decision processes.
   [propositional function]

4. It is possible for shareholders to rely upon annual company financial statements which are misleading, meaningless, incomplete, inaccurate, invalid, in which disclosure is inadequate or in which classification and presentation of information is unsuitable.
   [propositional function, derived from 1,2,3]

5. Annual company financial statements which are misleading, meaningless, incomplete, inaccurate, invalid, in which disclosure is
inadequate or in which classification and presentation of information is unsuitable are "unreliable".
[definition]

6. It is possible for shareholders to rely upon annual company financial statements which are unreliable.
[propositional function, derived from 4,5]

7. If shareholders rely upon annual company financial statements which are unreliable, decisions made on the basis of those statements will be unlikely to result in the desired outcome.
[propositional function]

8. There should be a means of minimising the risk of undesired outcomes of shareholder decisions.
[rule - fundamental normative statement]

9. There should be a means of ensuring that shareholders do not rely upon unreliable annual company financial statements.
[rule, derived from 6,7,8]

10. Shareholders will not rely upon annual company financial statements if
(a) they have been provided with an explicit indication that those financial statements are unreliable before they rely upon those financial statements, and
(b) they believe that explicit indication to be reliable.
[propositional function]

11. There should be a means of
(a) providing shareholders with an explicit indication as to whether
annual company financial statements are reliable before they rely upon those financial statements, and
(b) ensuring that shareholders believe that explicit indication to be reliable.
[rule, derived from 9,10]

12. A "company audit" is an activity which results in providing shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those financial statements.
[definition]

13. A "company auditor" is an individual who carries out a company audit.
[definition]

14. The company auditor should
(a) provide shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those financial statements, and
(b) ensure that shareholders believe that explicit indication to be reliable.
[rule, derived from 11,12,13]

15. The primary objective of the company auditor is to provide shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those financial statements and to ensure that shareholders believe that explicit indication to be reliable.
[propositional function, derived from 14]
As has been emphasised throughout this thesis, the purpose of a theory of company auditing is to enable the specification of company audit practices. The first company audit practice specified in the above argument is statement 14, requiring auditors to provide shareholders with an explicit indication of the reliability of annual company financial statements before those statements are relied upon, and to ensure that shareholders believe the explicit indication itself to be reliable. This statement of practice will be called the "primary audit requirement", and will constitute the basis of all later requirements. This primary audit requirement also enables the primary audit objective (Statement 15) to be stated.

The argument which derives this primary audit requirement has a number of attributes in common with the accountability and investment decision arguments presented in Chapter 4. In all three arguments, company financial statements are asserted to be relied upon by shareholders when making decisions. In the case of the accountability and investment decision arguments, the general class of decision was specified. In the argument given above, hereafter referred to as the "shareholder decision argument", the class of decision is not specified. Accordingly, the accountability and investment decision arguments can be considered to be sub-classes of the shareholder decision argument.

As with the accountability and investment decision arguments, the justification for audit in the shareholder decision argument is based on a single fundamental normative statement. In this case,
statement 8 provides that "there should be a means of minimising the risk of undesired outcomes of shareholder decisions". This rule is very similar to the fundamental normative statement in the investment decision argument, which differs only in that it refers to investment decisions.

An important implication of adopting the shareholder decision argument as the basis of a hard core for U.K. company audit theory is the effect of the definition of an "audit". In Appendix B, an audit is defined as an "independent examination of and expression of opinion on the financial statements of a company by an auditor in pursuance of that appointment and in compliance with any relevant statutory obligation" (Statement 1.12). This definition was specified by listing a number of previously stated audit objectives.

In the shareholder decision argument, an audit is defined much more generally as "an activity which results in providing shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those financial statements". The purpose of this definition is purely to allow the rule established in statement 14 to be applied to "auditors". As such, the definition only exchanges the word "audit" for the more complex phrase of "an activity which results in providing shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those financial statements". If an audit is to be understood in terms of the activities it involves (as suggested by the Appendix B definition), it is necessary to examine the requirements established as the argument develops further.
In the context of both the shareholder decision argument and the Appendix B theory, the argument will be developed further by deriving secondary audit requirements and, at the same time, specifying secondary audit objectives. Once derived, those requirements could be stated in the form of a definition of an audit which would more closely resemble that presented in the Standards and Guidelines. Secondary audit requirements will be derived within arguments which demonstrate that the primary audit objective will be attained by compliance with those secondary audit requirements. As such, those arguments will constitute "enabling arguments".
Section 3. The identification of Enabling Arguments

Seven "basic audit requirements" are specified in the theory based on the Standards and Guidelines and presented in Appendix B. They are;

a) to conduct an independent examination of the financial statements (statement 1.3)
b) to report on the financial statements (statement 1.4)
c) to comply with statutory regulations governing the audit (statement 1.6)
d) to comply with the terms of the audit engagement unless to do so would contravene statutory regulations (statement 1.8)
e) to provide an effective, economic and efficient service within an appropriate time-scale (statement 1.10)
f) to adopt procedures which will ensure that it is possible to conduct a successful defence if a legal action is brought against the auditor in which his judgement is questioned (statement 1.14)
g) not to search specifically for fraud unless required by statute or the specific terms of the audit engagement (statement 1.22)

Although these have been referred to as "basic requirements" in earlier chapters, the introduction of a precedent hard core, which contains a "primary audit requirement" will necessitate a change of terminology to "secondary audit requirements". As with the relationship between the primary objective and the primary requirement, secondary objectives will be expressed by secondary requirements. In order to establish the link between the identified hard core and the content of Appendix B (and the Standards and Guidelines), the secondary audit requirements identified in the hard
core must be those specified above.

Since all company audit practices are derived from one or more of these secondary requirements, and since the purpose of those practices is, according to the shareholder decision argument, either to provide shareholders with an explicit indication of the reliability of annual company financial statements, or to ensure that shareholders believe that explicit indication to be reliable, it must be possible to demonstrate the link between the primary audit requirement and those secondary requirements listed above. By establishing that link, the feasibility of achieving the primary audit objective will be demonstrated and the enabling arguments which would form part of the suggested theory will be identified.

The requirements to conduct an independent examination and to report

Although the requirement to form an opinion and to report on the "truth and fairness" of financial statements is presented in Appendix B as the primary audit objective, the introduction of the shareholder decision argument will reduce its status to that of a secondary objective. That is, reporting to shareholders on the truth and fairness of the financial statements will be the means of providing shareholders with an explicit indication of the reliability of those financial statements. An enabling argument to demonstrate this relationship is as follows;

16. Annual company financial statements which are misleading, incomplete, inaccurate, invalid, in which disclosure is inadequate or in which classification and presentation of information is unsuitable are not "true and fair".

[definition - see also Appendix B statement 4.5]
17. If shareholders are provided with an explicit indication of the truth and fairness of annual company financial statements, they will be provided with an explicit indication of the reliability of those financial statements.

[propositional function, derived from 5, 16]

18. The company auditor should provide shareholders with an explicit indication of the truth and fairness of annual company financial statements before they rely upon those financial statements.

[rule, derived from 14a, 17]

19. The company auditor should act to ensure that the explicit indication of the truth and fairness of the annual company financial statements is believed by shareholders to be reliable.

[rule, derived from 14b, 17]

20. The formation of an opinion and reporting to shareholders on the truth and fairness of annual company financial statements constitutes an "explicit indication of the truth and fairness" of those financial statements.

[definition]

21. The company auditor should form an opinion and report to shareholders on the truth and fairness of annual company financial statements before they rely upon those financial statements.

[rule, derived from 18, 20 – see also Appendix B statement 4.4]
22. A secondary objective of the company auditor is to form an opinion and report to shareholders on the truth and fairness of annual company financial statements.

[propositional function, derived from 21 - see also Appendix B statement 1.1]

23. In order to form an opinion on the financial statements it is necessary to conduct an independent examination of these financial statements.

[propositional function - see also Appendix B, statement 1.2]

24. The company auditor should conduct an independent examination of annual company financial statements.

[rule, derived from 21, 23 - see also Appendix B, statement 1.3]

25. The company auditor should report to shareholders on the truth and fairness of annual company financial statements before they rely upon those financial statements.

[rule, derived from 21 - see also Appendix B, statement 1.4]

One of the most important aspects of this argument is that it relates "reliability" to "truth and fairness", which is consistent with the shareholder decision argument and the content of the Standards and Guidelines. In so doing, the nature of the audit report as an indicator of the reliability of financial statements is established and the secondary audit requirements to conduct an independent examination and to report on the financial statements are derived.

Derivation of other secondary audit requirements is based on the
aspect of the primary audit requirement which refers to the need for shareholders to believe that the explicit indication of reliability is itself reliable (statement 14b)\(^5\). The shareholder decision argument has established this as part of the primary requirement on the grounds that, if it were not achieved, it is possible that shareholders would place reliance on unreliable financial statements despite being provided with an explicit indication that those financial statements were unreliable (statement 10). Accordingly, a number of audit procedures must be directed towards ensuring that shareholders believe the audit report to be reliable. This is specified in the statement that;

26. The company auditor should act to ensure that the audit report is believed by shareholders to be reliable.

[rule, derived from 19, 20]

At this stage, the introduction of propositional functions which assert that certain audit actions have the effect of ensuring shareholders believe the audit report to be reliable will enable the derivation of further secondary audit requirements.

The requirement to comply with statutory regulations

Statement 27 is the assertion establishing a link between compliance with statutory regulations and successful attainment of the primary audit objective:

27. If the company auditor does not act in compliance with statutory regulations governing the audit, shareholders will not believe the audit report to be reliable.

[propositional function]
28. The company auditor should comply with statutory regulations governing the audit.

[rule, derived from 26, 27 - see also Appendix B statement 1.6]

29. A secondary objective of the company auditor is to comply with statutory regulations governing the audit.

[propositional function, derived from 28 - see also Appendix B statement 1.5]

The requirement to comply with the terms of the engagement

This secondary requirement can be derived by an extension of the above argument, introducing a propositional function similar to statement 27.

30. If the company auditor does not comply with the terms of the engagement, shareholders will not believe the audit report to be reliable, unless such non-compliance occurred as a result of compliance with statutory regulations governing the audit.

[propositional function]

31. The company auditor should comply with the terms of the engagement unless to do so would contravene statutory regulations.

[rule, derived from 26, 30 - see also Appendix B, statement 1.8]

32. A secondary objective of the company auditor is to comply with the terms of the engagement unless to do so would contravene statutory regulations.

[propositional function, derived from 31 - see also Appendix B statement 1.7]
The requirement to ensure that it is possible to conduct a successful legal defence

A similar extension to the argument results in the derivation of this secondary audit requirement.

33. If the company auditor does not adopt procedures which will ensure that it is possible to conduct a successful defence if a legal action is brought against him in which his judgement is questioned, shareholders will not believe the audit report to be reliable.

[propositional function]

34. The company auditor should adopt procedures which will ensure that it is possible to conduct a successful defence if a legal action is brought against him in which his judgement is questioned.

[rule, derived from 26, 33 - see also Appendix B, statement 1.14]

35. A secondary objective of the company auditor is to adopt procedures which will ensure that it is possible to conduct a successful defence if a legal action is brought against him in which his judgement is questioned.

[propositional function, derived from 34 - see also Appendix B statement 1.13]

The requirement to provide an effective, economic and efficient service within an appropriate time-scale

The majority of the practices contained within the Standards and Guidelines have been derived in Appendix B from the requirement to provide an effective, economic and efficient service within an appropriate time-scale. Accordingly, the successful derivation of
that requirement from the primary audit requirement is essential to the provision of a hard core.

Derivation of this secondary requirement is facilitated if it is segregated into its component parts, resulting in four secondary audit requirements;

1. The company auditor should provide an effective service
2. The company auditor should provide an economic service
3. The company auditor should provide an efficient service
4. The company auditor should provide a service within an appropriate time-scale.

The first of these requirements can be established by introducing a definition which provides, in effect, that an audit which does not result in the attainment of the primary objective is not an "effective" audit.

36. If the audit report does not provide shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those financial statements, or if the shareholders do not believe the explicit indication to be reliable, the auditor will not have provided an "effective" service.

[definition]

37. The company auditor should provide an effective service.

[rule, derived from 14, 36 - see also Appendix B, statement 1.10]

In order to derive the requirement for an economic service, it must be possible to assert that an uneconomic service would prevent the attainment of the primary audit objective. That is, it is necessary
to introduce statements which have the effect of claiming that if the auditor failed to provide an economic service, shareholders would not be provided with an explicit indication of the reliability of financial statements before they rely on those statements or that they would not believe the explicit indication itself to be reliable.

Since the content of the Standards and Guidelines provides no indication of the reasons underlying the need for an economic audit service, any attempt to specify an argument requiring the auditor to provide such a service cannot be supported by reference to the professional literature. All that the argument can be based on is the primary audit requirement established in the shareholder decision argument and the secondary audit requirement contained within Appendix B and the Standards and Guidelines. The link between these, once established, might or might not be supported by the evidence. If it is not, either the primary audit requirement must be rejected as unacceptable or incomplete, the secondary requirement for an economic service must be recognised as unjustified or an alternative argument establishing the requirement for an economic service on the basis of the identified primary requirement must be invented.

A possible argument which establishes the link between the primary audit requirement and the need for an economic service is based on an assumption that shareholders would not wish the resources of the company to be exchanged for a service which provides a benefit unjustified by the cost. That is, if the cost of the audit were thought to be excessive, shareholders would act to remove the
auditor. Taken to its logical conclusion, if there were no requirement for an economic service, it could become impossible to appoint an auditor to provide a service in which the benefits outweigh the costs. Under these circumstances, shareholders would not wish to appoint any auditor and could take whatever steps are available to them to remove the requirement for compulsory audit from the companies legislation. If successful, and no auditor were appointed, it would not be possible to attain the primary audit objective.

These hypotheses are expressed in the following argument:

38. It is possible that shareholders will take whatever steps are necessary to remove the requirement for compulsory audit from the legislation if they believe the cost of the company audit to outweigh the benefit of that audit. [propositional function]

39. It is possible that the requirement for compulsory audit will be removed from the legislation if shareholders take whatever steps are necessary to remove that requirement. [propositional function]

40. It is possible that shareholders will choose not to appoint an auditor if the requirement for compulsory audit is removed from the legislation. [propositional function]

41. Shareholders will not be provided with an explicit indication of the truth and fairness of annual company financial statements if
they choose not to appoint an auditor.

[propositional function, derived from 12, 13]

42. It is possible that, if shareholders believe the cost of a company audit to outweigh the benefit of the audit, they will not be provided with an explicit indication of the truth and fairness of annual company financial statements.

[propositional function, derived from 38, 39, 40, 41]

43. If the company auditor minimises the cost/benefit ratio of the company audit, shareholders will be less likely to believe that the cost of the audit outweighs the benefit of the audit.

[propositional function]

44. The company auditor should minimise the cost/benefit ratio of the company audit.

[rule, derived from 18, 42, 43]

45. An audit in which the cost/benefit ratio is minimised is an "economic service".

[definition]

46. The company auditor should provide an economic service.

[rule, derived from 44, 45 - see also Appendix B, statement 1.10]

It must be recognised that the above argument deriving the requirement for an economic service contains a number of propositional functions which could be refuted as a result of empirical research programmes. If the suggested argument is shown, for whatever reason, to be unacceptable, one or more of three actions could be taken by those who would support the claim that the
auditor should provide an economic service;
a) invent a new argument containing different propositional functions to establish a link between the stated primary audit requirement and the secondary requirement to provide an economic service,
b) invent a new justifying argument which results in a different primary audit requirement, or additional primary requirements which are the basis of the requirement for an economic service, or
c) reject the claim that the auditor should provide an economic service.

These actions would only be necessary if the derivation above were shown to be unacceptable. For the time being, at least, an argument deriving the secondary requirement for an economic service from the primary requirement for an explicit indication of reliability of financial statements which is itself reliable has been constructed.

The third aspect of the service to be provided by auditors is that it be efficient. In a technical sense, efficiency refers to the relationship between outputs and inputs. For example, efficiency can be measured in terms of the number of useful products per unit of raw material used, or per hour of labour, or per hour of machine time. In a financial sense, efficiency refers to the relationship between funds invested and gains attained. In its broadest sense "to be efficient simply means to take the shortest path, the cheapest means, toward the attainment of the desired goals." Within the context of the justifying and enabling arguments being constructed in this chapter there are two goals, or outputs, of the company audit process. The first is the provision of an explicit
indication of the reliability of annual company financial statements to shareholders before they rely on those statements, and the second is the creation of a belief on the part of shareholders that the explicit indication is reliable. The smaller the inputs necessary to achieve these outputs, the more efficient is the audit, in the sense that the cheapest means will have been adopted in attaining the desired goals.

Thus, an efficient audit is one in which a reliable audit report is provided at least cost. In the sense that efficiency is the relationship between inputs and outputs, an efficient audit is one in which the benefits of the audit report are maximised and the costs of the resources necessary to provide that report are minimised. Accordingly, an efficient audit is one in which the cost/benefit ratio is minimised.

If this approach to audit efficiency is accepted, those procedures intended to result in the provision of an "economic service" will also lead to an "efficient service". This is introduced into the argument as follows;

47. An audit in which the cost/benefit ratio is minimised is an "efficient service".
[definition]

48. The company auditor should provide an efficient service.
[rule, derived from 44, 47 - see also Appendix B, statement 1.10]

The final aspect of the secondary audit requirement presently under consideration is that the audit service is to be provided within an
appropriate time-scale. It is possible to introduce this requirement by referring directly to the primary audit requirement, one part of which states that an explicit indication of the reliability of financial statements is to be given by the time that shareholders rely upon those financial statements. The requirement for the service to be provided within an appropriate time-scale is introduced by definition as follows;

49. If the audit report is not provided to shareholders before they rely upon annual company financial statements, the company auditor will not have provided a service within an "appropriate time-scale". [definition]

50. The company auditor should provide a service within an appropriate time-scale.
[rule, derived from 25, 49 - see also Appendix B statement 1.10]

At this stage in the development of the argument, it is possible to specify the requirements for an effective, economic and efficient service within an appropriate time-scale as a secondary audit objective (Appendix B, statement 1.9), thereby providing a further link between the suggested "hard core" and the contents of the Standards and Guidelines.

51. A secondary objective of the company auditor is to provide an effective, economic and efficient service within an appropriate time-scale.
[propositional function, derived from 37, 46, 48, 50 - see also Appendix B statement 1.9]
The requirement not to search specifically for fraud

This is the last "basic requirement" specified in section 1 of Appendix B. Accordingly, the derivation of this requirement within the hard core will complete the construction of a theoretical system to link with the content of the Standards and Guidelines.

The requirement not to search specifically for fraud unless required by statute or the specific terms of the audit engagement can be derived from the requirement to minimise the cost/benefit ratio of the audit (statement 45). An argument deriving this secondary requirement is as follows;

52. In order to minimise the cost/benefit ratio of the company audit, it is necessary for the company auditor not to search specifically for fraud, unless required by statute or the specific terms of the audit engagement.

[propositional function]

53. The company auditor should not search specifically for fraud, unless required by statute or the specific terms of the audit engagement.

[rule, derived from 45, 53 – see also Appendix B, statement 1.22]

54. To search specifically for fraud is not an objective of the auditor unless required by statute or the specific terms of the audit engagement.

[propositional function, derived from 53 – see also Appendix B, statement 1.21]
Section 4. An evaluation of the Hard Core

The shareholder decision argument and the associated enabling arguments presented in the preceding sections of this chapter have been constructed in order to provide a "hard core" for the theory which has been identified on the basis of the Standards and Guidelines. As such, the identified hard core will enable the derivation of those practices specified in Appendix B.

The relationship between the hard core and Appendix B has been established by specifying a fundamental normative statement (statement 8 in the shareholder decision argument) and presenting arguments which conclude with the seven "basic audit requirements" identified in Section 1 of Appendix B. Since the theory in Appendix B has been built such that all practices are derived from one or more of those basic requirements, the specified hard core will enable every audit practice to be derived from the fundamental normative statement that there should be a means of minimising the risk of undesired outcomes of shareholder decisions. The precise nature of the arguments and the way in which they link with Appendix B is represented diagrammatically overleaf.
The diagrammatic representation of the arguments reveals the relationship with Appendix B by indicating, where appropriate, that
particular statements appear in both Appendix B and the specified hard core. Such statements are indicated by two code numbers; one is that used earlier in this chapter and the other is that used in Appendix B.

It is apparent from the diagram that the effect of the justifying and enabling arguments is to "promote" some of the statements within Appendix B to a position within the hard core and to replace substantially Section 1 of Appendix B. In fact, the only audit practices appearing in Section 1 which are not in the hard core are those relating to compliance with auditing standards (statement 1.18) and compliance with ethical guides (statement 1.20). Both of these statements have been derived within Appendix B from the requirement for the auditor to ensure that it is possible to conduct a successful defence if his judgement is questioned. Since that same requirement appears in the identified hard core (statement 3), the requirements to comply with auditing standards and ethical guides can also be derived within the developed theory without the need to introduce new theoretical statements.

An important effect of the justifying and enabling arguments on section 1 of Appendix B is to alter the derivation of practices within that section. In section 1, practices were derived on the grounds that company auditors had certain objectives. The development of the hard core has, in effect, reversed the situation. Rather than the practices being derived on the grounds that auditors have certain objectives, those same objectives are now derived on the grounds that auditors ought to adopt certain practices. Thus, the assumption that company auditors ought to act to achieve
objectives is no longer necessary to the argument; a new "fundamental normative statement" has been introduced.

Two important aspects of the specified arguments warrant further discussion. Firstly, the role of definition ought to be considered in the light of the analysis presented in Chapter 6 and secondly, the extent to which the specified arguments constitute a "hard core" warrants closer examination in order to provide a sound basis for an identification of the fundamental propositions of U.K. company auditing.

Definition

Within the specified arguments, there are nine definitions, dealing with the following concepts;
1. unreliable financial statements (statement 5)
2. a company audit (statement 12)
3. a company auditor (statement 13)
4. a true and fair view (statement 16)
5. an explicit indication of truth and fairness (statement 20)
6. an effective service (statement 36)
7. an economic service (statement 45)
8. an efficient service (statement 47)
9. an appropriate time-scale (statement 49).

If the justifying and enabling arguments are to dovetail neatly with Appendix B, the introduction of such definitions is essential. However, this increases the extent to which derivation of practices can be criticised for excessive reliance upon definition.

The introduction of definitions can be defended on the grounds that
they are necessary to the identification of a hard core which will not result in changes to the theoretical framework identified on the basis of the Standards and Guidelines. Although one of the objectives of this thesis is to develop that theoretical framework, it is not an objective to introduce amendments. As a result, no attempt has been made to reduce the extent to which the theory relies upon definition. However, it is illustrative to outline very briefly how this might be achieved.

In general, it would be possible to reduce reliance upon definition by eliminating, where possible, practices derived on the basis of definition. For example, statements 46 and 48, which require the auditor to provide an economic and efficient service depend upon definitions of economy and efficiency as well as the earlier established requirement for the auditor to minimise the cost/benefit ratio of the audit (statement 44). As revealed in Appendix B, a number of later practices are derived from the requirement to provide an economic and efficient service (statement 1.10). If those practices were derived from the requirement to minimise the cost/benefit ratio of the audit, rather than from the requirement to provide an efficient and economic service, definitions of economy and efficiency would be unnecessary and statements 45 and 47 could be eliminated from the theory. A similar strategy could be adopted as regards the requirement for an effective service within an appropriate time-scale.

Since such changes would eliminate the specific requirement for an effective, economic and efficient service within an appropriate time-scale, they would result in a theory rather different to the
content of the Standards and Guidelines. However, if such changes were felt by the profession to be desirable, the Standards and Guidelines could be amended accordingly and reliance upon definition reduced.

Extent of the "hard core"

The discussion thus far has been based on the assumption that, since the conclusions of the justifying and enabling arguments are the "basic requirements" of Appendix B, those justifying and enabling arguments constitute the hard core of the theory. However, structural considerations suggest an alternative basis for the identification of the hard core.

It was suggested in Chapter 4 that the "hard core" consists of arguments deriving both the primary objective of company auditing ("justifying" arguments) and the secondary objectives ("enabling" arguments). In order to specify the limits of the "hard core" it was necessary to have some means of identifying secondary objectives.

If it is accepted that the objectives specified in Appendix B on the basis of the Standards and Guidelines are secondary objectives, then the arguments presented in this chapter do indeed constitute the hard core of U.K. company audit theory. If, however, secondary objectives were to be identified on the basis of structural position in the theory the "hard core" would be rather different to that presented in the chapter.

For example, it could be argued, on structural grounds, that "secondary objectives" would be achieved by complying with those
practices derived one structural level from the primary requirement. That is, secondary audit objectives would depend upon requirements established on the basis of the primary audit requirement and one other propositional function. If this approach were adopted, the secondary objectives of company auditors, on the basis of the shareholder decision argument, would be;

a) to provide shareholders with an explicit indication of the truth and fairness of annual company financial statements before they rely upon those financial statements (statement 18), and

b) to ensure that shareholders believe the explicit indication of truth and fairness to be reliable (statement 19). \(^1\)

Since the Standards and Guidelines do not specifically state the primary and secondary audit objectives, a good case can be made for specifying the hard core on structural grounds. If this approach were adopted, the hard core of U.K. company audit theory could be considered to conclude with requirements to act in accordance with the two secondary requirements specified above.

However, the purpose of the enabling arguments herein is to derive the basic audit requirements specified in Section 1 of Appendix B. Since those basic requirements depend directly upon identified audit objectives, the "hard core" will be considered to consist of the structured arguments presented in this chapter. Thus, it is assumed that statements in the arguments specifying the primary and secondary objectives are of fundamental importance to the theoretical framework of U.K. company audit activity. If any of the propositional functions in these arguments were shown to be invalid, a wide range of company audit practices would not be
justified by this argument. If this were to occur, a new theoretical framework would have to be constructed, or new practices specified.

Although the question of empirical validity of propositions has not been an important one to the research project undertaken in this thesis, it is not a question that can simply be ignored. By constructing a theory according to the model discussed in chapter 2, a basis for future development of U.K. company auditing theory and practice has been established. The identification of a hard core will provide both positive and negative guidance to future research efforts. Positive research guidance will lead supporters of the theory to conduct research directed toward protecting the hard core, either by empirical research obtaining confirming evidence for statements within the hard core, or by theoretical research amending the protective belt in the light of apparently refuting evidence presented by opponents of the theory. Negative research guidance will lead supporters of the theory away from conducting research intended to refute statements within the hard core.

Both opponents and supporters of the theory will wish to collect evidence concerning the empirical validity of the fundamental propositions on which the theory is based. Such research efforts would require, firstly, the specification of the fundamental propositions to be tested and, secondly, an empirical research project to collect evidence about those propositions. The next two chapters of this thesis are concerned with these two aspects of company audit research.
CHAPTER 8

THE FUNDAMENTAL PROPOSITIONS OF U.K. COMPANY AUDITING

This chapter has one objective; to specify the fundamental propositions upon which the theoretical framework of U.K. company auditing depends. The specification of these propositions is based on the continuing assumption that the hard core of the theoretical framework within which U.K. company auditing practices are derived is that which has been specified in the previous chapter.

In Chapter 4, a "fundamental proposition" was said to have a number of attributes. Inter alia, a fundamental proposition was considered to be a proposition which

a) is not derived from earlier statements within the theory, and

b) is indispensible to the theoretical system in which it occurs.

Whether a proposition satisfies the first of these criteria will depend upon the way in which the theory has been built. Once the theory has been structured in a particular way, however, it will be an easy matter to determine whether a proposition is derived from earlier statements. A glance at Appendix C or at the diagram presented in the previous chapter will enable such non-derived propositions to be quickly identified.

It is rather more difficult to determine whether a proposition satisfies the second criterion. "Indispensible" is a term not easily quantified, and to provide some guidance in the identification of such propositions, it was suggested in Chapter 4 that propositions occurring in the hard core of company audit theory
could be considered "indispensible". It was further suggested that the hard core would consist of arguments which justify the existence of company auditing by deriving a primary audit requirement, compliance with which is argued to be necessary in order to comply with a fundamental normative statement, and of further arguments demonstrating that compliance with the primary requirement is feasible. Beyond this, however, it is impossible to specify the content of a hard core since it depends upon the attitudes of individuals towards a particular theory.

In terms of the theory which has been specified in the previous chapters of this thesis, a hard core has been identified by constructing a series of arguments which conclude with the basic audit requirements specified in Appendix B on the basis of the Standards and Guidelines. In the previous chapter, a justifying argument was identified which concluded with the requirements for the company auditor

(a) to provide shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those statements, and
(b) to ensure that the explicit indication is believed by shareholders to be reliable (the primary audit requirement - Statement 14).

Enabling arguments concluded with the seven requirements for the company auditor to:

a) conduct an independent examination of annual company financial statements (statement 24);
b) report to shareholders on the truth and fairness of annual company financial statements before they rely upon those statements (statement 25);
c) comply with statutory regulations governing the audit (statement 28);
d) comply with the terms of the engagement unless to do so would contravene statutory regulations (statement 31);
e) ensure that it possible to conduct a successful defence if a legal action is brought against the auditor in which his judgement is questioned (statement 34);
f) minimise the cost/benefit ratio of the audit (statement 44); and

g) not to search specifically for fraud unless required by statute or the specific terms of the audit engagement (statement 53).

These seven secondary requirements are conclusions of arguments which show that it is possible to comply with the primary audit requirement by the adoption of procedures which result in the attainment of secondary requirements. As such, those arguments have been called enabling arguments.

Since the hard core consists of both justifying and enabling arguments, it will contain or imply both justifying and enabling propositions. Within this chapter, those propositions are identified in order to facilitate empirical research projects designed to determine the extent to which the identified theory is supported by the available evidence.

In the first section of this chapter, justifying propositions are identified and discussed. In the second, enabling propositions are identified. While it is intended that the specification of
fundamental propositions is complete within the context of the specified hard core, it is not argued that this is the only, or necessarily the most appropriate, hard core that can be identified on the basis of the content of the Standards and Guidelines. Accordingly, the propositions specified in this chapter are not the only possible "fundamental propositions" of U.K. company auditing.
Section 1. Justifying Propositions

As discussed at some length in Chapter 4, the identification of propositions in a theory of U.K. company auditing is a two-stage process. Firstly, it is necessary to specify the propositional functions from which propositions can be derived. Only after this has been done will it be possible, by a process of quantification of variables, to specify appropriate propositions.

Within the argument deriving the primary audit requirement of the specified hard core, there are seven propositional functions. Of these, five are not derived from earlier statements in the argument and, as such, are considered to be "fundamental". They are:

Statement 1.
Company directors are responsible for the preparation of annual company financial statements and the presentation of the information included therein to shareholders.

Statement 2.
It is possible for company directors to prepare annual company financial statements which are misleading, meaningless, incomplete, inaccurate, invalid, in which disclosure is inadequate or in which classification and presentation of information is unsuitable.

Statement 3.
Shareholders rely upon annual company financial statements in their decision processes.

Statement 7.
If shareholders rely upon annual company financial statements which are unreliable, decisions made on the basis of those statements will be unlikely to result in the desired outcome.

Statement 10.
Shareholders will not rely upon annual company financial statements if
(a) they have been provided with an explicit indication that those financial statements are unreliable before they rely upon those financial statements, and
(b) they believe that explicit indication to be reliable.

These propositional functions are the basis upon which the primary
audit requirement for the auditor to provide an explicit indication of the reliability of annual company financial statements and to ensure that shareholders believe the explicit indication to be reliable has been derived. Accordingly, they are of fundamental importance to the justifiability of company audit practices to be subsequently derived from that primary requirement. Since an argument has been constructed to show that it is possible to derive all company audit practices appearing within the Standards and Guidelines from the identified primary requirement, the propositional functions are of fundamental importance to extant company audit practices in the U.K.

These five propositional functions make assertions in three general areas. Statements 1 and 2 make assertions about the nature of annual company financial statements; statements 3 and 7 make assertions about the purpose of annual company financial statements, and statement 10 makes an assertion about shareholder behaviour under certain circumstances. If any of these assertions are shown to be untrue (by the collection of empirical evidence), the shareholder decision argument could not be accepted as a justification for the continued existence of the company audit function.

The nature of annual company financial statements

In deriving the rule that there should be an indication of the reliability of financial statements, the shareholder decision argument depends upon a claim that it is possible for financial statements to be unreliable. If the evidence suggested that
financial statements could not be unreliable, there would be no need for an audit.

The shareholder decision argument suggests that two factors create the possibility of unreliable financial statements;

a) the responsibility of directors for the preparation of financial statements, and
b) the possibility that directors, for whatever reason, could prepare unreliable financial statements.

If the available evidence suggests that either of these two claims are untrue, the claim that it is possible for financial statements to be unreliable will be without foundation. If this occurs, either it must be admitted that company audits are unjustified, or a different reason for the possibility of unreliable financial statements would have to be invented.

Two propositions, derived from statements 1 and 2 in the specified hard core, could be tested to determine whether the argument for the possibility of unreliable financial statements is without foundation. They are;

**Proposition 1**

Every board of directors has, in respect of the company for which it is the board, responsibility for the preparation of annual financial statements and the presentation of the information contained in those financial statements to each shareholder.

**Proposition 2**

For every board of directors, there are circumstances in which it could provide shareholders of the company in respect of which it is the board with annual financial statements which are misleading, meaningless, incomplete, inaccurate, invalid, in which disclosure is inadequate and/or in which classification or presentation of information is unsuitable.
The first of these propositions has been derived by quantifying the variables "company directors", "annual company financial statements" and "shareholders" appearing in the propositional function which is statement number 1 in the shareholder decision argument. If this proposition were shown to be false, actions of company directors could not be held to influence the reliability of the financial statements. Accordingly, the argument presented would not justify the need for an audit.

Proposition 2 has been derived from statement 2 using a similar approach to the quantification of variables as that used in respect of proposition 1. If this second proposition were shown to be false, company financial statements could not be unreliable as a result of the actions of directors, even if directors were responsible for the preparation of financial statements.

Considered together, if either proposition 1 or proposition 2 were false, the argument deriving the necessity for an explicit indication of the reliability of annual company financial statements would be without foundation, since there would be no evidence that it is even possible for annual company financial statements to be unreliable.

The purpose of annual company financial statements

The second step in the argument deriving the need for a company audit is to show that unreliable financial statements could lead to undesired outcomes of shareholder decisions. Given the fundamental normative statement that the risk of undesired outcomes of shareholder decisions should be minimised, action concerning the
reliability of financial statements would be necessary only if the information was actually used by shareholders when making decisions and if the reliability of information influenced the outcome of shareholder decisions. If that were not the case, the argument justifying company audits would be unacceptable.

Statements 3 and 7 in the shareholder decision argument are relevant to this issue and are not derived from earlier statements. By quantifying the variables in these statements, two further fundamental propositions can be identified.

**Proposition 3**

A majority of shareholders will, on at least one occasion while a shareholder, place reliance on the annual financial statements of the company in which they hold shares when making a decision in respect of their shareholding.

**Proposition 4**

If any shareholder relies upon the annual financial statements of the company in which he or she holds shares when making a decision in respect of his or her shareholding, and those financial statements are unreliable, the decision made on the basis of those financial statements will be less likely to have the outcome desired by that shareholder than would be the case if the financial statements were reliable.

In proposition 3, the variable "shareholders" has been quantified as "a majority of shareholders". The choice of this quantification is a matter of some judgement, the intention being to demonstrate that sufficient reliance is placed upon financial statements to justify the claim that an audit is necessary. To show that a small proportion of shareholders rely on financial statements would be unlikely to be accepted as sufficient. On the other hand, to be expected to demonstrate that all, or nearly all shareholders rely on financial statements would probably be more than is necessary to justify an audit.
If it is accepted that reliance upon financial statements by a majority of shareholders is necessary to establish the general claim that shareholders rely on financial statements, and if proposition 3 were shown to be false, there would be no grounds for suggesting that shareholders rely upon annual company financial statements when making decisions. If that were the case, an indication of the reliability of those financial statements would be irrelevant to the outcome of shareholder decisions.

Proposition 4 is the assertion that the quality of financial information influences the likelihood that decisions made in reliance upon that information will have the desired outcome. If this were not true, and the quality of the information contained within the financial statements made no difference to the outcome of decisions, an indication of the reliability of those financial statements would be irrelevant, even if shareholders did use the statements when making decisions.

Shareholder behaviour

Having established the possibility of unreliable financial statements and, as a result, the possibility that shareholder decisions might not have the desired outcome, the final stage in the shareholder decision argument is to suggest that an audit will prevent reliance upon unreliable financial statements. The purpose of the audit is argued to be to increase the likelihood that shareholder decisions will have the desired outcome.

This final stage is achieved by suggesting that shareholders will
not rely on financial statements if they have been provided with an explicit indication that those financial statements are unreliable and if they believe that explicit indication to be reliable (statement 10). A proposition reflecting this claim is:

**Proposition 5**

If any shareholder has been provided with an explicit indication that the annual financial statements of the company in which he or she holds shares are unreliable, and that shareholder believes the explicit indication to be reliable, that shareholder will not rely upon those financial statements when making a decision in respect of his or her shareholding.

If this proposition were false, it would be possible to claim that an audit report makes no difference to the outcome of shareholder decisions because it makes no difference to the likelihood of reliance being placed upon unreliable financial statements. That is, if the proposition were false, knowledge that financial statements were unreliable, or knowledge that the audit report was unreliable would make no difference to the willingness of shareholders to rely upon those statements. Accordingly, an indication of financial statement reliability would be unnecessary and actions to ensure that shareholders believe the audit report to be reliable would be irrelevant.

Each of the propositions 1-5 are of fundamental importance to the shareholder decision argument and, if that argument is accepted as the basis for the content of the Standards and Guidelines, to the theory which underlies extant company audit practices in the U.K. If one or more of these propositions were shown to be false, a different justification for company auditing would have to be identified. Accordingly, empirical research projects designed to test the above propositions could make a significant contribution to the development of company audit theory in the U.K.
Section 2. Enabling Propositions

In Chapter 4, enabling propositions were considered to be propositions which must be true if it is to be possible, within the context of a particular theory, to achieve the primary audit objective. Since the possibility of achieving the primary objective depends upon both the extent to which compliance with secondary audit requirements leads to compliance with the primary audit requirement, and upon the extent to which circumstances inhibit or prevent compliance with secondary requirements, two general classes of enabling propositions can be identified.

In the first class of enabling propositions are those which must be true if compliance with secondary requirements is to result in compliance with the primary requirement. That is, they are propositions appearing within arguments which establish the link between secondary and primary audit requirements. If such propositions were shown to be false, it would not be possible to argue that achievement of the primary audit objective is enabled by achievement of secondary objectives. In turn, this would indicate either that it is not possible to achieve the primary audit objective or that identified secondary objectives are inappropriate.

The second class of enabling propositions are those which must be true if it is to be possible to comply with secondary audit requirements. Despite the validity of the argument deriving secondary audit requirements and the truth of propositions within that argument, it would not be possible to comply with the primary requirement if it were not possible to comply with the specified
secondary requirements. As with the first class of enabling proposition, if propositions in this class were refuted, either it would not be possible to achieve the primary audit objective, or identified secondary objectives would be inappropriate in that they would not result in the attainment of the primary objective.

Propositions within the specified argument

The process of identifying members of the first class of enabling proposition will proceed in the same fashion as that carried out in order to identify justifying propositions. That is, propositional functions in that part of the hard core which derives secondary requirements will be identified and, if not dependent upon earlier statements, will be used as the basis for specifying enabling propositions.

As was pointed out in the previous chapter, the enabling arguments contained within the identified hard core have been developed solely in order to link the basic requirements specified in Appendix B with the primary requirement of the shareholder decision argument. It was also pointed out that, on occasion, this resulted in the exclusion of certain practices from the hard core which on structural grounds might have been included, or the inclusion of practices which might have been excluded. As a result, the enabling arguments under consideration have not been consistently derived on the basis of structural position and the identification of enabling propositions will be similarly inconsistent, although the principles involved in identifying such propositions (given a particular series of enabling arguments) will be adequately demonstrated.
In order to identify enabling propositions within the specified argument, it is necessary only to derive propositions from propositional functions in that argument which are not derived from earlier statements within the theory. Nine such propositional functions occur in the shareholder decision argument;

Statement 23.
In order to form an opinion on the financial statements it is necessary to conduct an independent examination of these financial statements.

Statement 27.
If the company auditor does not act in compliance with statutory regulations governing the audit, shareholders will not believe the audit report to be reliable.

Statement 30.
If the company auditor does not comply with the terms of the engagement, shareholders will not believe the audit report to be reliable, unless such non-compliance occurred as a result of compliance with statutory regulations governing the audit.

Statement 33.
If the company auditor does not adopt procedures which will ensure that it is possible to conduct a successful defence if a legal action is brought against him in which his judgement is questioned, shareholders will not believe the audit report to be reliable.

Statement 38.
It is possible that shareholders will take whatever steps are necessary to remove the requirement for compulsory audit from the legislation if they believe the cost of the company audit to outweigh the benefit of that audit.

Statement 39.
It is possible that the requirement for compulsory audit will be removed from the legislation if shareholders take whatever steps are necessary to remove that requirement.

Statement 40.
It is possible that shareholders will choose not to appoint an auditor if the requirement for compulsory audit is removed from the legislation.

Statement 43.
If the company auditor minimises the cost/benefit ratio of the company audit, shareholders will be less likely to believe that the cost of the audit outweighs the benefit of the audit.
Statement 52.
In order to minimise the cost/benefit ratio of the company audit, it is necessary for the company auditor not to search specifically for fraud, unless required by statute or the specific terms of the audit engagement.

As with justifying propositions in the previous section, the process of quantifying variables will be used to derive enabling propositions from propositional functions. Adopting this approach with respect to the first propositional function above (statement 23) could result in the following proposition;

Proposition 6
A majority of company auditors believe that it is not possible to form an opinion on the financial statements of any company without conducting an independent examination of those statements.

It should be noted that this proposition refers to beliefs. Since the auditor's belief in the truth and fairness of the financial statements is the basis for his opinion, it is appropriate to test the truth of propositions concerning the formation of the opinion in terms of auditor beliefs. If, for example, proposition 6 were refuted there would be no reason for an auditor to conduct an independent examination - the opinion could be formed in some other way.

As with previously discussed justifying propositions, the test to be applied is that the belief is held to be held by a majority. The choice of this particular quantification is based on the presumption that to require more than a majority to hold a belief would be to impose too severe a test on the proposition. Similarly, evidence that less than a majority hold a belief would be unlikely to be accepted as evidence of the truth of the propositional function.
Proposition 7
A majority of shareholders believe that a report provided by a company auditor who has not acted in compliance with statutory regulations governing the audit will be unreliable.

As with Proposition 6, this proposition refers to beliefs. Since the purpose of the audit report is to create a belief on the part of shareholders about the reliability of the financial statements, it is appropriate to test the truth of propositions concerning the role of the audit report in terms of shareholder beliefs. Thus, proposition 7 refers to the effect of compliance with statutory provisions on the shareholder's beliefs about the reliability of the audit report.

In the context of the identified hard core, compliance with legislative provisions is justified on the grounds that such compliance is necessary to the shareholder's belief in the reliability of the audit report. If proposition 7 were refuted, compliance with legislation would not ensure compliance with the primary audit requirement.

Proposition 8
A majority of shareholders believe that a report provided by a company auditor who has not complied with the terms of his engagement will be unreliable unless non-compliance with the terms of engagement was necessary in order to comply with statutory regulations governing the audit.

Proposition 9
A majority of shareholders believe that a report provided by a company auditor who has adopted procedures which are insufficient to ensure that it is possible for that auditor to conduct a successful defence if a legal action is brought against him in which his judgement is questioned, will be unreliable.

These two propositions are derived in a similar manner to Proposition 7, and for similar reasons. If either of these propositions were refuted, compliance with the terms of the
engagement and ensuring that a successful legal defence could be conducted would not enable the primary audit objective to be attained.

Proposition 10

A majority of shareholders would consider taking whatever steps are necessary to remove the requirement for compulsory audit from the legislation if they believed the cost of an audit of the annual financial statements of the company in which they own shares to outweigh the benefit of that audit.

This proposition is the basis of the requirement for the company auditor to act to minimise the cost/benefit ratio of the audit. In this case, the unspecified variable "shareholders" has been quantified as "a majority of shareholders" on the grounds that at least a majority would have to act in order to have any likelihood of successfully removing the requirement for compulsory audit from the legislature. On the other hand, to require that every shareholder who believes the cost of the audit to outweigh the benefits take steps to remove the compulsory audit requirement would impose too severe a test on the propositional function. However, if it is shown that only a minority of shareholders would take steps necessary to the removal of the compulsory audit requirement if they felt the cost of the audit to outweigh the benefit, then the stated reason for the auditor to minimise the cost/benefit ratio of the audit would be without foundation.

Related propositions derived from the other propositional functions in the argument concluding with the secondary requirement to minimise the cost/benefit ratio of the audit are;
Proposition 11

It is possible that the requirement for compulsory audit would be removed from the companies' legislation if a majority of shareholders took whatever steps are necessary to remove that requirement from that legislation.

Proposition 12

It is possible that, in respect of any company, an auditor would not be appointed if the requirement for compulsory audit were removed from the companies' legislation.

Proposition 13

If, in respect of any company, a majority of shareholders believe that the auditor has acted to minimise the cost/benefit ratio of the audit, a majority of shareholders of that company will also believe the benefits of the audit to outweigh the costs.

Taken together, propositions 10, 11, 12, and 13 are necessary to the requirement for the auditor to provide an effective, economic and efficient service. If any of those propositions were false, actions to minimise the cost/benefit ratio of the audit would have no bearing on the attainment of the primary audit objective. That is, if there were no possibility that a failure to minimise the cost/benefit ratio could lead to circumstances in which an auditor was not appointed (and, thereby, to a failure to achieve the primary objective), there would be no need to minimise the cost/benefit ratio, at least in terms of the argument suggested.

The final propositional function presented in the hard core relates to the detection of fraud, asserting that a specific search for fraud will increase the cost/benefit ratio of the audit. A suitable proposition derived from this propositional function is;

Proposition 14

If, in respect of any company, the auditor searches specifically for fraud when not required to by statute or the specific terms of his engagement, a majority of shareholders of that company will believe that the increase in the cost of the audit outweighs the increase in the benefit of the audit.
Each of the propositions 6-14 must be true in order for compliance with the derived secondary audit requirements to result in the provision by the auditor of an explicit indication of financial statement reliability which indication is itself believed to be reliable. If any of those propositions were found to be false, there would be no grounds for claiming that the practices derived within the theory would enable the primary objective to be achieved.

Propositions relating to compliance with audit requirements

Each of the propositions stated so far in this chapter are specific to the particular argument developed in the previous chapter. Thus, any demonstration that a proposition is not supported by the evidence will constitute an attack against that argument, but will not necessarily constitute a basis for the rejection of any of the specified primary or secondary audit requirements. For example, if proposition 14 were shown to be false, the stated argument for not searching specifically for fraud would have to be rejected. Were that to happen, other reasons might be invented in support of the claim that by not searching for fraud the primary audit objective could be attained. Research projects would then be necessary to determine the acceptability of those alternative arguments.

However, if it could be shown that circumstances are such that it is not possible to achieve the primary audit objective without searching for fraud, no argument concluding that the auditor should not search for fraud could be accepted. In general terms, any theory of company auditing contains implied assertions that it is
possible to comply with derived requirements and, at the same time, achieve the primary requirement specified in that theory. Those implied assertions constitute the second class of enabling proposition, and attacks against these propositions will constitute attacks against any argument deriving particular secondary requirements from a specified primary requirement.

Examples of such propositions occur in the literature on U.K. company auditing. In particular, Lee\textsuperscript{5} identified a number of "foundations"\textsuperscript{6} which, if true, would enable the achievement of the primary company audit objective, which he saw as "the giving of an opinion on the credibility of the annual financial accounting information supplied to company shareholders"\textsuperscript{7}. These "foundations" were;

1. "There is no unnecessary conflict of interest between the auditor and company management which hinders [the audit]"
2. "There are no unreasonable legal restrictions placed upon the auditor which would hinder [the audit]"
3. "The auditor is in a suitably independent position ...to ...[carry out the audit]"
4. "The auditor is sufficiently skilled and experienced to carry out his audit"
5. "The auditor can be held accountable for the quality of his work and the nature of his opinion"
6. "There is sufficient competent and reliable ...[evidence] available to allow the auditor to [carry out the audit]"
7. "The ...financial statements [are] free of major fraud and error"
8. "There are ...accounting concepts and bases ...which ...result
in... accounting information which satisfies the standards of truth and fairness to be reported upon by the auditor".

Essentially, these statements claim that there is nothing about the circumstances of company audits which necessarily prevents the adoption of appropriate audit practices and, through those practices, the attainment of the primary company audit objective. If any such claims were shown to be false, there would be good grounds for arguing that company audits can, in fact, serve no useful purpose, even if the desirability of such audits had been satisfactorily established.

Although Lee's statements have not been derived within the context of a formalised theory, they are similar to those which can be identified on the basis of the "hard core" requirements specified in the previous chapter. In order to identify those propositions it is necessary to consider the nature of the requirements which have been derived.

Beginning with the primary audit requirement, and ending with the secondary requirements, practices derived within the "hard core" can be diagrammed as follows;

```
Level 1  14a  14b
  ↓     ↓     ↓
Level 2  37    18    19
  ↓     ↓     ↓
Level 3  21    44    26
  ↓     ↓     ↓
Level 4  24  25  46  48  53  28  31  34
  ↓     ↓     ↓
Level 5  50
```

This diagram serves at least two useful purposes. Firstly, it
clearly indicates the aspect of the primary audit requirement which is to be achieved by adopting certain actions. For example, compliance with statutory regulations (statement 28) is intended to result in a belief by shareholders that the explicit indication of financial statement reliability is itself reliable (statement 14b). Secondly, the diagram indicates the extent to which the hard core is determined other than on structural grounds. For example, statements 37 and 50 both establish the limit of the hard core, even though statement 37 is one level below the primary requirement and statement 50 is four levels below that requirement.

Bearing in mind that the purpose of the present exercise is to identify circumstances which might prevent the implementation of derived practices and, thereby, the attainment of the primary objective, it is necessary to ensure that there is no duplication of practices in the above diagram. In particular, it is necessary to ensure that practices are not derived from earlier practices on the basis only of definition. If this were the case, circumstances which prevent implementation of the former practice would also prevent implementation of the latter.

For example, the derivation of the requirement for the auditor to ensure that the audit report is believed to be reliable (statement 26) from the requirement for the auditor to ensure that the explicit indication of truth and fairness is believed to be reliable (statement 19) is achieved simply by defining an "explicit indication" in terms of an "audit report" (statement 20). Circumstances which would prevent shareholders believing the audit report to be reliable would also (by definition) prevent
shareholders believing the audit report to be reliable would also (by definition) prevent shareholders believing the explicit indication of truth and fairness to be reliable. In general, for a practice to be substantially different from the practices upon which it depends, it must be derived by the introduction of a (testable) propositional function.

After removing those practices derived other than by the introduction of a propositional function, the above diagram becomes:

<table>
<thead>
<tr>
<th>Level 1</th>
<th>14a</th>
<th>14b</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 2</td>
<td>24</td>
<td>44</td>
</tr>
<tr>
<td>Level 3</td>
<td>53</td>
<td></td>
</tr>
</tbody>
</table>

These requirements are:

**Level 1**

Statement 14.
(a) to provide shareholders with an explicit indication of the reliability of annual company financial statements before they rely upon those financial statements, and
(b) to ensure that shareholders believe that explicit indication to be reliable.

**Level 2**

Statement 24.
to conduct an independent examination of annual company financial statements.

Statement 44.
to minimise the cost/benefit ratio of the company audit

Statement 28.
to comply with statutory regulations governing the audit

Statement 31.
to comply with the terms of the engagement unless to do so would contravene statutory regulations
Statement 34.
to adopt procedures which will ensure that it is possible to conduct
a successful defence if a legal action is brought against the
auditor in which his judgement is questioned.

Level 3

Statement 53.
not to search specifically for fraud, unless required by statute or
the specific terms of the audit engagement

These practices are, according to the argument specified in the
previous chapter, essential to the attainment of the primary audit
objective. Further, they are practices which are essentially
different. As a result, circumstances which prevent the attainment
of one of the above practices will not necessarily prevent the
attainment of the others. However, if circumstances are such that
any of the above practices cannot be implemented, it will not be
possible to achieve the primary audit objective, even if that
objective has been derived within a valid argument supported by the
available evidence.

The primary audit requirement

Since the primary audit objective is derived specifically from the
primary audit requirement, it is obvious that the attainment of that
objective depends upon the existence of circumstances which do not
prevent the implementation of the primary audit requirement. There
are two aspects to the primary audit requirement; providing an
explicit indication of the reliability of financial statements, and
ensuring that shareholders believe the explicit indication to be
reliable.

As suggested in the context of earlier enabling propositions
relating to the audit examination, a crucial element of the
circumstances of an audit is the set of beliefs held by the auditor. That is, if the auditor believes it is not possible to comply with the basic audit requirement, there will be no grounds for any attempt on the part of the auditor to do so, at least within the context of the arguments presented in this chapter. Thus, in order for the primary objective to be attained, the following propositions must be true;

Proposition 15
A majority of company auditors believe that there are accounting techniques which result in financial statements which satisfy the standard of reliability.

Proposition 16
A majority of company auditors believe that there are no factors which necessarily prevent a majority of shareholders from believing that an explicit indication of financial statement reliability is itself reliable.

In each of these propositions, the concept of "auditors" has been quantified as "a majority of auditors". As with earlier suggested enabling propositions, the choice of "a majority" is somewhat arbitrary. It has been selected here on the grounds that it provides a reasonable test of the likelihood of auditors in general believing that circumstances do not prevent compliance with the primary audit requirement.

Alternative approaches to the question of the possibility of conducting an audit could be adopted. For example, research projects could be conducted in order to determine the proportion of company auditors who hold beliefs referred to in propositions 15 and 16. The issue of whether sufficient auditors hold those beliefs might then be considered in the light of the research results.
Ensuring shareholders believe the audit report to be reliable

Statements 28, 31 and 34 require the auditor to comply with statute, to comply with the terms of the engagement and to ensure that it is possible to conduct a successful legal defence so that shareholders will believe the audit report to be reliable. By adopting an approach similar to that adopted with respect to the audit examination, the following propositions must be true if the primary audit objective is to be achieved;

Proposition 17
A majority of company auditors believe that they are not subject to statutory restrictions which are so severe as to prevent the formation of a reliable opinion on the truth and fairness of annual company financial statements.

Proposition 18
A majority of company auditors believe that they are not subject to terms of engagement which permit compliance with statutory regulations governing the audit and which impose restrictions so severe as to prevent the formation of a reliable opinion on the truth and fairness of annual company financial statements.

Proposition 19
A majority of company auditors believe that they are able to adopt procedures which will ensure a successful defence if a legal action is brought in which their judgement is questioned and which will not act so as to prevent the formation of a reliable opinion on the truth and fairness of annual company financial statements.

These three propositions assert rather more than "it is possible to comply with statutory requirements", "it is possible to comply with the terms of the engagement" or "it is possible to conduct a successful defence". It has been argued that these propositions must be true if the primary objective is to be attained. Accordingly, they must reflect the assertion that circumstances do not prevent implementation of the primary audit requirement. That
is, in order to demonstrate that it is possible to comply with secondary audit requirements and thereby attain the primary audit objective, it is necessary to interpret the claim that "it is possible to undertake certain actions" as "it is possible to undertake certain actions and, by so doing, achieve the primary audit objective".

One further point concerning the above propositions is that they refer to an "opinion on truth and fairness" rather than to an "explicit indication of reliability", the phrase used in the primary audit requirement. This substitution is justified by the definitions contained in statements 5, 16 and 20 (i.e. of "unreliable", "true and fair" and "explicit indication"). Since the present discussion is concerned with the identification of propositions which must be true if it is to be possible to achieve the primary audit objective, it must be recognised that evidence supporting propositions 17, 18 and 19 will only have any bearing on the achievement of the primary objective if the above definitions are accepted. Research directed towards determining the acceptability of definitions would also make a considerable contribution to the process of validating a suggested theory of auditing.

Conducting an independent examination

Statement 24 in the hard core requires the auditor to conduct an independent examination, and is derived on the grounds that an independent examination is necessary to the formation of an opinion on the financial statements. If it is to be possible to attain the
primary audit objective by conducting an independent examination, it must be true that;

**Proposition 20**

A majority of company auditors believe that they are able to conduct an independent examination which will enable them to form a reliable opinion on the truth and fairness of annual company financial statements.

If this proposition were not true, company auditors would not be justified in conducting an independent examination, since it would not lead to the attainment of the primary audit objective.

**Minimising the cost/benefit ratio of the audit**

The final area of audit practices specified in the hard core is the requirement to minimise the cost/benefit ratio of the audit and the derived requirement not to search specifically for fraud. Although the requirement to minimise the cost/benefit ratio of the audit has been derived in the hard core on the grounds that to fail to minimise the cost/benefit ratio might ultimately result in the removal of the requirement for compulsory audit from the legislation, alternative derivations are possible. For example, Lee implies that auditors need to be concerned with costs and benefits of the audit on the grounds that a relationship of accountability exists between auditors and shareholders. This is reflected in the assumption that "the auditor can be held accountable for the quality of his work and the nature of his opinion".

An enabling proposition expressed in the terms demanded by the identified hard core would be;
Proposition 21

A majority of company auditors believe that they are able to reduce the cost of the audit to a level at which they are able to form a reliable opinion on the truth and fairness of annual company financial statements and at which the majority of shareholders believe the cost/benefit ratio of the audit to be minimised.

The truth of this proposition is essential if compliance with the requirement to minimise the cost/benefit ratio of the audit is not to prevent the formation of a reliable audit opinion. That is, auditors must not believe that the perceived benefits of the audit are so small as to require a reduction in cost to a level at which the audit examination would not result in the formation of a reliable opinion. At that point, it would not be possible to achieve the primary audit requirement and, at the same time, minimise the cost/benefit ratio of the audit.

The requirement not to search specifically for fraud, derived from the requirement to minimise the cost/benefit ratio of the audit, implies that;

Proposition 22

A majority of company auditors believe that they are able to form a reliable opinion on the truth and fairness of annual company financial statements without searching specifically for fraud, unless required to by statute or the specific terms of the audit engagement.

In essence, this proposition asserts that it is possible to comply with the primary audit requirement without searching specifically for fraud. If this proposition were not true, it would be necessary for the company auditor to search specifically for fraud in order to form a reliable opinion on the truth and fairness of the financial statements.
Section 3. Conclusions.

In Chapter 4 it was suggested that a proposition will be treated, prima facie, as fundamental proposition of U.K. company auditing if it;
a) appears as a premise in arguments deriving company audit practices recommended in the Standards and Guidelines,
b) apparently does not depend on other statements in the Standards and Guidelines and
c) would necessitate a fundamental change to both the Standards and Guidelines and audit practice if it were refuted.

Provided that the series of arguments presented in Chapter 7 are accepted as a "hard core" for the theory identified on the basis of the Standards and Guidelines, all of the propositions identified in this chapter satisfy these criteria for fundamentality.

As regards the first criterion, it was established in Chapter 7 that the "hard core" had been build in order to provide a foundation for the content of the Standards and Guidelines. As regards the second criterion, the structure of the arguments in Chapter 7 and Appendix B provide detailed evidence that the propositions have not been derived from other statements within or implied by the Standards and Guidelines. As regards the third criterion, the identified propositions are all such that refutation would result either in the rejection of the specified primary objective of U.K. company auditing or in the impossibility of achieving that objective by compliance with secondary audit requirements. The consequence of refutation would be a need for a radical change either to the
primary audit objective or to present audit techniques.

A further criterion for deciding whether a proposition is fundamental is whether it is believed to be both true and beyond dispute by supporters of the theory in which that proposition appears. Accordingly, a further stage in the development of the theory identified in this thesis could be to collect evidence which would confirm that the identified propositions are believed to be both true and beyond dispute, and that there are no other propositions which satisfy this criterion which have not been included in the identified hard core.

Although it is not within the scope of this thesis to conduct empirical research projects to determine whether the hard core has been satisfactorily established or to determine whether the identified propositions are true, the issue of empirical confirmation is of considerable importance to the future development of any company audit theory.

An important problem related to the empirical verification of the identified fundamental propositions is that they refer to shareholder or auditor beliefs, which cannot be observed directly. Thus, empirical research in the field of company auditing is not as straightforward as in the physical sciences. The final area of concern in this thesis is with this issue of empirical verification of the propositions of U.K. company auditing. In particular, the next chapter is concerned with empirical verification of fundamental propositions of the kind specified in this chapter.
CHAPTER 9

THE VERIFICATION OF PROPOSITIONS OCCURRING IN A THEORY OF COMPANY AUDITING.

If the theory which has been identified in this thesis is to be developed further, it will ultimately be necessary to conduct empirical research projects in order to determine whether the evidence supports the propositions on which the theory depends. Although the establishment of theory is precedent to the conduct of empirical research, it is neither less nor more important. Empirical research is conducted within the framework of a specified theory, which develops and becomes more useful in the light of the results of that empirical research. It is therefore important to consider some issues which affect the methodology and the usefulness of empirical research which is carried out with the objective of confirming or refuting propositions in a theory of company auditing.

In this chapter, the process of empirical evaluation of propositions is under examination. In particular, necessary (and sometimes unstated) assumptions which underly empirical research into the kind of propositions encountered in company audit theory are made explicit. In the light of this explication of assumptions, a number of difficulties likely to be encountered by the empirical researcher are identified and discussed.

The chapter consists of two sections. In the first, the process of verification of the fundamental propositions identified in the previous chapter is discussed, and the assumptions implicit in that process are highlighted. In the second section, the fallibility of
empirical research is considered in order to emphasise that the conviction with which a theory is held must always be tempered by the knowledge that the theory, no matter how well confirmed, is always liable to be overthrown. Only by that means does knowledge progress.
Section 1. The Verification of the Fundamental Propositions of U.K. Company Auditing.

The general approach to propositions adopted in this thesis is substantially the same as that adopted by the American Accounting Association's Committee on Basic Auditing Concepts, which said:

A proposition is a statement which is the unit of logical thinking. Not every sentence expresses a proposition, but only those statements which express what is either true or false².

The committee went on to suggest that furthermore, not every proposition is empirically meaningful. An empirically meaningful proposition is one that can be tested by perceived evidence³.

Since the identification of the fundamental propositions of U.K. company auditing is likely to be followed by an empirical research programme designed to determine whether those propositions are true, it is necessary to consider the extent to which propositions of different kinds are empirically verifiable.

It has already been suggested that all propositions are truth-functional. That is, in principle all propositions can be tested to determine whether they are true or false. In only some cases, however, is it appropriate to determine the truth or falsity of propositions by empirical research. Baldwin⁴ has suggested that some propositions, such as propositions of immediate perception and verbal propositions are provable other than by empirical means. For example, the proposition that "all audits are carried out by an auditor" is a verbal proposition which hardly requires an empirical research project to determine whether or not it is true; its truth is contained within the terms themselves. Propositions such as
these, which are either immediately true or false are referred to by Baldwin as "immediate propositions".

Statement 17 in the suggested hard core is an example of a propositional function which could be used to specify an immediate proposition. It states;

If shareholders are provided with an explicit indication of the truth and fairness of annual company financial statements, they will be provided with an explicit indication of the reliability of those financial statements.

In essence, this propositional function provides that every explicit indication of truth and fairness is an explicit indication of reliability. Statements 5 and 16 in the hard core are definitions concerned with reliability and truth and fairness. Both definitions list a number of attributes of financial statements which are either "unreliable" or "not true and fair". Since those attributes are the same in both definitions, "unreliable" is, by definition, the same as "not true and fair", and Statement 17 is necessarily true.

Propositions which are not immediately true or false can, in principle at least, be tested either directly or indirectly by the collection of empirical evidence. Although it is clear that propositions in which the two terms and the copula refer to observable phenomena can be tested empirically, it is less clear that some classes of propositions which refer to non-observable phenomena are also empirically testable. To show this, it is convenient to consider propositions as falling into four categories: "empirical", "dispositional", "theoretical" and "bridging" propositions.

In an empirical proposition, the two objects or the properties
thereof and the relationship between them are observable. An object, property or relationship is "observable" if it is possible to verify the existence of that object, property or relationship without relying on evidence about the existence of any other object, property or relationship. For example, it is possible to determine whether an item of machinery exists by observing that item directly. On the other hand, it is not possible to determine whether goodwill exists by observing goodwill directly. In order to determine the existence of goodwill, it is necessary to observe other factors, such as above average reported profits, or larger market share than that of competitors. It could well be that these surrogate items are themselves not observable, and reference must be made to still further objects, events or relationships in order to determine whether goodwill exists.

An example of an empirical proposition in the theory of U.K. company auditing could be;

Every shareholder who expresses the belief that no audit report is reliable will also express the belief that there should be no requirement for compulsory audit in the Companies Acts.

The expression of a belief by a shareholder is observable. Similarly, it is possible to observe the relationship implicit in the proposition by observing whether it is the same shareholder who expresses both beliefs referred to in the proposition.

This proposition refers to observable phenomena and could be tested by the collection of empirical evidence concerning the expression of beliefs by shareholders. It makes no difference to the nature of the proposition whether the belief is expressed verbally or in response to a questionnaire; the expression of belief is observable.
without recourse to the observation of any other event. Since the empirical evidence is directly related to the terms of the proposition, the proposition is directly empirically verifiable.

In contrast to empirical propositions, dispositional and theoretical propositions make claims about non-observables and are therefore not directly empirically testable. Propositions which refer to non-observable characteristics of observable things will be called dispositional propositions and those which refer to non-observable characteristics of non-observable things will be called theoretical propositions.

For example, the following is a dispositional proposition;

Every shareholder who expresses the belief that no audit report is reliable also believes that there should be no requirement for compulsory audit in the Companies Acts.

The observable in the proposition is the expression of belief by the shareholder that no audit report is reliable. The unobservable characteristic is the belief actually held by the shareholder.

Although this proposition refers to a property which is not directly observable (the shareholder's beliefs), evidence collected in determining whether the empirical proposition discussed earlier is true or false could be used to support or refute the dispositional proposition, provided that it is assumed that if a shareholder expresses a belief that there should be no requirement for compulsory audit, then the shareholder holds that belief. In other words, the expression of a belief must be assumed to constitute evidence about the holding of that belief. An explicit statement of this connection between non-observable and observable phenomena will
be called a bridging proposition. If such a bridging proposition is introduced, observation of the observable phenomena could be taken as evidence about the existence of the non-observable phenomena. In essence, bridging propositions make claims which, if true, provide the means of observing phenomena which are not directly observable themselves.

Since it is quite possible to link the holding of a belief with other observable phenomena (e.g. a particular action under particular circumstances), other bridging propositions could be introduced in order to determine whether a shareholder holds a particular belief. Different bridging propositions lead to the possibility of different empirical observations which could be used to confirm or refute a dispositional proposition. Under these circumstances, it is important that the bridging propositions be justified in some way. Since bridging propositions are not themselves empirical propositions, they are not amenable to direct empirical testing, and must be accepted on other grounds if they are introduced. Other grounds might include, for example, general acceptance or rational argument.

The greater the number of bridging propositions which can be introduced, the greater will be the possible ways of verifying a dispositional proposition. The greater the possible ways of verifying a dispositional proposition, and the greater the justification for the bridging propositions used, the greater will be the support that the evidence provides for the dispositional proposition under examination.
The final class of proposition, the "theoretical proposition" refers only to phenomena which are not observable. For example, the following is a theoretical proposition:

Every shareholder who believes that no audit report is reliable also believes that there should be no requirement for compulsory audit in the Companies Acts.

This proposition refers to two non-observable phenomena; the shareholder's beliefs concerning two different matters.

However, a similar case could be made for the use of empirical evidence collected in an examination of the first proposition to be used to argue the truth or falsity of this theoretical proposition. A bridging proposition which would enable the presence or absence of a belief that there should be no compulsory audit requirement to be observed has already been considered. An additional bridging proposition such as:

If a shareholder expresses the belief that no audit report is reliable, then the shareholder holds that belief could be introduced in order to enable claims about the presence or absence of an opinion to be empirically verified. If this system of three propositions (the theoretical proposition plus the two bridging propositions) is accepted, evidence about the empirical proposition could be used to infer the truth or falsity of the theoretical proposition. It should be noted, however, that the evidence is by no means conclusive and would not even be persuasive if the bridging propositions were unacceptable.

To summarise, provided that sufficient bridging propositions can be identified in the professional literature, or can reasonably be introduced, it will be possible to infer the truth or falsity of
dispositional and theoretical, as well as empirical propositions by the collection of empirical evidence. Clearly, the researcher must be careful in drawing conclusions about dispositional or theoretical propositions on the basis of evidence about empirical propositions. The evidence could reflect errors in the bridging propositions as much as errors in the proposition subject to test.

For example, it could well be the case that an expression of belief is not a reliable guide to the actual belief held. Perhaps more reliable evidence as to whether a particular belief is held by an individual could be collected by observing that individual when faced with particular decision situations. Researchers need to consider carefully the nature of the bridging propositions being introduced if they are to be at all confident that evidence about an empirical proposition does in fact support (or refute) a dispositional or theoretical proposition.

Twenty-two propositions which are considered fundamental to U.K. company auditing were specified in the previous chapter. Each of those propositions is either dispositional or theoretical, so that the introduction of bridging propositions is essential if any of the fundamental propositions are to be subjected to empirical examination. As suggested above, a range of possible bridging propositions could be introduced. The choice of bridging proposition, and the responsibility for justifying that choice, rests with the empirical researcher. Since this thesis is not concerned with conducting such empirical research, the specification of bridging propositions is not carried out herein. However, it is useful to suggest a possible propositional system in respect of
Proposition 13, by way of illustration of the above discussion.

Proposition 13.

If, in respect of any company, a majority of shareholders believe that the auditor has acted to minimise the cost/benefit ratio of the audit, a majority of shareholders of that company will also believe the benefits of the audit to outweigh the costs.

The component elements of this proposition are;

Variable X: Companies in which a majority of shareholders believe that the auditor has acted to minimise the cost/benefit ratio of the audit.

Variable Y: Companies in which a majority of shareholders believe that the benefits of the audit outweigh the costs.

Copula: All X are Y.

The difficulty with both variables in this proposition is that it is not possible to observe directly the beliefs of shareholders. As a result, it is not possible to observe directly whether a majority of shareholders of a company hold a particular belief. If the proposition is to be tested, it is necessary to introduce at least two bridging propositions, such as the following;

Bridging Proposition 1.

Every shareholder who expresses a belief that the auditor has acted to minimise the cost/benefit ratio of the audit in fact holds that belief.

Bridging Proposition 2.

Every shareholder who expresses a belief that the benefits of the audit outweigh the costs of the audit in fact holds that belief.

This system of three propositions will constitute the basis for specifying an empirical test to determine the extent to which proposition 13 is supported by the evidence. The empirical proposition to be tested is;
Empirical proposition 1

In all companies, if a majority of shareholders express the belief that the auditor of that company has acted to minimise the cost/benefit ratio of the audit, a majority of shareholders in that company will also express the belief that the benefits of the audit outweigh the costs of the audit of that company.

In order to determine a research methodology by which this empirical proposition can be subjected to test, it is necessary to decide, inter alia, what number of shareholders to ask for an opinion and what technique to use in order to elicit the expression of opinion. Each of these decisions will introduce further elements into the propositional system under examination and will, as a result, expose the testing of the original proposition to further possible sources of criticism.

Empirical verification of propositions is not only important to theoretical work in company auditing. The Committee on Basic Auditing Concepts recognised that empirical verification was also important in the work of an auditor, suggesting that

the auditor's work would have little relevance if it were limited to valid assertions based only on definitions, rules and postulates. The assertions on which the auditor expresses his opinion must include as premises at least some empirically true assertions7.

The extent to which collected evidence does verify empirical propositions, however, warrants further discussion since it is not always the case that empirical propositions can be proven to be true.
Section 2. Empirical Evidence and the Verification of Propositions

Where empirical research is carried out in order to verify propositions, the evidence collected will enable the researcher to make a number of quite true singular statements, such as the following:

1. 53.8% and 58.5% of European and United Kingdom respondents said they would favour financial statements which reported different valuation bases.

2. 89% of respondents to a questionnaire expressed the opinion that audited financial statements and dated notes were of great to very great importance as sources of information for decision-making purposes.

3. Responses to the question: "Would the usefulness of additional (interim) statements be diminished if they were not attested by the auditor?" were:

<table>
<thead>
<tr>
<th></th>
<th>Europe</th>
<th></th>
<th>United Kingdom</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>n</td>
<td>44</td>
<td>34</td>
<td>30</td>
<td>23</td>
</tr>
<tr>
<td>%</td>
<td>56.4</td>
<td>43.6</td>
<td>55.6</td>
<td>43.4</td>
</tr>
</tbody>
</table>

All empirical research will enable empirical statements such as these to be made, since they are the result of the researcher's findings in a particular set of circumstances. Where the proposition under examination is also a singular empirical proposition, the collected evidence could be said to constitute compelling evidence that the proposition is true. The evidence does not, however, constitute a proof since the collection and presentation of evidence depends upon a complex system of
theoretical principles, experimental procedures, observational techniques, initial conditions and so on. Adverse empirical results show no more than that "something is amiss in the system...in question". No single proposition is necessarily refuted or proven by the presentation of empirical evidence.

Another reason for being uncertain about confirmation or refutation of a proposition is that empirical research is fallible. If it is admitted that errors can occur in the collection of empirical evidence, then the claim that propositions can be known to be true by repeated confirmation loses some of its force. There is never any guarantee that a proposition is true as long as there is doubt about the validity or accuracy of empirical observations, and that doubt must always exist, at least as a logical possibility.

This problem becomes particularly acute in research projects where the empirical evidence consists of responses to a questionnaire. In the first place, the questions asked and the form of the answer expected can serve to lead the respondent to answer in certain ways, so that the response does not necessarily reflect the belief actually held. Any empirical research based on the use of questionnaires or interviews must always assume that the response reflects the attitude or belief held. This is made explicit in the bridging propositions discussed in the previous section.

Secondly, there is some evidence which suggests the possibility of respondents simply not telling the truth, especially where their professional integrity or knowledge is being questioned. Thirdly, it is possible that questions which are asked are ambiguous, or that
the respondent's knowledge is imperfect and the question is interpreted in a way not intended by the researcher.".

The problem of fallibility of empirical research is compounded by additional logical problems where an attempt is being made to demonstrate the truth of statements about entire populations rather than statements which are singular propositions. Statements about entire populations are derived from propositional functions by the addition of quantifiers such as "all", "none", or "a majority" and refer to a quality of a particular population. On the other hand, a singular proposition is one which has been derived from a propositional function by the specification of variables and, as a result, refers only to those specific variables.

In order to assert the truth of a statement about a population, on the basis of a sample from that population, it is necessary to use a process of induction. The previous singular statements (together with others, perhaps) might be used as evidence to support propositions such as:

1. The majority of external users (in Europe and the United Kingdom) place great emphasis on the need for information expressed where possible in current replacement cost terms.
2. Audited financial statements are an important source of information to a majority of institutional users
3. Most institutional users prefer audited financial statements.

The use of induction in support of the claim that such statements are true introduces particular problems for the researcher, in that the claim that induction results in knowledge cannot be justified
either on the grounds of logic or on the basis of experience. A logically valid argument is one in which the truth of the conclusion is guaranteed by the truth of the premises: "if the premises are true then the conclusion must be true and this is what is meant by saying that they are valid inferences". Inductive arguments are not valid in this formal sense since it is possible for the premises (the singular observations) to be true but the conclusion (the truth of the statement about the population) to be false.

For example, if all shareholder respondents to a questionnaire expressed a preference for audited financial statements, it is not necessarily true that even the majority of all shareholders prefer audited financial statements, unless the sample size exceeded 50% of the population size. If the results of the questionnaire were used to conclude that a majority of (all) shareholders prefer audited financial statements, it would be possible (although perhaps unlikely) for the conclusion to be false, despite the truth of the premises. If a conclusion can be false despite the truth of the premises, the argument is not formally valid.

Induction may be defended by an appeal to experience, claiming that inductively proven propositions have been correct in the past, so there is no reason to suppose that they will not continue to be correct. The criticism of this type of defence of induction is based on what philosophers have come to call "the problem of induction". The criticism depends on the fact that the defence of induction is itself inductive. Since the means used to justify induction is itself unjustified, the justification must fail. It would seem that the process of induction is not a sure means of
determining the truth of statements about a population and cannot be the basis of certain knowledge.

If the statement about the population is universal (i.e. it asserts that "all" or "none" of the population have a particular attribute) and if the population is indefinitely large, the problem is further compounded. Under these circumstances it is not even possible, on the basis of a sample, to assert that the statement is probably true. No matter how many confirming observations are made, the probability that a universal proposition is true will always remain vanishingly small. Universal propositions make claims about every member of an indefinitely large population, whereas particular statements make claims about particular members of the population. Accordingly, any attempt to relate the two types of statement will divide a finite number by an indefinitely large number, which remains very near zero for all values of the finite number which are likely to occur in empirical research in company auditing.

An important response to the problem of induction is to claim that induction is unnecessary in evaluating whether statements about a population are to be rejected. This is the response of the "falsificationists"14, who deny that universal propositions can be established to be true or probably true on the basis of empirical evidence. New propositions are invented and introduced into theories as responses to problems encountered by earlier propositions. These propositions are then subjected to rigorous testing, not in order to establish support for them but rather in an attempt to refute them. A proposition will survive until empirical evidence shows it to be wrong, when a new proposition must be
invented which is not refuted by the evidence. Theories develop, under this view, by means of "conjectures and refutations"\(^1\), but it is never possible to say that a universal proposition is true or that certain knowledge has been obtained, since universal propositions are liable to be refuted at any time.

An important argument in favour of the falsificationist view is that it is based on deduction rather than induction. It is possible to deduce the refutation of a universal proposition which has been derived from a propositional function by the addition of the quantifiers "all" or "none" from a finite number of observations, so that it is possible to be reasonably sure that a universal proposition of this type is false (always providing the observations are correct) even if it is never possible to be sure it is true.

To take a simple example, a proposition in a theory of auditing could be that "the majority of shareholders in all companies desire the appointment of an auditor". If subsequent research discovers a company in which a majority of the shareholders do not desire the appointment of an auditor, then the proposition is clearly false. On the other hand, no matter how many research projects confirm the proposition, it is never certain that there will not come a time when a company is found in which the majority of shareholders do not desire the appointment of an auditor.

This very brief discussion of some of the more important philosophical issues in empirical research is intended to show that, although such research is fallible, it is nevertheless extremely important to the development of theories. It is only by a process
of both theoretical and empirical research that errors, false assumptions and invalid conclusions can be identified and removed. The purpose of this thesis has been to construct a framework, based on the philosophy of Lakatos, within which further research into the theory of U.K. company auditing can be carried out. As long as the difficulties involved are borne in mind, the identification and evaluation of propositions which form the basis of recommended company audit practices will provide the auditing profession with a clear indication of the security of at least part of the foundation on which those practices are built.
CHAPTER 10

CONCLUSIONS

This thesis has been concerned with analysing and restructuring the content of the Auditing Standards and Guidelines issued by the U.K. auditing profession in order to build a coherent, albeit imperfect, theory of company auditing. If successful, this project has brought the state of knowledge concerning company auditing in the U.K. only to an intermediary point. Much research effort is still necessary to bring to fruition the study herein commenced. In particular, the groundwork has been laid for a range of empirical research projects.

Although it is always hazardous to be overly confident in the extent of our knowledge, or to have too strong a commitment to it, this thesis has made progress in some directions, and has indicated some ways in which progress might be made in other directions. The conclusions to be drawn from the research undertaken herein relate to three important areas; methodology, application and development, and are briefly summarised below.

Methodology

Part 1 of the thesis was concerned with establishing a method by which a theory of company auditing could be identified or constructed. To this end, the early chapters of the thesis focussed attention on the nature of theoretical structures, especially as they relate to company auditing. It was argued that, although certain parallels exist between the practice of auditing and the practice of science, there are important differences between
scientific activity and audit activity which place severe restrictions upon the extent to which the philosophy of science is applicable to a philosophical examination of company auditing. Nevertheless, an important foundation of the later consideration of company audit theory was the argument that theories in auditing play a substantially similar role to theories in science.

Drawing upon the philosophy of science, theories were considered to be sets of statements ordered by the relation of deducibility. The role of such sets of statements was held to be to identify order in the real world so that objects or events are explained. Similarly, it was argued that the role of a theory of company auditing is to provide a framework for the imposition and explanation of ordered company audit practices. As a result, some of the attributes of scientific theories were held to be applicable to theories in the field of company auditing.

One of the primary roles of a theory of company auditing was argued to be the derivation of consistent, justifiable and appropriate practices. Since consistency within scientific theories was held to depend at least in part upon the structure of those theories, the philosophy of science was drawn upon in order to identify a structure which would be applicable to a theory of company auditing. It was argued that the philosophy of Lakatos suggests a structure which not only enables the consistency of statements within a theory to be examined, but also indicates the means by which theories expand and develop. Accordingly, a Lakatosian structure was adopted as a framework appropriate to the construction of a theory of company auditing.
The importance of this structural paradigm ought not be underestimated. Lakatos' philosophy provides a way of organising statements in a logical sequence such that the relationship between those statements is made explicit. In particular, a Lakatosian structure requires the explicit statement of all propositions necessary to the derivation of conclusions. As a result, it focusses attention upon hitherto unstated assumptions and provides guidance as to how a theory might be further developed. In short, it is a very useful methodology for researchers in any area of human activity directed towards the attainment of specified objectives, since it enables extant actions to be structured in a way which identifies inconsistencies and unjustified or inappropriate practices.

One such area in which the methodology could also be adopted is accounting. Like auditing, the activities of accountants are directed towards the provision of information for particular purposes. The identification and explicit statement of those purposes would provide a foundation for the development of a consistent set of accounting practices.

The need for a theoretical framework of accounting has been long recognised in the literature. The following quotes are typical;

accounting...can be thought of as a system (and ideally an internally consistent system) of measurement and disclosure rules. It is increasingly recognised within the profession that such a set of logical and internally consistent measurement and disclosure standards cannot be developed until the profession agrees upon the objectives of accounting and upon a conceptual structure into which individual standards can be fitted.\footnote{\textsuperscript{1}}
the present fragmentary state of accounting theory has precluded the development of conceptual standards by which existing and proposed practices can be evaluated... The absence of theory... means that we lack the capability to effectively evaluate what we are now doing and to provide innovation in response to new demands as they arise².

Perhaps even more so than with auditing, the U.K. profession has recognised the need for research into a theoretical framework of accounting³. The paradigm provided by Lakatos and adopted in this thesis seems as applicable to accounting as it does to auditing. If the profession were to adopt such a structural model, considerable guidance would be given to theoretical and empirical research in both accounting and auditing.

Application

Chapters 3, 4 and 5 of the thesis were concerned with applying a Lakatosian theoretical structure in the area of company auditing. An initial task was to specify a source within which a theory of company auditing could be identified. It was argued that although legislation and common law have played an important role in the development of audit practice, it is professional pronouncements which have ultimately determined the broad classes of audit procedure and have provided some explanation and justification for those procedures. Of particular importance in this process has been the Statement of Auditing Standards and Guidelines issued in May 1980.

In addition to a responsibility for the development of practices, it was argued that the auditing profession also has a responsibility for the development of theory. Of the various pronouncements issued by the profession which are relevant to company auditing, the
Auditing Standards and Guidelines contain the most explicit statements of justification and explanation in addition to recommendations of practice. Accordingly, that statement was adopted as the most appropriate source for the identification of a company audit theory which could be said to underly extant company audit practices in the U.K.

There are two major conclusions of the first part of the thesis. The first is that, in order to identify the theory which underlies extant U.K. company auditing practices, it is necessary to examine the Standards and Guidelines and to structure the content of that document in such a way as to ensure a logical development of argument leading to the derivation of extant audit practices. The second conclusion is that the philosophy of Lakatos provides a structural model by which this can be achieved.

Chapters 4 and 5 were concerned with the implementation of the conclusions from Part 1 of the thesis. In Chapter 4, it was argued that the "formal system" of company auditing theory would contain arguments deriving recommended audit practices and would be supported by an "operational system" containing definitions and examples and establishing the scope of the theory. The formal system would contain three major classes of argument; one which justifies the existence of the audit function by establishing a desirable primary audit objective (the "justifying argument"), one which demonstrates the possibility of achieving the primary objective of the audit function by establishing secondary objectives (the "enabling argument"), and another which establishes the detailed procedures by which the secondary objectives of the audit
function can be achieved (the "procedural argument").

The results of the detailed examination of the Standards and Guidelines are presented in Appendices B and C and discussed in Chapter 5. In the theory of company auditing specified in those appendices, all company audit practices contained within the Standards and Guidelines are derived from one or more of seven basic audit requirements. In turn, those seven basic requirements are derived from six statements of objective. Thus, recommended company audit practices have been explained and justified in terms of a single theoretical structure. By the end of Chapter 5, a theory consistent with professional statements of, and explanations for, extant company audit practices had been identified.

In order to facilitate a consistent understanding of the identified theory, the structure of the argument was explicitly stated. For example, where propositions essential to the derivation of audit practices were introduced rather than identified in the Standards and Guidelines, that introduction was explicitly indicated, and where statements were dependent upon others, the nature of that dependence was clearly stated.

Since a large number of statements were introduced into the theory in addition to those found within the Standards and Guidelines, it is quite possible that other researchers could have constructed a different theoretical framework by, for example, the introduction of alternative propositions or the specification of alternative chains of argument. This admission amounts to nothing more than a recognition that alternative theories of auditing exist. Indeed,
the philosophy of Lakatos suggests that it is by competition between alternative theories that theories develop and improve.

Part 3 of the thesis (Chapter 6) reported the results of an extensive and detailed evaluation of the identified theory. It was concluded that the theory (and, by implication, the Standards and Guidelines from which it is derived) suffers from a number of inadequacies. These are;

a) The theory contains no justifying argument and only an extremely rudimentary enabling argument. That is, the Standards and Guidelines offer no indication either of the purpose of the audit report or of the function of the audit examination. The existence of the company audit is assumed rather than derived. Further, the most obvious "enabling argument" is one which derives company audit practices on the grounds that, quite simply, the objectives of the auditor should be attained. Since the theory consists almost entirely of procedural arguments, it provides no justification for the company audit function and only very general guidance to audit research.

b) Discussion of the nature of audit objectives in the Standards and Guidelines is very superficial and, frequently, objectives can only be identified as implications of stated practices. In the absence of explicitly stated objectives, the possibility of inconsistent practices arises. Further, without a precise statement of objectives, it is extremely difficult to identify the purpose to be served by the audit function.

c) The Standards and Guidelines are incomplete if it is assumed that
the intention in that document was to present a reasoned argument. There are, in fact, very few company audit practices which are fully explained in terms of the achievement of company audit objectives. Further, there are statements within the Standards and Guidelines which have nothing to do with the derivation of practices and are, arguably, irrelevant to a theory of company auditing.

d) Audit practices specified in the Standards and Guidelines are often derived on the basis of definition rather than empirically testable propositions. Consequently, the confidence with which practices are applied must be tempered by the knowledge that a change to definition could result in significant change to practice. A related problem is that the operational system contains very few definitions. As a result, it is often difficult to interpret important concepts, which introduces the possibility of inappropriate audit practices being implemented.

e) The final area of criticism identified in Part 2 of the thesis is that, on a number of occasions, the theory does not provide clear guidance to the auditor. As a result, practices recommended in the Standards and Guidelines will not necessarily lead to the attainment of identified audit objectives.

**Development**

The final part of the thesis was concerned primarily with an attempt to overcome the first of the inadequacies identified above. Chapter 7 presented justifying and enabling arguments which are consistent with the content of the identified theory and which result in the derivation of the seven basic audit requirements upon which the
practices within the Standards and Guidelines depend. The suggested justifying argument is based upon the assumption that there should be a means of minimising the risk of undesired outcomes of shareholder decisions. The argument was called the "shareholder decision" argument, and suggested that an audit is necessary in order to minimise the risk of shareholder decisions resulting in undesired outcomes. The primary audit objective was established as the provision to shareholders of an explicit indication of the reliability of annual company financial statements.

Enabling arguments were derived to demonstrate that it is possible, by complying with certain general audit requirements, to achieve the primary objective. In so doing, the seven basic audit requirements were derived and the final link with the theory identified on the basis of the Standards and Guidelines was established.

The thesis concluded by identifying certain fundamental propositions of U.K. company auditing on the basis of the proposed hard core. Only by a process of identifying fundamental propositions and subjecting them to empirical evaluation is it possible to ensure that a firm theoretical foundation for company audit practices has been established. Accordingly, the final two chapters of the thesis represent an important phase in the further development of the identified company audit theory by suggesting the direction future research into the theory and practice of U.K. company auditing might take.

One of the reasons for choosing a structural model on the basis of a Lakatosian philosophy was that it provides a set of rules for the
guidance of research, as a consequence of the specification of a "hard core" and a "protective belt". Research guidance is provided in that the specification of a hard core indicates the essential features of a theory. Knowledge of "essential features" provides guidance as to the most important areas to be attacked by opponents of a theory or to be defended by supporters of a theory. If opponents of a theory are able to present evidence contradicting a proposition appearing in the "hard core", it will be necessary for supporters of the theory to respond, as far as possible, by amending the "protective belt".

Although there are undeniable difficulties in determining the extent of the "hard core", there can be little doubt that at least general guidance is provided to research. In the context of the theory presented in this thesis, for example, opponents could conduct research projects intended to demonstrate that the fundamental propositions identified in Chapter 8 are refuted by the available evidence. Supporters, on the other hand, could attempt to demonstrate that the fundamental propositions are supported by the evidence, or that apparently refuting evidence can be accounted for by changes to the protective belt of procedural arguments.

Other research projects are suggested in terms of the further refinement and improvement of the theory. Detailed examination of the theory could well lead to the identification of additional inadequacies or to the possibility of reduction of the fundamental propositions to more elementary concepts. Although efforts were made to avoid the creation of inconsistencies when introducing additional statements into the theory, it would be presumptuous to
suppose that all inconsistencies have been identified. This ought to encourage others to undertake theoretical research in an attempt to attain a greater degree of consistency and comprehensiveness.

The emphasis on the practice of company auditing which is to be found within both professional and academic literature suggests that auditing is a practical pursuit, developing in response to changes in demands of clients and in the environment of business. In order to ensure that there is a close relationship between audit practices and the demands placed upon auditors by recipients of audit reports, it is essential for professional pronouncements to be promulgated within the context of a fully developed theoretical structure.

This thesis has demonstrated that it is possible to develop a coherent system of statements within which a clear and consistent set of practices can be derived. An important implication of this demonstration is that it provides the U.K. profession with a framework for the specification of future auditing standards and guidelines, and with a basis for the consistent definition of structural concepts. For example, the profession could consider auditing "standards" to be those audit practices derived and specified within the hard core. Such practices, as part of the hard core, could be placed "beyond dispute" by practitioners and adopted as compulsory under all circumstances. Auditing "guidelines" could be those practices derived within the protective belt of procedural arguments and, as such, subject to amendment and the exercise of professional judgement according to circumstances encountered.

The theory proper (as opposed to the practices derived therein)
could constitute a consultative document available to researchers, through whose efforts the theory could be extended, modified and improved. Although "standards" could be placed beyond dispute as far as practitioners are concerned, research might reveal that the assumptions on which those standards are based were in error. Accordingly, there is no suggestion that the development of a theoretical framework could be the result of a single research project. Rather, a theoretical framework can only develop through an ongoing research programme, carried out with improvements in audit practices firmly in mind.

In summary, the research undertaken herein has established a theoretical framework which provides a justification for company audit practices required or recommended by the U.K. auditing profession. As such, it provides both a description of current audit practice and a normative statement of what practices ought to be adopted in the audit of companies. If the argument is valid and if the statements within the argument are supported by the available evidence then derived practices will be an ideal. Whether this is the case can only be determined by an extensive programme of empirical research into the many propositions upon which the theory depends, and further investigation to identify remaining inconsistencies and other inadequacies.

Although much work needs still to be done if the theory presented herein is to become an ideal system, it nevertheless does make an important contribution to the developmental process. In place of a series of statements related only by common subject matter, this thesis substitutes a coherent set of statements, systematically
related and mutually dependent. As such, it contributes to an integrated view of company audit practices and opens the door to further developments which will ensure that the company audit function in the U.K. commands a widespread respect based on the provision of a genuinely useful service.